Beyond state aid

The future of subsidy control in the UK

Thomas Pope | Alex Stojanovic

About this report

The future of subsidy control in the UK has become the critical barrier to reaching a deal with the EU, which has made clear it wants the UK to replace its state aid regime with a similar or equivalent model. But subsidy control is also crucial domestically to ensure good management of public funds and to manage the relationship between the constituent countries of the UK. This report outlines the rationale for and practice of subsidy control around the world. It then assesses the options for domestic subsidy control in the UK, regardless of an EU deal, before evaluating the implications of a possible compromise with the EU that would respect both sides' red lines.

@instituteforgov

Find out more:
www.instituteforgovernment.org.uk

September 2020

Contents

Summary 4

1. Introduction 11

2. Why do governments use subsidies – and restrict their use? 13

3. Subsidy control around the world 18

4. What should a UK subsidy control regime look like? 28

5. A regime for January 2021 44

6. Reaching a deal on subsidies with the EU 48

7. Recommendations 57

References 61

About the authors 67

Summary

As a member of the European Union for over 40 years, the UK has abided by EU state aid rules, which restrict the subsidies that can be granted by governments and public bodies. With the UK formally leaving the EU single market and customs union when the transition period comes to an end on 31 December, the question of what rules – if any – will apply to government subsidies in the UK has emerged as one of the critical stumbling blocks in the future relationship negotiations.

The impasse may prove terminal. The EU is unlikely to agree to a free-trade agreement without evidence of a strong subsidy control regime being put into place in domestic UK law. The government initially indicated that it did intend to do so, but has since said that, at least in January 2021, it will not replace state aid. It will consider its own regime next year, but it has been unwilling to make any commitments on subsidies to the EU and has not articulated what system it would like. The UK still has big decisions to make: whether or not a deal is reached, it needs to decide what system of subsidy control, if any, it will adopt as it leaves the EU and its state aid rules.

This paper explores what the government should do on subsidy control beyond the end of this year. Based on the strong rationale for a proper regime and the experience of those countries – especially ones with federal government – that have suffered from not having one, we argue that a legally enforceable regime is in the UK's interests. We set out ways the UK can improve on the current EU state aid regime to the benefit of its businesses and its governments – in Edinburgh, Cardiff and Belfast, as well as Westminster.

A deal with the EU currently looks unlikely. But a compromise on both sides' positions on subsidies (that includes the UK adopting a regime) could help to overcome one of the key stumbling blocks to a deal. We set out such a compromise in Chapter 6.

There is good reason for governments to restrict the use of subsidies

There are good subsidies and bad ones

Government subsidies can play an important role. They can help to address market failures – for example, by providing incentives for research and development (R&D) activity that would otherwise not provide a sufficient commercial return – as well as to meet strategic objectives such as promoting the use of green technologies. But poorly designed subsidies can be wasteful and harmful. They can give money to projects that would have happened anyway, or curb the growth of a better domestic competitor. They can distort local economies, for instance by propping up a failing firm and preventing workers and capital re-allocating towards more productive activities. A culture of state subsidies can discourage inward investment from abroad.

Bad management of subsidies can lead to damaging 'subsidy races' and politicisation
In federal jurisdictions there is also a risk of inter-regional 'subsidy races', in which different parts of the same country compete to attract business. This might be entirely rational for a sub-national government looking to promote economic activity in its region, but can drain government resources and prove counter-productive for the country as a whole.

Political incentives can encourage governments to offer 'bad' subsidies. Poor economic decisions – like propping up a failing business – can be attractive politically because the short-term 'winners' are concentrated and the 'losers' are diffuse. Saving a factory from closure plays far better than letting it fold. When a government makes clear it is open to subsidies it also opens itself up to lobbying and there is a risk of 'cronyism'.

Beyond EU state aid law, legal subsidy control regimes are rare

The EU state aid system is the main example of a legal subsidy control regime
Under the EU state aid system, any subsidy that could, in theory, "distort competition" and "have an effect on trade between member states" must be pre-approved by the European Commission. Subsidies are often approved: the UK offers subsidies of around £10 billion per year (0.4% of GDP), mainly to support environmental goals. Other countries make more use of the system. Germany spends 1.3% of GDP per year subsidising its businesses. Most receive approval by meeting specific criteria (the so-called block exemption). A minority of measures must be notified to the Commission, which then applies a balancing test, weighing the benefits to the common European interests against the harmful effects of the subsidy. Subsidies can be and are rejected at this stage. If a subsidy is not notified and is subsequently found to breach the rules, the Commission has the power to demand it be repaid in full.

Few countries have legal subsidy control regimes
The World Trade Organisation (WTO) anti-subsidy and countervailing measures agreement applies to all its members (including the UK currently and after Brexit). The government has indicated that these will be the only subsidy rules in January 2021. But due to its state-to-state enforcement mechanism, it does little in practice to restrict subsidies. With the exception of EU association countries that have a subsidy control system closely modelled on state aid, such as Ukraine and Moldova, most countries do not have a domestic regime and rely on other mechanisms to restrict subsidies. Others simply do not restrict them.

Federal countries suffer from damaging subsidy races when left unchecked
Centralised countries, such as Japan with its powerful economic and finance ministry, are able to limit wasteful subsidies and avoid subsidy races through strong central government spending control. Federal countries, like Canada, rely on other mechanisms to restrict subsidy races, including an intra-provincial free trade agreement (FTA) with subsidy provisions. But even with these other safeguards, most federal countries have experienced problems with subsidy races – the most damaging consequence of failing to control subsidies. This problem is most apparent in the US, and has led to expensive inter-state subsidy races, where public funds are used to attract big companies, such as Amazon, to locate in one state rather than another.

The UK should adopt a legal subsidy control regime, even in a no-deal scenario

The UK's quasi-federal structure puts it at risk of subsidy races

A UK-wide legal subsidy control regime would provide a check on egregious subsidies that harm competition or have no good justification. This is because the spending powers of the devolved administrations of Scotland, Wales and Northern Ireland make the UK particularly vulnerable to subsidy races, especially as trade among the four nations of the UK is more integrated than most federal countries.

Poor relations between Westminster and the devolved administrations are a hindrance

But while the nations are closely integrated, their governments are not. The fallout of the Brexit process has severely harmed relations between Westminster and the devolved governments, meaning the UK cannot rely on informal inter-governmental co-operation to reach agreements on subsidies. Channels of communication such as the joint ministerial committee have not been operating effectively – and distrust between London and, in particular, Edinburgh runs deep. A legal regime that applies to all of the UK's governments is the best way to ensure the threat of subsidy races does not rear its head.

A light-touch 'advisory' regime does not go far enough

The prime minister's influential chief adviser, Dominic Cummings, is said to favour a system in which a regulator would have only an advisory function. This could function in a similar way to fiscal rules – setting out principles, rather than legally binding requirements – but without a legal enforcement mechanism that would ensure policy stuck to these principles. This is unlikely to work. A system that lacks the means of enforcement will not be effective at preventing subsidy races between the governments of the UK.

A robust domestic system similar to state aid would still permit some subsidies to support the government's strategic priorities (net zero, 'levelling up' and the tech industry, for example) as they are anyway covered by exemptions in the existing state aid system. The government could offer more subsidies in this area without abandoning a regime that plays an important domestic role, which means an advisory regime has little to commend it.

Westminster must include the devolved administrations in the development of the regime

This is an area where co-operation between the countries of the UK – and buy-in from Edinburgh, Cardiff and Belfast – will be important for the success of the regime and its role in helping the UK internal market to function. All sides have something to gain from a well-functioning subsidy control system. The government should explore ways to include the devolved administrations in the development of the rules, the setting of any regulator's remit, and appointments to it. Failing to do this will rob the system of the legitimacy it needs.

The UK has options for the design of its regime – and can improve on the EU's system

While the UK has much to gain domestically from adopting a system similar to the EU's state aid system this does not mean that it should copy all aspects of it. Making different design choices could lead to a more effective regime that better serves the UK's domestic interests.

A well-designed regime is one that is effective at preventing wasteful subsidies and subsidy races while still allowing the government to use 'good' subsidies to pursue its policy priorities and without an undue administrative burden on public bodies and businesses. For a post-Brexit UK regime to be effective it must:

- **retain a definition of 'subsidy' similar to that enshrined in EU state aid law as a starting point.** There is little to gain from basing a new regime on a different definition of a 'subsidy'; doing so could create uncertainty as the body of EU case law would cease to apply. Where the UK government wants to go against precedents established by EU case law or change specific state aid concepts, it should legislate for these exceptions explicitly.

- **have a well-resourced independent regulator rather than relying on enforcement through the courts.** This will prevent harmful subsidies going unchecked, reduce the possibility of major political battles in the courts and help provide certainty.

- **require remedies to be imposed when a subsidy is deemed illegal.** Failing to have a remedy for non-compliance would render the regime ineffective and the regulator toothless.

There are also a number of deviations from EU state aid rules which, if implemented well, could lead to a more effective UK regime. These include:

- **Changing the scope of some exemptions.** Making changes to the types of subsidies that are allowed without notification or clearance within the rules ('exemptions', in state aid law) would allow the UK government to move some types of subsidy outside the scope of the regime. The UK could, for example, increase the *de minimis* threshold so that smaller subsidies are not captured – reducing the burden for businesses and public bodies – or change the existing restrictions on regional aid to allow more support.

- **Changing the test for a harmful subsidy.** Under EU state aid law, there is a 'minimalist' requirement for judging that a subsidy is harmful, requiring only a theoretical risk of harm. The UK could choose to adopt a different standard: for example, one that was based on demonstrable economic harm, similar to the approach to regulating company mergers. This would reduce the administrative burden for small subsidies as it would be unlikely they would cause demonstrable economic harm.

- **Time limits on approvals.** The UK could adopt stricter time limits on investigations and a better process of prioritisation by following the merger regulation regime's first stage and second stage process. This approach would allow the new regulator to prioritise only the cases that require the most in-depth assessment, but it would need sufficient information-gathering powers to prevent investigations being 'timed out'.

Each of these changes has strong upside benefits, but also brings risks and if implemented poorly could render the regime less effective.

The UK should adapt its subsidy control system to suit its priorities – even without an EU deal – and publish a white paper on its plans for it

The UK should be willing to start with something that closely resembles state aid and change it over time. The changes we suggest above should allow the UK to have a more effective and less burdensome regime. But choosing the right course relies on knowing what the government hopes to achieve through any new regime – and poor implementation would risk an ineffective regime and/or additional administrative burdens.

The UK should adopt an interim regime parallel to the EU's in January 2021

The government has announced that it will only follow the ineffective WTO rules in January. This is a mistake. While there is now not enough time to implement a well-designed new subsidy control regime with an effective regulator before the end of the transition period, it would be better for the government to adopt an interim regime that closely resembles EU state aid while it gets a new regime up and running. Having no regime creates short- and long-term problems. In the short term, there will be little to stop damaging subsidy races and there will be a risk of cronyism. But any subsidies offered in the short-term will also have long-term effects and it will become harder to re-impose restrictions at a later date. This is also likely to further sour UK–EU relations post January.

A 'parallel regime' is a better option in both a deal or no-deal situation

January 2021 will be a difficult time for a new regulator to start approving subsidies, especially given the possibility that disruption from coronavirus and Brexit may necessitate additional state intervention. However, the Competition and Markets Authority (CMA) has been preparing to take on state aid responsibilities for a number of years, and should be capable of regulating a system that mimics it (a 'parallel' one), at least in the short term. Following the EU's rules in the short term would make the CMA's job easier and also provide greater certainty to businesses and public bodies who are familiar with what is allowed and prohibited under the EU system.

A compromise with the EU on state aid is possible and in the UK's interests

A UK subsidy control regime would make a compromise deal with the EU possible

The parties' current positions on subsidies are far apart, and both would need to move for a deal to be reached. At this stage, a deal seems unlikely. But on subsidies at least, a compromise would be in both sides' interests.

A deal would agree obligations on both parties to regulate subsidies domestically, but also require a mechanism for settling disputes over subsidies. The EU's starting position was to maintain a reference to EU law in UK law and therefore give the European Court of Justice (ECJ) a final say on any international dispute. The UK is right to reject such an asymmetric proposal, but it should propose more concessions to achieve a deal. We outline a compromise proposal that could help find agreement in three key areas:

- **The rules:** Both sides need to agree which subsidies are prohibited and which not. We recommend that a *de minimis* threshold is chosen that is above the low value currently allowed in EU state aid rules. We also recommend that the test of harm be a substantive one – similar to the WTO requirement – rather than the minimal test applied in the EU regime.

- **Enforcement:** The most difficult aspect of an arrangement will be how to resolve disputes over the application of the rules by either side's regulator. The EU would not accept that a European Commission judgment could be overruled. One solution would be for both sides to retain standing in the other's legal system and for remedies to be imposed without an independent arbiter needing to rule that a subsidy violates the agreement.

- **Remedies:** When the rules are broken, or if one side disagrees with a ruling by the other's regulator or courts, it could impose tariffs (or, in the case of services, regulatory measures) in retaliation. Both sides could commit to ensuring such duties were proportional and – where possible – matched the sector or goods being subsidised. The extent and the proportionality of the duties imposed could be the subject of dispute resolution.

Such an agreement would not be overly restrictive on the UK

The UK would retain freedom to design its own subsidy control regime – anyway to its own benefit – rather than being bound by EU state aid rules, and most of the changes outlined above would be consistent with this agreement. There are likely to be few subsidies restricted by this agreement in practice, and those that are could likely be redesigned to assuage concerns.

The UK has more to gain from a deal on subsidies than the EU

A compromise agreement would not only place restrictions on the UK – but also on the EU. Given the larger economic size of the EU and the inclination of some of the large member states (such as Germany) for offering subsidies, the protection afforded to the UK from harmful EU subsidies is likely to be greater than vice versa.

A compromise may allow the UK to supersede Article 10 of the Northern Ireland protocol

Article 10 of the protocol, which means state aid rules continue to apply to any UK measures that potentially affect goods trade between Northern Ireland and the EU, could catch a number of UK-wide subsidies, or even subsidies to GB companies where there is a knock-on impact in Northern Ireland. The government's current approach is to legislate to give ministers power to breach the state aid provisions of the Northern Ireland Protocol in its Internal Market Bill. A better option is to agree a system with the EU to supersede them. If the UK can propose a subsidy control system that the EU is confident in, it may be able to replace the current provisions in Article 10 of the protocol. This would be in the UK's interests as the alternative would leave the Commission with control over some UK-wide subsidies even in the case of no deal.

The government's choice not to have a regime to replace state aid, at least initially, is a mistake. Such a regime is in the UK's best domestic interests and also holds the key to a UK–EU trade deal – which would also be in the UK's interests. The government should reconsider its plans and set its sights on a strong legal regime to be adopted next year.

1. Introduction

The European Union's system of state aid restricts the amount of support member states can offer businesses. As such, the UK has been bound by these rules since joining the EU 47 years ago, but until recently the topic has attracted only fleeting attention. However, the future of state aid rules – or their replacement in the UK – has emerged as a principal stumbling block in future relationship negotiations, and the prime minister, among others, has highlighted the potential benefits of deviating from the EU's rules to help boost the UK economy after Brexit.

Subsidies can help achieve a government's policy priorities. Evidence suggests that government support for research and development (R&D) can be highly effective at generating research activity, for example.[1] Well-targeted subsidies can also generate foreign direct investment and spur growth.[2] The current government's response to the coronavirus crisis has also shown that widespread intervention to support companies can sometimes be necessary.

However, government subsidies can be harmful too. They may be granted to projects that would have happened anyway, and therefore represent wasted public funds. When subsidies do change companies' behaviour, they can also cause problems. 'Subsidy races' between different regions, states or countries can emerge as each competes to attract company headquarters or production facilities. Often, richer regions can provide more generous subsidies, entrenching their economic advantage.

Acknowledging these tensions, the EU state aid regime limits when and to what extent public bodies can grant state subsidies, weighing up the overall costs and benefits to the bloc. Although the rules do not totally prohibit subsidies, they have restricted what public bodies in all member states, including the UK, have been able to do.

After the end of the transition period, the UK government had indicated that it intended to replace the EU's state aid rules with some form of domestic subsidy control regime. It has now declared that the UK will only be bound by its existing international commitments in January 2021, meaning the state aid rules will not be replaced, although it has left open the option of introducing a new domestic regime next year.

The government has still provided no indication of what that regime might look like or what sort of regulator – if any – will be required to oversee it. The no-deal plans developed in March 2019 do not provide much of a blueprint: in both a 'deal' and 'no deal' situation, the May government intended to adopt EU rules wholesale – a course of action that Johnson has ruled out.[3] There are also not many 'off-the-shelf' models from elsewhere in the world for the UK to adopt: the EU model from which it is so keen to depart is in many respects the only one of its kind in the world.

This report is based on more than 20 interviews with legal experts, officials and state aid experts in the UK, the EU and the rest of the world, and attempts to identify the best course forward for the UK. We examine the rationale for having an subsidy control regime – that is, enforceable legal constraints on public bodies' ability to grant subsidies – and set out the options available to the UK and the key design choices the government faces in putting one together. We focus on systems that would be binding on public bodies in the UK, including the UK government. We also address the possibility that the UK could adopt a non-binding 'advisory' system as was briefed to the Financial Times by sources inside the government.[4]

In Chapter 2, we set out the rationale for government subsidies and evidence for their efficacy as well as the costs they can impose. In Chapter 3, we describe how subsidy control works in the EU and elsewhere. In particular, we explore the consequences of a lack of control in countries that do not have subsidy control regimes, as well as alternative mechanisms for controlling subsidies other than a legal prohibition.

In Chapter 4, we set out why adopting a robust subsidy control regime is in the UK's domestic interest – regardless of whether or not it reaches a deal with the EU. It looks at the broad design choices the government faces in setting up a new subsidy control regime. We assess these options against three criteria for what might constitute a good future regime (although different political actors are likely to place different weight on each criteria).

Tight timeframes mean that the 'best' regime cannot be in place by January. In Chapter 5 we therefore address what the UK should do in the short term – the 12 months following the end of the transition period – to tide the country over until a new system can be put in place. The government has announced that it will not replace state aid rules at first, but this is not the only option and we set out a better alternative that would provide certainty to businesses and public bodies, while allowing for a transition to a different setup over time.

Finally, Chapter 6 addresses the EU negotiations. A compromise on state aid between the UK and EU could be in both parties' interests. We outline a possible compromise arrangement that it would be in the UK's interests to agree considering only narrowly the benefits of a subsidies settlement, let alone the potential wider benefits from a free trade agreement that such a state aid compromise might open up.

2. Why do governments use subsidies – and restrict their use?

A 'subsidy' can take many forms – for example, a direct grant, a tax exemption or favourable loan terms. Both the EU and the World Trade Organization (WTO), restrict their members' abilities to provide subsidies to businesses.

More specifically, they restrict members' abilities to provide 'selective' subsidies: that is, help only for some firms or some business activities. This means, for example, that a specific tax exemption – such as for research and development (R&D) expenditures – would count as a subsidy, but a universally low rate of corporation tax would not. Similarly, the UK government's Coronavirus Job Retention Scheme (CJRS, or 'furlough'), which pays a percentage of furloughed employees' wages for all employers in the UK, does not constitute a selective subsidy, but grants offered to retail and hospitality businesses did.

All governments offer subsidies (in both crises and normal times) for a variety of reasons and there are good economic justifications for at least some of them. However, such subsidies can also do economic harm as well as potentially wasting taxpayer money. In this chapter we first lay out some of the reasons why governments offer subsidies, before considering why and when it might be beneficial to restrict their use.

Why do governments offer subsidies?

Market failures provide a clear rationale for government intervention

There can be sound economic reasons for governments to offer selective subsidies where they correct a 'market failure' – which means that without government action, the market delivers an inefficient outcome.

R&D incentives are a classic example of this. An R&D project may lead to a successful, profitable idea that benefits the business undertaking the research. But there are also usually spill-over benefits (or externalities) to other businesses in the case of both success and failure. In the case of success, other businesses may be able to profit by building on the idea, but even a failure adds to knowledge. Without additional government incentives, the amount of R&D carried out would be inefficiently low from the perspective of society (this a so-called 'market failure'). There is strong evidence that targeted incentives such as R&D tax credits, which allow businesses like pharmaceutical companies to deduct more than 100% of research costs from profit for tax purposes, do boost activity and lead to higher growth.[1]

R&D is just one relatively clear-cut example of where an identified market failure could justify government subsidy on economic grounds. Geography might be another: an economic area may be depressed due to an inefficiently low level of infrastructure and investment, and ordinarily no single business could justify making the investments required in that area, making it unattractive for businesses to locate there. Providing incentives for businesses to invest in those depressed regions can improve the capital stock in those areas, create jobs and generate a spillover benefit. The Regional Growth Fund – a relatively small scheme that operated in England in the 2010s, did generate new employment according to an analysis by the National Audit Office (NAO).[2] Governments sometimes step in to save ailing companies with similar justifications about the benefits to a region of that employer. Companies that receive a subsidy under EU state aid's 'rescue and restructuring' exemption typically have very high regional concentration,[3] for example Peugeot, which received a subsidy in 2013 and which is a major employer in Sochaux in France.[4]

The coronavirus crisis provides another example where widespread government intervention can be justified for the benefit of society. Government loan guarantees, tax holidays and grants have helped to keep many businesses afloat at a time when private banks would have been unwilling to lend due to high uncertainty and poor prospects. The government has duly stepped in, and this intervention should help the economy recover more quickly by retaining viable and well-run businesses with 'intangible capital' that it would be difficult to replace quickly.[5]

Strategic priorities can also justify the use of subsidies

Government subsidies in the EU over the past 20 years have encouraged the economy to become greener. This is a classic correction of a market failure, subsidising clean energy sources over those which cause harm to the planet. But it has also contributed to the government's strategic priority of changing how the private sector approaches energy investment. Subsidising renewable energy has encouraged more private investment (for example, in electric cars) because the original, underdeveloped technology did not make for an attractive business proposition but, through extensive public support, the technology has developed into an attractive private sector investment. Kattel and co-authors at the Institute for Innovation and Public Purpose argue that this 'dynamic' effect of government subsidies means that a conventional cost benefit analysis would vastly underestimate the benefits they have generated.[6]

The use of subsidies to pursue other strategic priorities may have other justifications that are not explicitly economic. For example, a 'national security' concern may lead to governments supporting 'essential industries' – such as steel– in case global trading of those goods becomes impossible at some point in the future. Those in favour of the government subsidising the steel industry in the UK often rely on this sort of argument to justify intervention,[7] although it is important that these potential benefits are weighed up against possible economic inefficiencies.

Why should the use of subsidies be restricted?

The costs of subsidies to the government can outweigh the benefits

While subsidies can reap benefits, each necessarily entails a cost to government. This can come in terms of direct public spending or tax cuts, or an opportunity cost (could taxpayers' money have been spent better elsewhere?), and may also create economic distortions (propping up some forms of economic activity even though they may generate lower value than alternative uses of the same capital and labour). These costs are clearest in instances where the subsidy has little benefit. For example, subsidies are sometimes granted to businesses locating to a given area they were planning to move to anyway (this is a 'deadweight' cost). Similarly, failing businesses will sometimes go bust shortly after governments have attempted to prop them up (UK government support for regional airline Flybe earlier in 2019 was a clear example).[8]

However, even in instances where there are some benefits, the associated costs may mean the subsidy is not worth it overall. For example, the Regional Growth Fund created some additional employment but did so at the hefty cost of £41,000 of taxpayer money per job.[9] Even R&D tax credits, generally considered to be well-targeted subsidies, entail some deadweight cost because it is not possible for the government to target the subsidy only at those projects that would not have happened without it.

Subsidies can also generate unintended indirect costs. The cost of supporting a failing company is not just the money spent, but also the economic costs of failing to allow the capital and workers currently tied up in that unproductive firm to be reallocated to other sectors of the economy. Sometimes the market moves on, and capital and labour must do the same. Similarly, attempting to support 'national champions', or to strengthen specific domestic industries, can result in a less dynamic economy that will ultimately lead to lower productivity.

A further source of costs from subsidies can come from effects on competition. The selective support of a limited number of firms over others can lead to an unbalanced market with dominant corporate players.[10] This can be reinforced if there is a perception that governments will provide unfair support to domestic businesses as this will further discourage entry from new, and especially foreign, players.[11] Increased market concentration, and dominant positions for some firms, can lead to higher prices and other costs for consumers (hence why governments' antitrust policies try to prevent firms abusing a dominant position and merger control policy is designed to limit harmful concentration).[*]

* For example, in 2007 Silvio Berlusconi's government was required to repay state aid provided to its dominant Mediaset media company.

Competition between regions means a subsidy could provide local benefit but be costly overall

In federal structures where decisions are made at a lower level of government, it may be rational for a sub-national tier of government to offer a subsidy but this will still be harmful for the country overall. The granting of a subsidy in one region can negatively affect other areas. For example, in the US it may be in Wisconsin's interest to offer a subsidy to FoxConn,[12] an electronics manufacturer, for locating its operation in the state. However, the benefit to Wisconsin is likely to be a loss to another state where the company would otherwise have operated – and it would be a loss to the US overall if FoxConn would have located somewhere else in the US otherwise.

By the same logic, within the EU, individual member states may face an incentive to subsidise businesses to operate in their country but this could be detrimental to the EU economy as a whole. This is why the EU imposes restrictions on countries' use of state aid. In 2017, as prime minister Theresa May said that the EU and UK "share the same set of fundamental beliefs… that trying to beat other countries' industries by unfairly subsidising one's own is a serious mistake".[13]

The use of 'economic development subsidies' is widespread among US states, and there is much evidence of 'subsidy races' between the states in order to attract companies' production facilities and headquarters.[14] Even for incentives for R&D, where the evidence generally supports their efficacy at boosting innovation, a substantial fraction of additional activity generated from state level R&D tax credits in the US means lower activity in other states.[15] The overall effect of these subsidy races is to reduce the resources of US states to fund public services or to reduce other taxes, while benefiting shareholders and business owners who would have invested in the US anyway but – by virtue of the competition between states – get a better deal. This is a so-called 'race to the bottom'.[16]

There will be a tendency towards subsidy races in any situation where the decision to offer subsidies resides in a lower level of government. In the UK this applies to an extent to local authorities (though their spending powers are limited) and to the devolved administrations. This also applies to the EU, where the subsidy choices of one member state may hurt other member states. A further risk, and one that is especially acute in the EU, is that richer countries or regions with more resources will 'outgun' poorer ones. This risk has been highly visible in the coronavirus crisis, with Germany granting about 52% of the overall approved subsidies to its domestic businesses– roughly twice its share of EU GDP.[17]

This provides a rationale for an subsidy control regime

Almost any policy has a risk of unintended consequences, and this is true also for state aid and subsidies. If the democratically elected government of the day wants to offer a particular subsidy, why should it not be able to? We do not generally have laws that prohibit 'bad' policies. However, in some policy areas (for example on fiscal policy) politicians will choose to tie their hands. And the specific characteristics of this area of policy – namely the threat of lobbying and the incentive to engage in subsidy races – mean that there would be particular benefits to having a legally enforceable subsidy control regime.

First, even if a subsidy is harmful overall for the country or region (that is, ignoring any 'subsidy race' concerns), decision makers may nonetheless face a short-term incentive to offer it. One reason why 'bad' subsidies are granted is that political pressure can persuade governments to support a business.[18] Saving a failing manufacturing plant will usually lead to positive headlines and a grateful workforce. Any costs of the subsidy will be spread more diffusely than the benefits, and will likely not materialise until later. But this is, at best, short-termist, if not cynical, and this process of 'picking winners' as part of UK industrial policy up to the 1970s is broadly regarded as having been unsuccessful and disproportionately resulted in shoring up ailing businesses rather than putting them on a sustainable footing.[19]

Beyond pressure from public opinion, lobbyists can also be effective at getting governments to provide subsidies. Evidence from US states finds that industries that are already more established are more effective at getting government subsidies, suggesting that a political presence in the state is an important determinant of gaining subsidies.[20] Some go as far as to call the widespread use of subsidies in the US 'crony capitalism'.[21]

Given these pressures, a restriction on the use of subsidies could lead to better policy making. Fiscal rules provide an example where politicians have chosen to tie their hands in order to better achieve their desired policy objectives. Successive UK chancellors have chosen to commit, at least nominally, to fiscal rules that impose constraints on tax and spending. The advantages are twofold: first, they provide a signal to potential investors that the government is committed to a sound fiscal approach. This, in theory, means there is little risk of default on debt, allowing the government to borrow at lower interest rates. Second, they allow the chancellor to resist calls from other ministers and special interest groups for more spending or lower taxes. While the rules themselves can be changed by the government (indeed, most have been abandoned since they were first introduced in 1997), they nonetheless operate as a useful constraint.

Similar arguments could apply to a system of subsidy control. This could act as a credible commitment to foreign firms thinking about entering the UK market that they will receive fair treatment and their competitors will not be provided with an unfair advantage. It would also allow politicians to resist pressure from the public, lobbyists and other politicians to extend popular but unwise subsidies, for example to (temporarily) save a failing business.

In addition, the negative effects from one region's subsidy to other regions effectively generates a co-ordination problem between different parts of the same country. All regions could be better off if they all committed not to use subsidies to undercut one another – but without a legally binding commitment not to, it is hard to coalesce around this outcome: no region or country wants to be the one left behind while other regions entice businesses in. Broad overarching restrictions on subsidies can break such a cycle of competition and lead to UK-wide benefits.

3. Subsidy control around the world

The EU state aid regime is unique in that it applies by way of domestically enforced legal prohibition across the 27 member states. Outside the EU, checks on subsidies exist in all countries, including via commitments made by members of the WTO, which provides for international disputes over subsidies. But WTO rules operate quite differently.

The EU state aid regime

State aid law restricts use of subsidies but allows them under some conditions

State aid rules – and their enforcement – constitute the EU's subsidy control regime. Codified in Article 107 of the Treaty on the Functioning of the EU (TFEU), EU rules restrict the use of "state aid", which are defined as:

> any aid granted by a Member State, or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods[1]

Key features of this definition include that it must be imputable to a member state; use **state resources**; that it must favour an **undertaking** (i.e. a business engaged in economic activity, not an individual); that it is **selective**, favouring certain businesses or activities over others; and that it **distorts or threatens to distort competition and trade between member states**.

If this were where the state aid law began and ended, it would amount to an almost total prohibition on selective state subsidies. It would permit general measures to support all businesses, but it would not allow measures that are available only to some businesses or types of economic activity. In practice, however, further provisions allow for selective subsidies in some instances.

The exceptions to the blanket ban on subsidies are specified in EU regulations, which set out instances in which a state aid may be consistent with the preservation and efficient functioning of the internal market. These include, for example, regional aid to areas with low living standards, aid that supports projects of common European interest and 'other categories that can be legislated for by the EU'.[2]

State aid rules are regulated by the European Commission

To understand what this means in practice requires understanding the role of the European Commission in enforcing the rules. The Commission is the EU's state aid regulator. It decides whether a subsidy should be permitted or not and is the ultimate arbiter of whether that subsidy is in the interests of the EU.[*]

The starting point is that any subsidy needs to be notified to the Commission *in advance* of being paid. The Commission will then investigate it, come to a judgment as to whether it constitutes 'state aid' (according to the Art. 107 definition above) and, if it does, weigh up the contribution it makes towards 'European interests' or the other objectives set out in the Treaties (such as regional aid). If the Commission decides that the subsidy *is* state aid and does not contribute sufficiently to any of these objectives, then the member state will be banned from implementing the subsidy.

To compel member states to notify the Commission of any aid being considered, the regime needs to have a robust enforcement mechanism. The Commission has this through its recovery powers: if a subsidy is granted but then found to be illegal, it can require that the aid be repaid in full to the public body that allocated it.

Over time, the Commission has moved away from a model requiring prior notification of all subsidies to try to streamline policy development. Projects that meet certain criteria now gain automatic approval. For example, any aid worth less than €200,000 per business over three years is automatically approved (the *de minimis* threshold).[3] This is a low level for a *de minimis* threshold, and means that many even relatively small local authority projects need to comply.

The remaining instances where aid need not receive explicit Commission approval fall under the General Block Exemption Regulation (GBER).[4] This is designed to capture uncontroversial measures and to allow the Commission to focus on investigating the most important cases. Specifically, the GBER allows (among other things):

- Regional aid, so long as the fraction of the project paid for by aid does not exceed certain thresholds and the aid goes to particular regions defined as 'assisted areas'.
- A range of R&D support, including R&D tax credits.
- Support for small and medium-sized enterprises (SMEs), up to a certain threshold per business.
- Environmental aid, providing the environmental and energy objectives exceed base EU standards.

In practice, the the vast majority of all state aid offered in the EU falls under one of the categories set out in the GBER, as Figure 1, overleaf, shows.

[*] Appeals to the European Court of Justice (ECJ) can consider whether a subsidy constitutes state aid, and whether the Commission abused its power or procedural role in some way but in considering whether state aid is in the interests of the EU the Commission is given very wide discretion.

Other forms of aid can still be granted but require a Commission investigation beforehand. In these cases, the Commission's processes vary and they retain considerable discretion. Broadly, they assess whether the benefits to European interests exceed the costs of the subsidy. In general, this will require that the new activity is genuinely additional, that the measure is proportionate and that effects on competition and trade do not outweigh this.

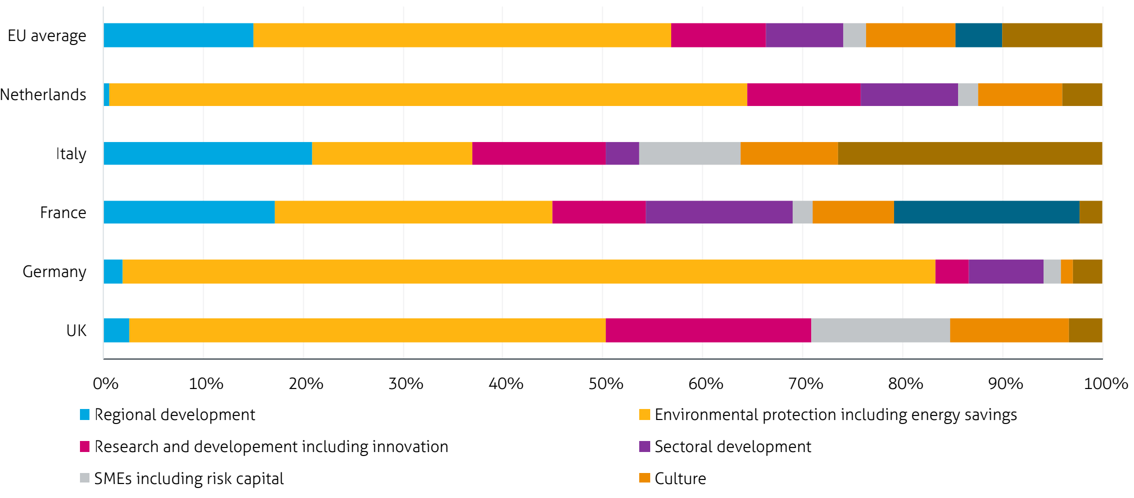
Subsidies are widely used in the EU, including in the UK

The EU's state aid rules do not, and were never intended to, prohibit the use of government subsidies altogether. But they still put genuine restrictions on what states can do. For example in 2018, the EU's General Court (a younger cousin of the ECJ that hears cases against EU institutions) annulled the Commission's earlier approval of state aid for an underwater tunnel between Denmark and Germany.[5] The court found that there weren't adequate time limits for the duration of the state guarantees and that state support for operating costs like labour and energy was illegal. These rulings effectively brought the project to a halt.

While in the above case,the project halted altogether, more often state aid law works to influence the design of subsidies. The low *de minimis* threshold means that even relatively small measures – including those offered by local authorities in the UK – need to meet particular conditions to fall under the exemptions set out in GBER. Subsidies are therefore often redesigned to fit a mould – making them 'good' rather than 'bad' subsidies.[6] This is not always seen as a hindrance. The UK State Aid Law Association, a public forum composed of legal experts, commented that "checks and balances [were] not always a bad thing", and that the discipline imposed by the EU regime often resulted in a "significantly improved policy".[7]

One example was during the 2007/08 financial crisis, according to then Treasury permanent secretary Nick Macpherson.[8] The rules led to the UK separating Lloyds from TSB, and limited the subsidy to Northern Rock, in his view resulting in better value for money for the taxpayer and a more competitive sector.

Figure 1 **State aid granted in 2018 by purpose of subsidy (% of total aid granted), selected countries**

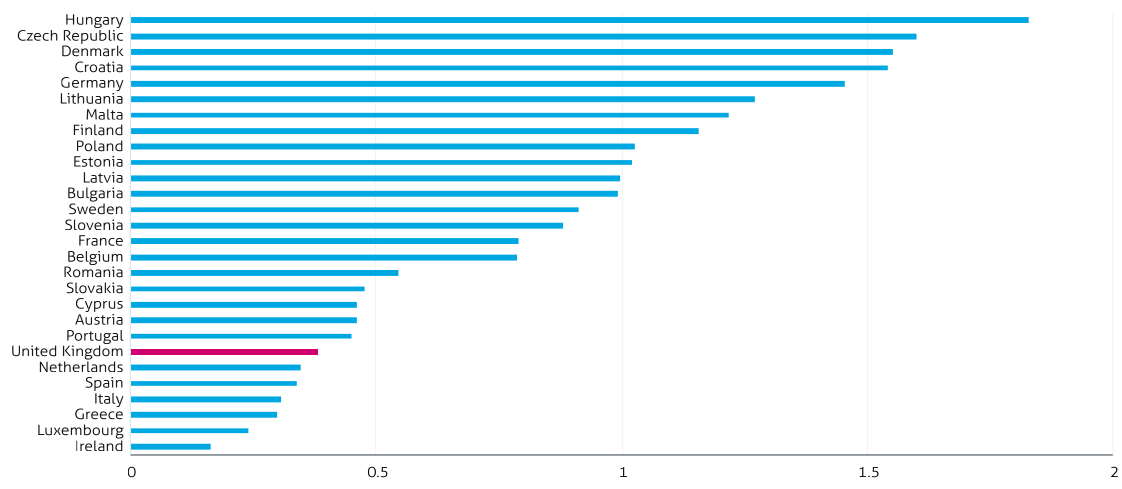


Source: Institute for Government analysis of European Commission, State Aid scoreboard 2019, https://ec.europa.eu/competition/state_aid/scoreboard

As Figure 1 shows, most of the value of subsidies granted under state aid are in support of environmental protection and, to a lesser extent, R&D. The disciplining role of state aid can be said not so much to prevent subsidies but to direct them.

The UK makes less use of subsidies than most member states

Figure 2 **Amount of state aid granted in 2017, % of GDP**



Source: Institute for Government analysis of European Commission, State Aid scoreboard 2019, https://ec.europa.eu/competition/state_aid/scoreboard

As Figure 2 shows, subsidies are used more widely by some member states than others. Germany makes relatively extensive use of subsidies as a share of GDP and, as it is the largest EU economy, it accounts for 30% of all state aid granted in the EU. In contrast, compared with most EU countries, the UK makes little use of subsidies. Total state aid granted in the UK in 2017 was only 0.4% of GDP (or £8bn in today's terms), compared with 1.3% of GDP in Germany (£30bn if the UK spent an equivalent share).

There have been several instances in which the UK – presented with similar circumstances – has chosen not to offer subsidies that were permitted under state aid rules, while other member states did. For example, when Thomas Cook went into administration in 2019, the German government developed a recovery package for the company's German subsidiary, but the UK government did not do the same for the UK-based parent company. Indeed, the UK has been one of the main proponents of EU state aid rules, perceiving them to be to its advantage because it is traditionally more sceptical of state intervention than the continental European tradition.[9] In evidence to the House of Lords EU Select Committee, the UK State Aid Law Association noted that:

> "The United Kingdom (under both Labour and Conservative governments) has played a major role in shaping EU state aid policy: although the UK government may not always agree with the application of the state aid rules to its own decisions, it has generally vigorously supported the Commission's overall policy approach."[10]

The WTO subsidy control system

The other system of subsidy control that currently applies in the UK is the World Trade Organisation (WTO) Agreement on Subsidy Control and Countervailing Measures (SCM Agreement), which applies to all 164 members of the WTO. EU members are bound by the WTO system in addition to state aid.

The WTO system shares many similarities with EU state aid rules

In keeping with the EU's definition of 'state aid', the WTO defines a subsidy as a financial contribution by a government or public body that provides a "selective advantage" to a business or businesses.[11] Also like the EU rules, a subsidy for WTO purposes can comprise of grants and tax breaks but also guarantees or loans on preferential terms. The WTO agreement is designed to give governments redress when they are harmed by subsidies offered by another WTO member government. This notion of 'harm' within the WTO system is similar to the concept of 'trade distortions' described in the EU's state aid rules.

But the WTO system differs from the EU state aid regime in several important respects

One important difference between the WTO subsidy control system and the EU's state aid regime is that the WTO agreement only covers goods and not services; state aid rules cover both. This is especially important when considering the UK's future relationship with the EU, as services account for almost half of UK exports to the EU.[12]

The state aid system begins with a presumption of illegality: unless cleared by the Commission, a subsidy is not permitted. Under the WTO system, the vast majority of subsidies are 'actionable', and are presumed to be allowed until challenged (although 'export subsidies' are prohibited outright).

Another fundamental difference between the two systems is the way in which they are regulated. The WTO system does not have the equivalent of the European Commission as a regulator. Instead, it relies on state-to-state enforcement. Only a member of the WTO (a state) can complain about another member's subsidy. Whether that complaint is upheld is then determined by an independent panel. Under the EU state aid regime, not only is the Commission a regulator, but businesses can also make complaints through their national court system against policies that they believe constitute unnotified state aid.

A further important difference between the two systems is how the subsidy is assessed by the independent panel and the Commission, respectively. The judgment made by the WTO's independent panel is 'effects based' – that is, the complainant country must demonstrate that the subsidy has caused them harm. In contrast, under the EU's regime, it is sufficient to show that there is *potential* for the subsidy to distort trade and competition. This difference means that the WTO system will only constrain very large subsidies that demonstrably harm another member, whereas the state aid regime can (and does) catch much smaller subsidies. Both approaches have been criticised for their approach. The WTO rules are seen as not being stringent enough, while the scope of the EU state aid rules is seen as too granular.

Finally, the 'remedy' when a subsidy is found to be in breach differs. Unlike the European Commission, the WTO does not have the power to demand that the offending subsidy be repaid. Instead, it permits the injured party to adopt countervailing measures and duties to counteract the harm done. Most often, this will mean imposing new tariffs on the subsidised product, if possible, or on other products if not.

But this is an imperfect system. Tariffs often harm the country *imposing* them by lessening choice or increasing prices for consumers,[13] so the complaining country is itself harmed by this action. Furthermore, the recipient of the offending subsidy is not directly sanctioned or made to repay the aid – rather, the sector in which the recipient operates is targeted under the WTO system. This mode of enforcement is also be less effective for restricting subsidies on services because tariffs cannot be applied to services and therefore must be applied goods.

These differences make the WTO agreement much more permissive

The enforcement of the WTO regime – at the state-to-state level – means that, unlike EU state aid rules, it does nothing to constrain smaller subsidies that do not distort international trade but may still distort domestic markets. For example, in Canada a subsidy offered by the government of Alberta that affected Nova Scotia would not be prevented by the WTO regime in the way such a situation would be prevented between, say, Germany and France. But as noted, this kind of intra-country subsidy war can be just as economically damaging and fiscally wasteful as international actions.

Even when subsidies do distort international trade, countries only infrequently appeal to the WTO to challenge them. One interviewee described this as an "honour among thieves" approach, where states mutually choose not to bring cases. This means that very few cases have actually been settled under the WTO system: just 130 disputes have arisen since 1995 (including on more straightforward 'prohibited subsidies'), most of which were brought against China.[14]

Japan, the US and the EU have recently set out to reform the WTO systems. This is largely a response to China's economic system in which the state is intertwined with the private sector. As a result market economies in the WTO are concerned that the current definition of subsidy is too narrow to capture some of China's extensive state support for industry. But they are also attempting to reverse the burden of proof, especially for large subsidies, so there is a presumption that the subsidy *does* distort trade and harm competitors, and that the granting country must prove otherwise if it wants to avoid sanction.[15]

However, these reform efforts are hampered by the current US approach to the WTO. The Trump administration is currently blocking appointments to the WTO appellate body, which hears appeals against rulings on subsidies. As a result there are not enough members to rule on cases and so the body is defunct.

These factors mean that even when the system is working, the WTO does not practically constrain states from offering most subsidies.

Other regional trade blocs have struggled to implement supranational rules on subsidies

There are a small number of other examples of trade blocs that have sought to strengthen subsidy controls with varying degrees of success – but none provide anything like the extent of control over subsidies that the EU regime imposes.

One of the few trade blocs to have specific supranational rules to control state aid is the West African Economic and Monetary Union (WAEMU).* The WAEMU state aid rules have – in theory – been heavily influenced by the EU approach. But the WAEMU Commission acknowledges that the rules are not enforced effectively yet. According to the OECD, one of the reasons for this is that the WAEMU Commission has to overcome the absence of the 'supranational culture' that would be needed to ensure that their state aid rules prevail over national regulations.[16]

The member states of the customs union of MERCOSUR (the 'Southern Market', including Argentina, Brazil, Paraguay, Uruguay, and Venezuela) have made less progress towards imposing such controls, although here the use of subsidies is perceived to be an issue. For example, several members object to the Brazilian government offering subsidies to domestic sugar producers. The MERCOSUR countries have signed a competition chapter that commits them to preventing policies that distort competition or trade among them. But it does not include explicit rules about state aid.

But other regional groupings like the Association of Southeast Asian Nations (ASEAN)** do not perceive the need for subsidy control at all. Within ASEAN there is some discussion of co-ordinating competition policy rules but this falls short of considering adopting common rules and has not led to discussions on subsidy control.[17]

Domestic subsidy control: outside the EU

The WTO system provides at best a limited restriction on large subsidies, and hardly any restriction on smaller subsidies that may still have distortive effects within a country. Despite this, most WTO members outside the EU have not adopted any form of domestic subsidy control regime as such – but there are a range of systems in use that provide some constraints.

Countries with privileged links to the EU have signed up to state aid rules

Countries with association agreements with the EU – a trade agreement which offers privileged access to the single market in return for adopting parts of the EU's *acquis* – have robust subsidy control policies. Trade agreements signed with the EU by both Ukraine and Moldova stipulate that the EU's state aid rules must also apply domestically. Both have a domestic regulator that plays the role of the Commission – though the regulators' ability to control subsidies is very much in its infancy in

* WEAMU comprises Benin, Burkina Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal and Togo.

** ASEAN comprises Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

comparison to the Commission.[*] Their decisions on subsidies are subject to dispute resolution, which in effect means that the ECJ has the final say in contentious cases. In addition the EU is seeking substantive subsidy control provisions in its current agreement with Switzerland.

Most trade deals do not contain binding commitments on subsidies

The Ukraine and Moldova examples are unusual in containing binding commitments on subsidies. Most other EU trade agreements (including those with Japan and Canada) contain chapters that commit to upholding certain standards on subsidies. But these chapters are not subject to dispute resolution, which means that in practice they are non-binding and specific subsidies would need to be challenged through the usual WTO system.

The US-Canada-Mexico trade deal (CUSMA) also contains chapters that commit the signatories to uphold certain standards on subsidies – but goes further than the EU deals in including a bilateral dispute settlement mechanism.[18] The US has challenged Canadian subsidies to steel, aluminium and lumber producers in recent years.[19]

Subsidy control regimes and trade agreements are not the only check on wasteful subsidies

While international obligations do little to restrict countries from offering most subsidies, and most countries do not have explicit domestic subsidy control regimes, this does not mean that subsidies are entirely unchecked. Elsewhere, as in the UK (as noted above), prior evaluation and scrutiny of policies after the fact restrict the use of subsidies.

Prior evaluation by a central government ministry can help to identify whether a subsidy represents good value for money. In Japan, many subsidy programmes – both to attract foreign investment and to support domestic industry – are overseen by the powerful Ministry for Economy, Trade and Industry (METI). One subsidy programme for "Industrial Location and Job Creation" run by METI sets out constraints on what the subsidies can be used for, what companies can apply and ongoing monitoring of the subsidy in use.[20] While this does not amount to an independent, legally enforceable system, it does demonstrate that some kind of controls are applied in advance by METI, which have some similarities to state aid aims of providing a discipline on wasteful spending.

Scrutiny of spending is a further check on possible wasteful subsidies, especially in cases where there are concerns about cronyism. Interviewees emphasised the role of the Public Accounts Committee and National Audit Office in the UK in assessing the value for money of government spending. This acts as a mechanism to help politicians learn about what represents a good (and bad) use of public money.

In addition to such controls, many countries' competition laws are used to constrain some kinds of subsidies. For example, Brazil and Australia have a "competitive neutrality principle"[21] that seeks to ensure that state-owned enterprises compete

* For example see below for more details on the Ukraine's designated regulator the Antimonopoly Committee. The Committee is developing the capacity and legal powers to effectively regulate subsidies, but still has substantial flaws in how it regulates central government, http://competitionlawblog.kluwercompetitionlaw.com/2019/08/02/two-years-of-state-aid-in-ukraine/

on fair grounds against private entities. However, the competitive neutrality principle does not address cases where governments provide private entities with a competitive advantage. In other cases – such as Peru, Japan and South Africa – independent competition authorities' mandates to enforce fair competition can bleed over into regulating government subsidies. For example, subsidies can start to affect competition when companies use them to lower prices to the point where other private companies cannot compete (known as predatory pricing).[22] Again, this approach is not as comprehensive as the EU's state aid regime but it does indicate how some control can be applied to government's use of subsidies without an explicit state aid regime.

Additional mechanisms are required to limit subsidy races

While these mechanisms may be effective for controlling the use of subsidies by national governments, additional mechanisms are required to avoid damaging subsidy races between sub-national governments.

The US provides an example of a country with substantial subsidy-granting power at a sub-national level but that also has few mechanisms in place to restrict subsidy races. There are some high-profile cases, such as the offers that Amazon received from various states when it was considering where to locate its headquarters. [23] Analysis by Good Jobs First, a non-profit organisation based in the US, tracks subsidies offered by US states and found that US states and cities offer tens of billions of dollars each year in subsidies to businesses.[24]

In other federal countries, reports of rampant subsidies are not as widespread, but the OECD has warned that, in general, federal countries will be susceptible to subsidy races and should take steps to mitigate them.[25]

There are other specific examples where there have been subsidy races. In Brazil, there has been intense subsidy wars across Brazilian states trying to attract automotive plants. For instance, in 1995 and 1996, the state of Paraná and the municipality of Sao Jose offered Renault an attractive package, including a capital contribution of about $300 million and subsidised electricity, launching what became known as the "fiscal war" across Brazilian states.[26] In Canada, multiple provinces have engaged in a subsidy race in order to attract video games developers such as Ubisoft. These incentives were effective in luring the companies away from Europe (prompting the UK government to respond with its own tax relief for video game makers), but also led to intense competition within Canada.[27]

The case of Canada is also instructive because its intra-provincial free trade agreement, signed in 2014, provides further restrictions on subsidies. It states that:

> the Parties acknowledge that certain incentives may cause adverse effects to the economic interests of other Parties. Accordingly, each Party shall take into account the economic interests of other Parties in developing and applying its incentives.[28]

This is an explicit acknowledgment of the beggar-thy-neighbour problem of subsidy races. The article further provides for a consultation mechanism (though not formal dispute resolution) should two provinces disagree.

In sum, most countries are bound only by the WTO SCM Agreement, which provides a limited discipline on subsidies that affect other WTO members. The main other example is EU state aid, which is the most comprehensive example of a systematic but flexible check on wasteful subsidies. It is particularly federal countries and trade blocs that would benefit from more systematic controls as they have multiple independent sources of subsidy provision and relatively open markets. The UK is in a unique position as a quasi-federal state that has been regulated by state aid in the past. Consequently, relying on the WTO or implicit controls are unlikely to fail to provide a real check on wasteful subsidies or subsidy races between different parts of the UK.

4. What should a UK subsidy control regime look like?

In this chapter we address what domestic regime the UK could implement after the end of the transition period on 31 December. Such a regime is likely to be needed to secure a free trade agreement with the EU, but would be beneficial in either a deal or no-deal scenario. We set out some of the main choices the UK faces when drawing up a new subsidy control regime, and assess the relative merits of different options.

Should the UK have an subsidy control regime and what should it be trying to achieve?

The government had stated that it would be setting up its own subsidy control system after Brexit. In March, cabinet minister Michael Gove responded to the Future Relationship with the European Union Select Committee by saying that: "The subsidy regime that the UK proposes to put in place after we have left the EU will be one that the EU will recognise as a robust system."[1] But it has now stated that there will be no system in place in January 2021, with only vague promises to look again at a domestic system next year.[2] And at the same time the reported preference of Dominic Cummings, the prime minister's chief adviser, is to have an 'advisory' regime – that this, one that would not pose any legal restrictions.[3]

The UK's constitutional make-up makes a subsidy control regime especially beneficial

As outlined in the previous chapter, few developed economies have a legal prohibition on certain subsidies – our definition of a subsidy control regime. This is despite the fact that such measures could help reassure foreign investors that they will receive fair treatment and also help (particularly finance) ministers to resist poorly evidenced calls for targeted state support from people – within and outside government – with vested interests.

In addition, subsidy control regimes help guard against unhelpful over-subsidisation – something that the UK's constitutional make-up makes it especially vulnerable to. This is because since 1999 increased devolution and, more recently, building tensions within the Union (brought to boiling point during Brexit), mean that the UK should be compared with federal states rather than centralised ones. The devolved administrations (DAs) have genuine fiscal autonomy – without Treasury oversight – that has never been given to local authorities.

As a result, whereas 30 years ago the UK Treasury could resist calls for subsidies it deemed unsuitable (as its Japanese counterpart can), today there is a risk of damaging 'subsidy races' between the countries of the UK, for example the possibility of subsidies to encourage sheep farmers in the north west of England to locate across the border to Scotland or Wales. Indeed, this was commonly cited as the primary reason for the UK to adopt a robust new subsidy control regime. Interviewees agreed that this would be in the interest of the Westminster government, as it would prevent the DAs from offering subsidies to move activity away from England.

However, it is also the case that a common regime would be in the interests of the DAs, too, as it would protect their interests *from* England. England is a far larger economic entity than Scotland, Wales or Northern Ireland, meaning England has much greater fiscal capacity to use subsidies to lure businesses away from the other nations should it choose to do so.

The current state aid rules protect smaller, poorer countries from being out-subsidised by the bigger member states: the recent relaxation of the rules in response to the coronavirus crisis has been taken advantage of by Germany more than any other state – which has accounted for over 50% of the EU's domestic aid granted through the temporary framework.[4] Indeed, the Welsh government has stated this concern, arguing that:

> **The risk from moving away from the EU's state aid and 'Assisted Areas' models is that wealthier parts of the UK will be in a stronger position to 'spend their way out of a Brexit dip' by attracting inward investment and supporting local businesses, potentially increasing regional inequality. This risk is exemplified by the USA, where individual states are free to offer incentives to businesses to locate in their territories.**[5]

The fact that the devolved administrations are in favour of a domestic regime does not mean that there would be no risk of subsidy races if there were no regime. The benefit of a restriction on subsidies is that it prevents *any* region from engaging in subsidy races, which can benefit the UK overall and also benefit regions that would otherwise offer subsidies and engage in subsidy races that could ultimately make them worse off. In other words, a legal restriction on subsidies changes the rules of the game and therefore changes the behaviour of the players.

While other countries show that subsidy races between states or regions can be avoided or minimised even without a formal subsidy control regime, this may be more difficult for the UK. As one interviewee noted, the current UK devolution settlement is less mature than the longstanding federal agreements elsewhere. It is also less stable. While Westminster might usually be able to rely on political backchannels of communication with, say, Holyrood to prevent the escalation of subsidy races, the UK government's handling of Brexit has severely dented the relationship. Discussions surrounding a possible future subsidy control arrangement is itself a good example of this breakdown in communication.

The Scottish government has said that:

> **The entire UK position for the negotiations has been developed unilaterally by the UK government. Despite the existence of the Joint Ministerial Committee on EU Negotiations, and supporting structures at official level, there has been no meaningful engagement with devolved administrations on the UK position.**[6]

Furthermore, even compared with federal countries like Canada, the UK's nations are especially integrated. Scotland and Wales each export as much to the rest of the UK as the rest of the world combined, and internal trade barriers are low – and much lower than the German equivalent.[7] Similarly, Canada's intra-province FTA includes trade barriers that make it less integrated than the UK's economy. The more integrated the economies are, the easier it will be for businesses to relocate and the greater the risk of subsidy races – it is a lot easier to relocate a firm from Newcastle to Edinburgh (or vice versa) than between Canadian states.

An 'advisory' regime offers few practical benefits

It is this quasi-federal structure, peculiar to the UK, and the resulting fear of subsidy races, which means that an informal 'advisory' approach, supposedly favoured by Cummings,[8] would not be sufficient. As the UK government's own recent proposals for safeguarding the internal market have stated, a uniform approach to subsidies "is key to our ability to remain competitive."[9] Without some sort of formal regulation of subsidies, the government cannot guarantee such a uniform approach. An 'advisory' approach would be just as non-binding on the Scottish government as it would be on the UK one, and in practice would provide no credible safeguard against subsidy races.

The advisory regime has little else to recommend it. To start with, the general objective of having more freedom to subsidise is complicated by the Northern Ireland protocol. Its provisions mean that some subsidies intended just for Great Britain could require approval by the European Commission. The provisions are very broad: any subsidy that could theoretically affect trade between Northern Ireland and the EU could be caught, restricting the relative freedom provided by an advisory regime. The government's counter to this is to legislate to breach the terms of the protocol. This is not without consequence to the UK's reputation and could lead to a border being imposed on the island of Ireland. We discuss this in more detail in Chapter 6.

In addition, the reasons most often given for why the government needs to remove a legal restraint – that it would allow more freedom to subsidise strategic priorities, reaching net zero and 'levelling up' – overstate the restrictions that would actually apply.[10] These are within the scope of the existing exemptions to the current system:[11] there is no reason why the government could not subsidise these areas more now if it wanted to (although there would be limits on how those subsidies could be designed). What the government would lose, however, is a valuable constraint on the most egregiously wasteful subsidies. Removing this constraint could have consequences well beyond the tenure of the current government and future governments may choose to use flexibility on subsidies in a way that the current government disagrees with.

The regime should include co-operation between Westminster and the devolved administrations

Given that one of the primary benefits of a domestic subsidy control regime in the UK would be to manage potential subsidy races across the four nations, it is crucial that such a system should have buy-in from the devolved administrations. Both Edinburgh and Cardiff have indicated a preference for a set of rules that closely resembles state aid, and so they are not averse to subsidy control regimes in principle.

The UK government insists that subsidy control is a reserved matter and therefore the exclusive competence of the Westminster parliament. But, given that the strongest argument for introducing a legally binding domestic subsidy control regime (aside from the need to satisfy EU demands) is to ensure a fair environment across the UK, a government committed to 'levelling up', and led by a prime minister who in 2019 added 'Minister for the Union' to his title, should work out ways to ensure that the regime is treated as legitimate and politically uncontroversial in all four nations.

The government should explore ways in which DAs could be included in the development of any subsidy control rules and appointments to a regulator (should the UK choose to adopt one). As we show in Chapter 3, regional trade blocs that have attempted to introduce subsidy controls have struggled due to non-implementation of the rules at the national level. If one nation of the UK refused to accept the legitimacy of the new system, it could render the whole regime dysfunctional.

The criteria for an effective UK subsidy control regime

The UK has much to gain from a subsidy control regime, but it must also ensure that it is designed as effectively as possible. An effective subsidy control regime should achieve the following:

1. Effective at preventing wasteful subsidies and harmful subsidy races between constituent countries of the UK.

2. Still allows the government to use well-designed subsidies to pursue its policy priorities.

3. Limits the administrative burden on public bodies and businesses and provides certainty through consistent judgments.

This set of criteria recognises that the main costs of a regime – especially if poorly designed – would be that the regime prevented the UK from pursuing its policy priorities and imposed undue burdens – both through administrative costs and uncertainty – on businesses and public bodies.

As we showed in Chapter 2, well-designed subsidies are valuable and can correct market failures and drive forward the government's policy priorities. It is therefore important that an subsidy control regime provides an effective filter that weeds out harmful subsidies but still allows beneficial ones. In many ways, the EU state aid rules currently do this. Those rules do not prevent all subsidies, and indeed that

some European countries offer subsidies that amount in total to several percent of GDP. There is little evidence that the EU rules severely impinged on elected UK governments' abilities to offer the subsidies they wanted while the UK was a member.

But it is possible that the current government has different preferences than its predecessors that *would* fall foul of the EU rules. So far, its reported ambitions for subsidies – most recently its interest in subsidising tech companies – could be permitted within an effective and robust regime.

A further cost of a subsidy control regime is the administrative burden it imposes on both the public body providing the subsidy and the business in receipt of it. This is likely to be especially heavy for smaller businesses and public bodies, where the subsidies are also less likely to affect competition or cause economic harm.[12] There are two main ways in which this can be addressed: by adopting a proportionate approach, limiting which subsidies need to be assessed in the first place; and by ensuring the process for evaluating subsidies is clear, quick and effective.

A subsidy control regime could also impose unnecessary costs on business and having a chilling effect on the uptake of public funding if the rules are unclear or applied inconsistently. Public bodies will be reluctant to offer subsidies, and businesses reluctant to accept them, if they are unsure whether it will subsequently be ruled illegal, with the risk of some form of monetary penalty (such as repayment). It is important that any regime has clear and understood processes for assessing subsidies so that public bodies and businesses can make decisions on an informed basis.

How existing EU state aid rules fair against our criteria

Maintaining the existing EU rules would limit new sources of uncertainty but would retain the uncertainty and administrative costs of the existing system. To date, there is little evidence that the state aid regime has stopped public bodies in the UK from offering subsidies they would like. There have only been four instances where aid that has been notified from the UK has been outright considered incompatible in the last 21 years.[13] This does not mean that only four projects have been stopped, because the state aid regime will also have a deterrent effect, but none of our interviewees thought it had represented a substantive constraint. Perhaps the best evidence for this is that the UK makes much less use of subsidies within the rules than many other countries in the EU.

One of the main benefits of adopting a regime like this would be that UK public bodies, businesses and courts are familiar with the EU rules. This would avoid one source of uncertainty – around how any new rules or exemptions would be applied, or how new processes worked. Public bodies in the UK already approve state aid measures per year totalling £9 billion, and lawyers would benefit from continuing to operate in the same system while their EU state aid work would likely continue. The UK judiciary have been applying EU law in this area for the last 40 years, so their legal judgments and interpretations are unlikely to surprise.

Limiting uncertainty from the rules themselves, and their broad interpretation in the courts, could be welcome given that the approach of the new regulator would be a major source of uncertainty. This is especially the case because the state aid system grants the European Commission broad discretion, meaning a different regulator could interpret the same rules differently. While the ECJ is the ultimate arbiter of whether a subsidy constitutes state aid or not, the Commission is the sole decision maker about whether a subsidy that is state aid should nonetheless be allowed because it contributes sufficiently to permitted policy objectives. A UK regulator could therefore take a different approach, especially in big cases.

The discretion of the Commission has also led to changes in what constitutes state aid over time – at least in terms of what is practically enforced if not in theory. For example, following the earlier *Aeroports de Paris* judgment, the *Leipzig-Halle* judgment expanded the definition of state aid to include public funding for infrastructure that is subsequently used commercially.[14] Likewise, the recent tax cases of Apple in Ireland and Amazon in Luxembourg have had a similar effect. It is uncertain how the approach could be expanded further in practice to cover other types of state activity in future.

Furthermore, the procedures under the existing system can be burdensome and time consuming. The starting point of EU law – that any subsidy is prohibited unless it meets specific conditions – means that many subsidies that do not threaten competition or distort trade are still caught and must jump through the EU's hoops. Lawyers need to be hired, and the subsidy shown to comply with GBER, before the subsidy is permitted. Some of this administrative burden is unavoidable in a system of subsidy control (not least by having a properly resourced regulator), but the EU system is particularly burdensome because its *de minimis* threshold – the monetary value below which a subsidy does not need to be notified– is relatively low (only €200,000 per business over three years).

Changes to state aid the UK could make

Taking the EU rules as a starting point, there are several changes that the UK could make in the design of its own regime. Some are more radical than others: indeed some changes would mean that the system barely resembled the EU's state aid regime at all.

The UK should not make changes for the sake of it. The UK government consulted upon how what the EU affects the UK in its Balance of Competences Review in 2012 and concluded that, of all the aspects of EU membership, the state aid and competition regime was most in the UK's interest.[15] Therefore, the government needs to justify any changes it makes.

In most cases there is little to gain from changing the definition of a subsidy

If the UK is going to set up its own subsidy control regime it will need to define what constitutes a subsidy in the first place. It could start with the definition used by the WTO, it could adapt those set out in the EU's state aid rules, or it could adopt a hybrid which would retain some concepts from EU law.

The definition of a 'subsidy' under WTO rules is substantively the same as the definition of 'state aid' in EU law.[16] As a result, many interviewees did not believe that adopting the WTO definition would provide any substantive benefit: rather it would merely create the perception of having left the EU's regime. As state aid critic James Webber acknowledges:

> **The EU definition of State aid has substantial merit as a reference point. In particular, the concepts of advantage, State resources and State imputability are all well developed, relatively stable and overlap almost completely with the WTO concept of subsidy.**[17]

Webber nevertheless goes on to identify specific criticisms of particular concepts, even while generally accepting the usefulness of state aid as a reference point. For example he criticises the development of the concept of "selectivity" which is a criterion for distinguishing between measures that apply generally (and are therefore not state aid) and measures which apply to a subset of recipients (and therefore are). The criticism, perhaps most usefully summed up by the ECJ's general advocate Henrik Saugmandsgaard Øe in his opinion in *Finanzampt B* v *A-Brauerei,* is that newer methods of assessing this criterion could extend the reach of state aid too far to member state tax systems and render it excessively complex to predict whether a measure is a subsidy or not.[18] They recommend returning to an earlier method of assessing selectivity.

For the most part however, other interviewees pointed to the lack of case law for a new UK–EU deal at the WTO which means that these 'edge' cases are largely untested and could easily end up in the same outcome. They emphasised that – given the similarities between the state aid and WTO definitions, a much greater body of case law in state aid and UK judges' familiarity with EU law – interpretations would likely lean heavily on state aid precedent anyway.

While there would be little discernible benefit from changing the definition wholesale, there could be big risks. Some interviewees expected that the UK courts would continue to rely on state aid precedent even if the definition of a subsidy were changed, but others emphasised that a lack of case law would introduce new uncertainty. If judges departed from EU state aid precedent, there would be a number of settled matters that would again be open to question. Even if it eventually became clear that judges were relying on state aid precedents, a new definition would mean uncertainty for businesses and public bodies, at least until this was resolved.

There is therefore relatively little to be gained by adopting a different definition of subsidy in most cases. The UK should instead adapt the current definitions and concepts where there is a case to be made that the development of state aid may overreach or increase uncertainty in the system. What it should not do is start from scratch with WTO definitions that are broadly similar and unlikely to lead to much change other than a wave of litigation.

But the UK should make changes to what constitutes an 'allowed' subsidy

While there is little to gain from changing what constitutes a subsidy, the UK could change which subsidies are allowed. There are three aspects to this question: the stated policy priorities that subsidies can contribute to; the exemptions that allow for the automatic granting of aid without the need for an assessment; and the possibility of a more radical change to the interpretation of trade and competition distortions.

Changes to stated policy priorities

The EU's state aid law specifies that a subsidy may be permitted if it is:

- regional aid to support economic development in areas with low living standards
- aid to support projects of common European interest or to address a serious economic disturbance
- aid to support development of certain economic activities or of certain economic areas (including innovation aid)
- aid to support culture and heritage conservation.[19]

This covers a broad set of potential justifications for a UK domestic subsidy ('common European interest' simply switching to 'common UK interest'). What further categories would be needed depend on the government's priorities, which are not yet articulated, but the UK could adopt a new subsidy control regime that included a somewhat different set of categories of allowable aid. For example it might broaden the regional aid definition to capture priority areas – such as towns – which may not have very low living standards but which the government would like to be more productive to achieve 'levelling up'.

In order to ensure this was not a frequently changing list, the list of priorities would be enshrined in primary legislation, and therefore require primary legislation to change it.

Changes to exemptions

Of far more practical importance within the EU system are the exemptions that have been explicitly legislated for, which mean that some types of subsidy are approved automatically and need not be subject to an investigation. Most of the state aid measures that would otherwise require notification to the EU fall under one of these exemptions. It is these exemptions that explicitly permit forms of R&D aid, small and medium-size enterprises aid and regional aid. The precise formulation of these exemptions could be changed in a new UK system and could make a big difference in practice. Some key areas are given here.

De minimis threshold

A frequent complaint about the EU system, especially from local authorities, is that the state aid regime affects many small subsidies that pose no threat to competition or trade within the single market. At present, the *de minimis* exemption requires that any subsidy of more than €200,000 to a single business over three years must comply with the rules. One option in a new UK subsidy control regime would be to increase this threshold.

The main advantage of this change would be to reduce administrative burdens on public bodies and the enforcers of the regime by no longer requiring that these small subsidies meet the specific criteria of the other exemptions. Even though most small subsidies will eventually satisfy another exemption, designing subsidies in this way requires costly legal input which, for some local authorities (and indeed subsidy recipients on whom granting authorities typically place the compliance burden contractually via grant offer letters), can mean that small subsidies are not worth it. The Local Government Association has noted that:

> **Councils find the EU state aid regime to be complex, requiring knowledge of a whole host of different pieces of EU legislation dependent upon the sector, the purpose of the aid, and the financial amounts involved. The cost of external legal advice can be disproportional to ensure a small grant is compliant with EU rules.**[20]

However, such a move would not be without risks. Too high a threshold would mean that harmful subsidies that *can* affect competition and trade – and may lead to subsidy races within the UK – would go unchecked. An impact assessment produced by the European Commission for raising the EU *de minimis* threshold to €500,000 noted that this could lead to many more subsidies in some member states with a risk of distortion of competition.[21] Interviewees also pointed out that, while most relatively small subsidies do not pose a risk to competition, some might. They pointed to another part of the competition regime – merger control – where the CMA is sometimes concerned with the effects on competition at a local level of mergers between small companies. If the *de minimis* threshold were set at too high a level, therefore, there is a risk that some subsidies that affect competition in local areas, and are therefore harmful, may be approved automatically.

Regional aid restrictions

'Levelling up' is a stated priority for the current government and a new subsidy control regime could impose restrictions on UK policies in this area if it closely followed the EU's state aid rules. At present, regional aid subsidies are approved automatically only if they are restricted to 'assisted areas' – that is, designated areas with low living standards. Furthermore, the maximum support allowed for regional aid projects (the so-called aid intensity ceiling) is 10% of project cost in most assisted areas and 25% in low density areas. The Industrial Communities Alliance, a lobbying body for economic regeneration in local authorities in the UK's former industrial areas, among others, has criticised this aid intensity ceiling.[22] While noting that allowances were greater in West Wales and the Valleys, and in Cornwall, the Alliance argues that the 10% ceiling is often not sufficient to influence companies' decision making.

The UK could extend the areas where more extensive subsidies could be provided to include all those parts of the country designated assisted areas (areas where, due to living standards, some incentive is permitted). But that definition, too, is restrictive: for example, many of the 'red wall' constituencies that the Conservatives won in the last election fall outside assisted areas.

Historically the UK has made little use of developmental regional aid in comparison with other EU countries. The main recent example is the Regional Growth Fund, but this had mixed results: it did generate additional jobs but each came with a hefty price tag. It is certainly possible that the UK will want to make greater use of regional aid in future, but that is not the only way to 'level-up' and may even prove ineffective if the aid is poorly targeted.[23] Furthermore, regional development subsidies by their nature could be especially prone to subsidy races, so the UK should be wary of liberalising these rules too much.

There would be some advantages to looking again at which parts of the country are designated assisted areas and what aid intensity thresholds are used. But, as with the *de minimis* threshold, these changes would not be without risks and a failure to calibrate these parameters correctly would risk undermining one of the key criteria for the regime: a credible check on intra-UK subsidy races. One approach which might yield benefits with regional aid, is a three-yearly assessment of which areas meet the relevant criteria, which would allow for changes to the regional aid map.

Infrastructure spending

The UK could adopt additional exemptions for its regime, including on infrastructure spending. The *Leipzig/Halle* judgment in 2012 (combined with the ECJ's earlier *Aeroports de Paris* judgment) means that certain types of public infrastructure spending are deemed to be state aid where they are commercially exploited. This is frequently cited as one area where the UK may wish to take a different approach. The UK's Balance of Competences review of the split of responsibilities between the UK and EU highlighted that, while "the judgment itself is no more than a codification of existing law, it leaves public authorities with little room to claim that their development activities are free of State aid implications."[24]

Some of the review's evidence suggested that, at the time, stakeholders feared this might inhibit some innocuous public spending. One option would be to exempt infrastructure projects that have been competitively tendered.[25] Of course, infrastructure spending could also be covered by extending the relevant exemptions (currently most infrastructure caught by the *Leipzig/Halle* principle proceeds on the basis of Article 56 of the GBER).

In practice, it is unclear how often this restriction is likely to affect the UK in any case as it has not often built public infrastructure in this way, but it would represent a significant restriction of what might be an illegal subsidy.

Changes to the definition of a distortion of competition

The number of exemptions that the UK could offer is clearly greater than the small subset considered above, but these examples show that in most cases any change would require the government to trade off competing objectives. A more radical approach – that could complement or replace the exemptions – would be to provide a different interpretation of the clause in EU law which states that a subsidy may violate the regime if it "distorts or threatens to distort competition and trade".[26]

The EU test is 'minimalist' – requiring only that a subsidy could *in theory* distort competition or trade. The UK could choose to adopt a different standard: for example, one that was based on demonstrable economic harm. This would be similar to the UK's approach to mergers and the WTO's subsidy control regime.

Doing this would have two implications. First, it would make the complex system of exemptions a less important part of the system. Authorities offering (and businesses receiving) smaller or innocuous subsidies that had no prospect of affecting competition would not need to worry about meeting other criteria. The regime should still incorporate guidelines outlining when a subsidy is likely to be compliant, but those guidelines would not need to be as specific or constraining.

The second implication would be that, for those bigger subsidies that could impact competition (and which likely would not have been covered under EU exemptions either), the decision over their legality would be based on a robust evaluation process using economic evidence.

The main benefit of this approach would be, as with raising the *de minimis* threshold, a reduction of administrative burdens for smaller public bodies offering innocuous subsidies. It would also bring the state aid system into line with other aspects of the competition regime (anti-trust and mergers), which are based on provable economic harms.

Such a radical change in regime would lead to initial uncertainty. It would be unclear whether different types of aid did constitute a distortion of competition especially because, again as noted above, even relatively small subsidies could distort competition at a local level and the UK's merger regime still investigates and sometimes blocks mergers that have this effect. Furthermore, some interviewees noted the capacity for economic consultants working for different sides to come to opposite conclusions based on the same data: relying on 'economics' to prove harm does not mean that each case will be clear cut. Furthermore, what constitutes economic harm is capable of changing very quickly, requiring multiple economic reports.

The reliance on economic consultancies to provide evidence means that this approach would not eliminate administrative costs for businesses and public bodies. In general, however, it would probably shift these costs from those offering and in receipt of small subsidies to those offering and in receipt of large ones, for whom the burden may represent less of a deterrent or a distortion to choices. The administrative burdens on a regulator (should one exist) could also be substantial and additional resource and expertise would be required if this approach were to operate without delays.

For public sector bodies wanting to review state aid in-house it would require a new skill set to be recruited or developed.

In summary, adopting a rigorous economics-based test based on demonstrated harm to competition and trade is not a silver bullet that satisfies all of the criteria for an subsidy control regime simultaneously. If implemented poorly, it could lead to long delays, high costs on public bodies and businesses and even more uncertainty than the current system. It is nonetheless worthy of serious consideration.

The government should have a regulator to enforce its subsidy control rules

In addition to deciding what subsidies will and will not be allowed, the government will also need to choose how those rules will be enforced. Broadly, the UK has two options for a legal regime: to operate through a regulator (as with state aid) or to leave enforcement to the courts.

The regulator will need to be properly resourced and given powers to make judgments about, for example, whether a subsidy provides sufficient contribution towards a public policy objective to justify the distortion wrought to competition and trade. Within the EU system, the ECJ judges whether a subsidy qualifies as state aid, but does not challenge European Commission rulings about whether the benefits are deemed to outweigh the costs. It would be very difficult for UK judges to make decisions about the public interest as they are not ultimately a matter of law but of policy. The UK State Aid Law Association (UKSALA) has argued that courts would be "ill-equipped" to assess whether public policy objectives justified "the distortion of competition inherent in State support."[27]

Relying on enforcement through the courts would also have other downsides:

- Only measures that were challenged, either by a competitor or another public body, would be subject to scrutiny – and there is no guarantee that competitors would challenge, which could allow damaging subsidies to slip through the cracks.

- This could also lead to major political battles – for example, if the UK government challenged a subsidy offered by the Scottish government. An independent regulator provides a degree of political separation from proceedings which would be more likely to lead to an effective system.

- Enforcement through the courts could not be combined with a system of ex-ante approval, whereby a subsidy is approved before it has been paid. This would generate additional uncertainty for businesses who would face a greater risk than under the current system of having to pay back a subsidy after it had been granted.

Furthermore, having a regulator is likely to allow more and faster decisions to be made about the compliance of subsidies. This offers valuable certainty especially in the early stages of the new regime. If the EU system is as slow as some critics claim, then it would provide the UK with a competitive edge.

For all of these reasons, we concur with the House of Lords report on competition and state aid, which concluded that relying on the courts for enforcement of an subsidy control system has serious deficiencies and that a robust independent regulator is preferable.[28]

A UK regulator cannot have the same powers as the EU Commission but must be independent of government

For almost all public bodies in the UK, including the devolved administrations, a new UK regulator could be given similar powers to the European Commission to enforce a new regime – to declare aid illegal and to demand remedies. However, a UK body cannot have exactly the same enforcement powers as the Commission currently has because it ultimately could never overrule an act of parliament. (While the UK was a member of the EU, the primacy of EU law meant that EU law prevailed if there was ever a conflict between it and UK law.)[*] A new regulator could not, therefore, technically have powers of enforcement over the UK government.

One of the main advantages of a domestic regime is its ability to restrict subsidy races, which may make this less of a concern – since the UK government should be less likely to engage in such subsidy races. However, the UK parliament also operates as the parliament for England, and the EU is likely to demand a system that does provide constraints on the UK government.

As noted in our 2018 paper *Supervision after Brexit*, there are some examples of UK bodies that already have limited enforcement powers against government. For example, the Equality and Human Rights Commission (EHRC) is tasked with monitoring the government's compliance with equality and human rights obligations, and can take action when government bodies fail to comply. It has powers of enforcement against central and local government, along with their arms-length bodies. The Information Commissioner's Office (ICO) can also take enforcement action against government, should it improperly hold or process personal data.

Ultimately, if the government decides to overrule a judgment by an act of parliament, there is nothing that the regulator can do to stop it (as is also the case for the EHRC and ICO). However, subsidies would normally be granted using statutory instrument (SIs) rather than primary legislation – and SIs could still be overruled by the regulator. Thus a regulator could still operate as a meaningful constraint on central government.

But the precise operation of a regulatory body with respect to central government would require further consultation and evaluation. We do not seek to solve that here but it will be the subject of future work if the UK government indicates a desire to adopt such a model. The other bodies mentioned here provide a starting point, but being able to show that the regime acts as a credible check on the UK government will be central to the legitimacy of the regime, especially with the devolved administrations.

* See the now defunct statutory instrument by the previous government setting out how the CMA could take on powers necessary for state aid to work in the UK after Brexit.

As well as constraining the government in principle, the regulator must also be credibly independent of the government in practice. The government should ensure that the regulator is not just a Westminster body, but is one that has buy-in from across the nations of the UK. This could include, for example, an inclusive approach to appointments to the regulator and in setting the regulator's mandate that gave the devolved administrations a say.

We leave the choice of an appropriate regulator to future work but note that the Competition and Markets Authority (CMA) would appear to be well placed, given its experience in related competition fields and its established credibility. Under Theresa May's government, the CMA was set to take on the Commission's role in the event of no deal. The CMA recruited some state aid experts and also opened offices with each of the devolved administrations when the UK expected to leave the EU in March 2019. The current government has not indicated whether it continues to envisage the CMA serving this function. If a new regulator is chosen then we would recommend that the organisation has representation in each of the devolved administrations.

Changes to the approvals process would make the regime more effective

A frequent complaint among practitioners, even those broadly in favour of the EU's state aid regime, is that the procedures generate unnecessary complexity and slow down the process of offering subsidies. But given the lack of a comparable alternative regime, there are no direct precedents for procedural changes that could streamline the process. The UK's merger regime is a useful comparator here, given its similar focus on assessing impact on competition. Where mergers do not have an EU dimension, national merger rules apply. As a result the UK's merger regime has developed procedural differences that are distinct from other member states and the EU's state aid regime.[29]

Powers of recovery

Without actual recovery of unlawful aid, the state aid rules are toothless and would be largely ineffective. As a consequence, the Commission considers actual and speedy recovery essential to an effective state aid policy.[30] It also sees the aim of recovery as restoring the conditions of the single market prior to the aid being granted. This means that under state aid law the recipients of aid can be required to pay back in full the amount of subsidy regardless of the benefit they actually received (which could be less than the total value of the subsidy). For example, in the case of *Aer Lingus v Commission*, Aer Lingus and Ryan Air were found to have been granted an illegal subsidy of lower air passenger duty for domestic flights in Ireland. They were required to repay the full value of the subsidy despite the fact that they argued they had passed on much of the benefit to consumers in the form of lower prices. The Commission has recently strengthened its powers to recover aid: if the amount cannot be recovered from the beneficiary, it should be forced into insolvency, with no opportunity for restructuring or temporary continuation of its activities unless the full aid amount is recovered.[31]

A UK regime will also need teeth if it is to be effective, and therefore the regulator must be able to issue penalties when the rules are not followed. But the government should still consider whether it wants to replicate exactly the powers of the

Commission. The UK could consider a different approach to remedies and recovery that would avoid perverse outcomes such as the air passenger duty example outlined above.

Speed of approval

The speed of the state aid approval process was identified by the coalition government as a key issue that could be improved in its Balance of Competences review.[32] The Commission has demonstrated over the past few months that it can move with speed to approve cases in a crisis. But UKSALA still argue that in general "the delay in issuing decisions remains a problem that causes considerable expense and frustration to all those involved in the process".[33] A speedier process could reduce administrative burdens for businesses and public bodies.

The administrative benefits of increased speed must be traded off against the precision of analysis and the possibility of mistakes. One of the reasons that approvals of state aid are taking longer than they used to is because of the increasing complexity of cases. It is therefore important that a speedier process is initiated in a sensible way.

One option would be for the government to set stricter time limits on investigations and a better process of prioritisation by following the merger regime's first stage and second stage process. In the first stage the CMA has 40 days to assess whether it is necessary to do a more in-depth investigation.[34] If it deems that is necessary, the case moves to phase two. This approach would allow the new regulator to prioritise only the cases that require the most in-depth assessment. In addition, it would also mean the process of approval for innocuous aid would have more certainty of being resolved efficiently if notified voluntarily. If time limits on investigations are to be imposed, however, the regulator would still need to have the necessary resources to assess complex cases without compromising the quality of the assessment.

Process of appeal

Another set of issues with the current system derives from the logjam in the courts. One interviewee with many years' experience of the system told us:

> **"it can take three or four years to get cases there and [it is] impossible to get the general court to move any faster. What then happens if the General Court annuls a decision of the Commission that approves aid is lots of people who may already have received a lot of money have to pay it back."**

The EU has recently placed a limit of 10 years on the recovery of aid.[35] But this is a long time for the uncertainty of whether the beneficiaries of an important project will end up having to pay aid back in full to persist – in any event the time period is tolled (i.e. time stops running) if the Commission starts to investigate during the 10-year window. The UK courts could speed up this process – the Competition Appeal Tribunal can be very fast at resolving cases when it comes to merger cases. Under its fast track procedure, a hearing will take place within six months. If the UK copied this structure for state aid, most interviewees agreed that the UK courts should be able to process cases more quickly.

The best approach is to adapt the system over time

Many of the changes from state aid we consider – in particular changes to process – should, if implemented well, make the UK regime more effective than the existing state aid regime according to the criteria we set out above. This would be to the UK's advantage. However, the UK should also not make changes from the EU's state aid system for the sake of it. There is little rationale for changing definitions of a subsidy, and dispensing with a regulator risks making the regime ineffective. Given this, the UK should be willing to adopt a system that is close to the EU's at first and make changes iteratively over time as it identifies improvements it can make. This is preferable to starting from scratch with an unrecognisable system that would generate substantial initial uncertainty and risk being ineffective if its implementation is rushed.

5. A regime for January 2021

There are many good reasons the UK government should establish a robust legal subsidy control regime to protect it against damaging or 'bad' subsidies as it settles into life as a non-EU country. But with the end of the transition period fast approaching, it is not in a position to muse over hypothetical optimal regimes. The government has announced that it will not replace the EU rules when the transition period ends at the end of 2020.[1] This chapter addresses the UK's (limited) options between now and the end of the transition and sets out why the UK government's approach is a mistake.

Legislation is necessary before the end of the year

The UK's European Union (Withdrawal Agreement) Act 2020 states that on the point of exit, EU law will be transposed into UK law. This means that, technically, state aid law will be on the UK statute book on 1 January. However, without secondary legislation, it will be inoperable. This is because there will be no legal body in the UK with the powers to approve subsidies. At the same time the European Commission will have no legal authority to do so either. To grant a subsidy without notification and approval would be *illegal*, but there would be no body to notify to that could approve a subsidy as *legal*.

This means that some form of legislation – either in the form of primary legislation or a statutory instrument – is necessary if the UK is to avoid having a nonsensical regime that would sow confusion.

The government therefore faces a choice in the short term: it could simply repeal the existing law and effectively have no subsidy controls for a period of time, or it could try and put in place a temporary regime as a stop-gap before consulting on what it wishes its permanent regime to be.

But the government should not attempt to legislate for an entirely new regime

Chapter 4 identified a series of possible deviations from the EU state aid regime. But the UK should not attempt to implement all – or even any – of those changes in time for January. In a note published during the election campaign, the Conservative Party committed to "develop these rules in full consultation with British business".[2] But the government has so far not even set out what it would like the regime to achieve, let alone consulted on any proposals.

Any of the options set out in the previous chapter – except one in which the UK made only minor changes (for example, to specify a 'UK common interest' as opposed to a 'European' one) – would require big decisions to be made. Many of these proposals entail difficult trade-offs and would only be successful if they were implemented well. The UK should explore the options – including more radical ones – in the form of a

white paper and extended consultation. These questions are sufficiently important that they should not be rushed. This would also allow the government to consult in detail, as promised during the election campaign.

Finding the time to pass primary legislation, which would be necessary for a new regime, would also be difficult before the end of 2020. The parliamentary timetable is likely to be full of other Brexit-related legislation, and a bill like this would normally take at least two months to pass – not including its drafting, which is also time consuming.[3] Legislation can be passed much more quickly than this, but even if the parliamentary time could be found, the risks of mistakes in parliamentary drafting on such a tight timetable would be high.

As so much will change for business at the end of the year, whether or not a deal is struck, providing as much certainty as possible to businesses should be a high priority for the government. That would have meant setting out details of the immediate plans for subsidy control as early in the autumn as possible.

Furthermore, a regime needs to not only be on the statute book but to be operational. The government has not yet officially appointed a regulator, or even confirmed if there would be a regulator. Expecting that regulator to be up to speed with an entirely new system by the start of next year is unreasonable. This is even the case for the Competition and Markets Authority (CMA), which was lined up for the role under the May government and which hired additional staff in anticipation.

Early 2021 could be a time when lots of subsidies are granted

In 2020, the UK has notified more big support measures for business than usual as a result of the coronavirus crisis. The pandemic is unlikely to have disappeared in four months, and so the government may be forced to maintain its more interventionist for some time to come. On top of this, the economic disruption that will accompany the end of the transition period – which will be all the more drastic should the UK not reach a deal with the EU – is likely to increase pressure for the government to support specific disrupted industries and businesses. This is especially true of the current government, which has put much stock in the success of the Brexit project.

This means that a new subsidy control system would be busy from the start and would not be able to bed in quietly. In that environment, there would be a heightened risk of a new regulator being put under political pressure early on, which could risk undermining its longer-term credibility. This is a further reason why trying to get an entirely new regime up and running by January is a bad idea.

Abolishing state aid rules without a replacement will cause problems

The government has accepted that there is not time to implement a new regime, and indeed is yet to decide what that regime should look like. Its approach for January 2021 is to abolish the state aid rules and have no domestic regime. Its only constraint will be the WTO rules, which we have already established are unconstraining. Proponents of this approach suggest that a new regime, and a new regulator, would be fighting a losing battle and could be undermined almost from the start.

Instead, they argue, the government should adopt no subsidy control regime in the short term, allowing time to consult on the introduction of a new regime. This approach is a mistake, and doing so will have both short- and long-term negative consequences.

In the short term, unfettered subsidies could open the doors to cronyism.[*,4] While some additional subsidies would be justified given the economic disruption, others may be implemented merely to take advantage of the temporary lack of rules (especially if there was an expectation that more stringent restrictions would be imposed at a later date). There is also little reason to think that many of the problems we identified if the UK had no regime (such as subsidy races) would not also apply in the short term.

In the longer term, the problems are threefold. First, subsidies have long-run effects. A business that is supported at one time can then grow bigger, with a resulting distortion to competition that is maintained beyond the period that the subsidy is offered. Thus the negative impacts can be long lasting. Second, it may prove difficult for the government to "put the genie back in the bottle", as one interviewee put it. Such attempts could be subject to lobbying from firms who have benefited from a more relaxed environment.

Third, it will make doing a future deal with the EU harder. Even if the UK leaves the EU without a deal in December 2020, this or a future government may still wish to reopen negotiations at a later date. The EU is still likely to be the UK's biggest trading partner for the foreseeable future, so this is not an unfounded aim. Adopting no subsidy control regime at all could be seen as a provocation, given the importance placed on such controls in the current negotiations, and is likely to sour tensions between the two parties further. This would make a future agreement more difficult, and could even lead to the EU doubling down on its requirements for robust commitments on subsidies.

Given these downsides, the benefits of taking this approach would need to be considerable and demonstrable. But there is an alternative that would still allow most subsidies to be approved without these short- and long-term consequences: an interim 'parallel system'.

The UK should adopt an interim 'parallel system'

The only other option is for the UK to put in place a system that resembles, in most respects, the EU regime as an interim measure while it consults on possible improvements. This would be an appropriate approach in both a deal and no-deal situation.

The May government had drafted secondary legislation on state aid that would come into effect in the event of no deal. Under the European Union (Withdrawal) Act 2018, it would have given the CMA powers similar to the European Commission and it would have retained the whole of the EU's state aid rules as far as possible. The current government could revive this secondary legislation.

* The Johnson government has recently been accused of cronyism relating to contracts for personal protective equipment. See https://goodlawproject.org/news/the-ppe-fiasco

The advantage of doing this would be that the UK would still have an subsidy control constraint which could act to prevent fraud and corruption and would require the least disruption for public authorities and recipients of subsidies. While the CMA has not had active experience of regulating state aid, it will be aware of the rules and will have considerably more expertise in this system rather than a new one.

The main risk is that the CMA would still be in a difficult position as it begins to regulate subsidies, and it could lead to a loss of credibility, a slowed down process,or both. But by adopting the same rules and clarifying that they were interim measures, this would add the minimum additional uncertainty for businesses and public bodies. The CMA would be better able to process cases more swiftly and predictably with the well-established EU state aid rules.

Starting with a regime similar to the EU's is also consistent with the iterative approach we advocated in Chapter 4. Given that there is little to gain from starting from scratch, starting with the EU regime will allow the UK to retain its best features while also making improvements based on the UK's experience of the new regime.

None of the options now available to the UK government for January 2021 is ideal. Subsidies are likely to cause some disruption at the start of 2021, especially in the event of no deal. But adopting an interim parallel regime is the approach that is most likely to minimise disruption and enable a smooth transition to a new, well-thought-through regime.

There is nothing to prevent the government from changing course and announcing this plan of action now as it is the right approach regardless of the outcome of UK–EU negotiations. This would give businesses, public bodies and the CMA at least some time to prepare. It should do so.

6. Reaching a deal on subsidies with the EU

Subsidy control has emerged as one of the major stumbling blocks in the UK–EU negotiations. Unlocking a deal would require the UK to make some additional commitments on subsidies (as well as adopting a robust domestic regime) as part of a compromise agreement within an FTA.

In this chapter we outline the current UK and EU proposals for how any deal should constrain subsidies and highlight the ways in which they are currently incompatible with one another. We then set out a possible compromise agreement that would require the UK to adopt a robust domestic anti-subsidy regime (the subject of previous chapters) as well as additional provisions for resolving disputes. We set out several reasons why such an agreement is in the UK's interests.

The opening positions of both sides are unlikely to provide the basis for a deal

Based on their opening positions, the UK and the EU are a long way from reaching an agreement on state aid. The EU outlined its position on state aid in its negotiating mandate in February 2020[1] – arguing that a deal should include obligations for the UK to adopt EU state aid rules, with the European Court of Justice (ECJ) acting as the final arbiter of any disputes. In addition, for day-to-day operation of the system, the UK would need to set up a counterpart to the European Commission to enforce the rules. The Commission would then oversee the decisions of its UK counterpart. The EU also envisioned having the ability to put in place interim "safeguard measures" in the event that the UK breaches its commitments, although the EU has not set out exactly what these would entail.

In contrast, the UK has offered only to accept obligations similar to those provided in the EU's trade deal with Canada (the EU-Canada Comprehensive Economic and Trade Agreement, CETA).[2] The provisions on subsidy in CETA do little more than reaffirm the commitments made in the WTO subsidy control agreement and provide for additional information sharing. While CETA does outline a shared definition of a subsidy, this is virtually the same as the definition used by the WTO. The anti-subsidy commitments in CETA are not accompanied by any mechanism for either side to raise disputes, meaning that they provide no additional safeguards beyond the WTO commitments.

The EU argues that strong obligations on state aid between the UK and EU are warranted for two reasons. First, the size and proximity of the UK's economy means the risk of UK subsidies harming the EU is much greater than with other trade partners, who are either smaller (e.g. Albania) or further away (Canada). Second, the UK – despite claiming to be asking for an 'off the shelf' deal similar to CETA – is in fact asking for

greater access to EU markets than has been offered to the likes of Canada. For example, the UK government is asking to have UK professional qualifications recognised across the bloc (and vice versa), as well as provisions covering fishing rights, haulage and cabotage.

The UK has rejected the EU's proposal, arguing that it is inconsistent with the EU's obligations under the Withdrawal Agreement and restrictive of the UK's future autonomy.[3] This is a fair argument. The EU's proposal would put the UK in a similar position to Ukraine and Moldova (two states seeking accession to the EU) and countries in the European Economic Area (EEA), which have greater access to the single market than the UK is asking for. The reference to EU law would give the European Court of Justice (ECJ) the power to overturn an UK act of parliament and would leave the UK unable to change the focus of its subsidies to reflect domestic priorities.

Despite signs that the EU might be persuaded to modify its position,[4] the UK has done little so far to outline what it might be willing to compromise on. Nor has it presented the EU with details of the subsidy control regime it plans to implement in the future.

What kind of commitments on subsidies would a deal require?

While the UK and the EU's position are far apart, this does not mean a compromise is impossible. There are four areas that any agreement on subsidies will need to touch upon.

The rules: What is the definition of subsidy? When is a subsidy prohibited?

A deal will need to spell out an agreed definition of a subsidy and a definition of when that subsidy is harmful and therefore counter to the agreement. The legal definitions adopted could be closer to the definition used in the WTO subsidy control agreement or the definition used in the EU's state aid provisions, or a mixture of both. As EU law professor Luca Rubini notes, the EU has settled for options along this spectrum in negotiating previous trade agreements.[5] For example, the recent agreements with Japan, Vietnam and Singapore employ "hybrid provisions" where the language of the WTO is adapted "with significant inputs from EU state aid law".[6]

The House of Lords EU Internal Market Sub-Committee concludes that a hybrid approach "could give the EU the reassurance it is seeking without negating the Government's objective of establishing an independent subsidy control policy."[7] In practice, the concepts of 'subsidy' in the WTO and 'state aid' in the EU are similar, and the precise choice of definition is far less consequential than other aspects of an agreement, such as how a subsidy is judged to be harmful and how the agreement will be enforced.

Far more important for the operation of the agreement is the test which will determine whether or not a subsidy is caught by the agreement. The state aid test is, in the words of the committee, "astonishingly superficial" in that there is no requirement to show with any rigour that aid has impacted competition or trade in the EU.[8] Instead, the possibility that there has been a distortion of competition is sufficient, even if that may not be the case in practice.

The effect upon trade test can be met where an organisation in another member state may be dissuaded from entering into the market due to a subsidy, which makes it almost impossible for an organisation to satisfy itself that this test is not met.

This approach is understandable given member states' economies are extremely integrated. Any aid measure could potentially affect trade in the EU when business activity is so integrated across national borders. But the UK government can justifiably argue that only accession states accept such obligations and, given the UK's de-integration, it will now face many new trade barriers that other trade partners do not. Spending on relatively small-scale projects by local authorities in the UK,which are currently caught under the EU system, are not going to affect UK–EU trade and therefore should not be subject to EU complaint. For example, an English council's decision to support local broadband rollout is unlikely to affect UK–EU trade but would currently be caught under the existing rules.

The possible compromise will therefore need to establish a test that catches measures that genuinely risk distorting trade and disadvantaging one of the parties without affecting domestic spending that is unlikely to have such an impact. Such a test could be similar to the WTO system, requiring proof of economic harm for a subsidy to be ruled illegal. Alternatively, or in addition, the test could include a *de minimis* threshold that is higher than the one specified in the EU's state aid rules and is combined with other conditions (such as those used by the Commission to judge state aid).*

Domestic enforcement: How will both sides ensure they comply with the rules?

Once rules are agreed, both sides need to be confident that they will be adhered to – disputes over subsidies should be a last resort rather than a matter of course. As we noted above, the EU system operates through the Commission as a powerful regulator. The UK will need to set up a credible alternative to reassure the EU that the rules will be followed.

In practice, it will be difficult for a UK regime to be sufficiently credible without a domestic regulator with similar powers to the Commission. Without that, a deal is unlikely because alternative mechanisms – for example, the courts – would lead to frequent disagreements that could be protracted. Setting up a credible UK-based counterpart of the Commission would mean fewer issues would need to be referred to the formal dispute-resolution mechanism. Any UK–EU agreement will therefore require reciprocal commitments from the UK and EU to ensure such a body is independent of government and well resourced. To ensure the regime has teeth, the body would also require appropriate powers to impose remedies for breaches (as covered in Chapter 4).

Dispute resolution: How will disputes be resolved?

Most previous trade agreements signed globally have included provisions on subsidies, but few have been binding. The EU is not likely to drop demands about the need for reassurance even if its original proposal is unacceptable. If the UK is to reach an agreement with the EU, it will need to sign up to a robust dispute resolution

* One place where this has previously been set out is in Webber 2020. See https://uksala.org/compromise-position-for-subsidy-control-in-a-uk-eu-fta

mechanism that allows one party to challenge and seek redress for non-compliant subsidies. This is perhaps the most difficult aspect of an agreement on state aid.

Within the EU, the ECJ is the ultimate arbiter of disputes between member states. The EU has proposed that the ECJ should continue to serve this function in disputes between the UK and EU on subsidies. But from the UK's perspective, it is unreasonable that an EU institution should have the final say over such disputes as well as inconsistent with the Withdrawal Agreement and Political Declaration. But within the EU the ECJ is the final arbiter on matters of law. That means the EU cannot commit to being bound by an independent panel that could decide that a member state had provided an illegal subsidy when that same subsidy had not been deemed illegal by the ECJ. Furthermore, even if there were no EU law in the text of a UK–EU agreement, EU member states do not want to be subject to a double tier of international supervision: one by the EU institutions and another via an independent panel through a UK–EU FTA.

One way to resolve this would be to offer the right of both sides to retain standing in each other's separate legal systems to bring cases on subsidies.[9] That means that, for example, if BMW wants to complain about a subsidy breach, under the FTA they have standing to make that complaint to a UK regulator or the English court. The same would be true in reverse. Each side would get national treatment, meaning access to the same procedural rights. But neither side would have their legal autonomy overruled because cases would be ruled on according to each sides' subsidy laws (which would be required to acknowledge the requirements in the FTA).[*]

Under this proposal, there would still be a role for inter-state dispute resolution. But it would only deal with two questions: whether the domestic enforcement regime meets agreed criteria and or whether the safeguards and remedies (dealt with below) that each side imposes are justified and proportionate. By this means, a new dispute resolution panel would avoid ruling on whether something was a subsidy or not (which only the ECJ can determine for the EU).

Safeguards and remedies: What happens when the rules are broken?

If either party considers there to be a breach of the agreement the next question is what the consequence for that will be. The standard remedy in trade agreements for a breach is the ability to suspend parts of the agreement and/or impose duties on trade that are proportionate to the breach. These sorts of remedies do not normally apply to subsidy provisions[**] but without something along these lines there would be no consequence to a breach.

Assuming there is no dispute resolution panel that can rule on whether subsidies breach the agreement (for the reasons outlined in the previous subchapter), it will be up to the regulator of either party to receive complaints and make assessments

* The EU's original proposal in the Withdrawal Agreement negotiated by Theresa May had proposed a version of this that granted the Commission standing in the UK legal system but not vice versa.

** In most trade agreements, subsidy provisions are included but not subject to dispute resolution. This means they amount to little more than a statement of general commitments, but with no way for such commitments to be enforced.

according to domestic rules. In the EU system the remedy would therefore be the full recovery of aid by the beneficiary. In the UK system that is yet to be determined.

If either party disagreed with a decision made by the other's regulator, they could also then adopt unilateral tariff measures as a proportionate retaliation. To the fullest extent possible, such measures would need to be focused on the same beneficiary or sector that received the disputed subsidy and the harm caused by the subsidy should not exceed the harm caused to competition by the subsidy complained of.[10] There could be a role for an independent panel to adjudicate on the proportionality of the tariffs.

Ideally such unilateral measures would not be taken immediately without pursuing other avenues of resolution – firstly through the other's legal system and secondly through joint committees that provide a political forum for raising and addressing disputes (rather than a panel that makes a legal judgment). There could be agreed timelines for the committee to resolve a dispute before a party could impose the remedy unilaterally.

The downside is that it encourages the use of trade-targeted remedies that could damage the relationship. But the alternative is a system with no teeth that would be likely unacceptable to the EU.

The UK has a lot to gain from a compromise on subsidy restrictions

The above sets out the commitments that the UK may need to make on state aid to secure a deal with the EU. While this would impose some restrictions on the UK, it also confers a number of advantages (simply focusing on the state aid aspect of a deal, rather than benefits that may arise from other parts of a trade deal with the EU).

The UK's autonomy would not be significantly restricted

A compromise will involve some reciprocal commitments on subsidies. Some may regard this as a pragmatic solution; others as an intolerable contravention of the UK's autonomy. However, if an agreement were to be reached similar to the compromise outlined above, the UK would still retain freedom to provide most subsidies – and be able to adjust its system of subsidy control to suit its needs.

An agreement would impose some important restrictions. In particular, it would require the UK to adopt a legal subsidy control regime and would preclude a light-touch advisory system. However, as we have already argued such a regime is in the UK's interests. Furthermore, the commitment to have a legal prohibition enforced by an independent regulator would not prevent the UK from making most of the changes we set out in the previous chapter. There would likely be a negotiation over how closely the definition of subsidy matched state aid – with particular attention on infrastructure given how contentious this is among member states. But most of the procedural changes which deliver more certainty and efficiency would not be restrained.

The main practical constraint on subsidies from a UK–EU FTA, apart from the requirement to have an effective subsidy control regime, would be that some large subsidies would be affected and restricted by the agreement reached. For example,

the government has a proposal to introduce freeports – low-tax and low-regulation enterprise zones. If these were adopted at a large scale, and with major tax benefits, they could result in punitive safeguards being applied by the EU. However, it would be possible to design freeports in a way that would be consistent with a UK–EU trade agreement that included subsidy provisions akin to state aid. This is because some freeports are permitted within the EU (for example in Bordeaux)[11] – and the UK has previously had them when a member state.

Just as the current EU state aid system rarely prohibits subsidies outright, but rather affects their design, so an agreement with the EU is likely to restrict but not prevent the few very large subsidies that might fall within the ambit of any new agreement between the UK and EU to limit the use of subsidies. If the UK is careful to ensure transparency of business activity and specifies how subsidies achieve aims set out as legitimate exemptions for subsidies in the FTA – for example regional development – UK government actions would be less likely to fall foul of any agreement with the EU.

In sum, a deal with the EU need not unduly prevent the UK from providing subsidies or from changing its rules. The EU's opening offer may justifiably be characterised as contravening the UK's objective of retaining autonomy and the EU is unlikely to accept any situation in which the UK has no subsidy control regime at all, or a regime with no teeth. But there is space for a compromise in between that would leave the UK with considerable freedom to offer a range of subsidies, the ability to change the rules in future, and could help the government achieve other objectives – such as regulating the differential use of subsidies across the UK.

The UK has more to gain from reciprocal constraints on subsidies than the EU

A compromise agreement would not only place restrictions on the UK – but also on the EU. Given the larger economic size of the EU and the penchant of some of the large member states for offering subsidies, the protection afforded to the UK from harmful EU subsidies is likely to be greater than vice versa. The House of Lords EU inquiry into the level playing field concludes, on the basis of multiple expert testimonies, that:

> **"it would be in the UK's own strategic interest to have stronger subsidy control safeguards in its agreement with the EU, given that some Member States – for example France, Germany and Italy – have much greater propensity than the UK to subsidise their domestic industries."**[12]

The impact of coronavirus further illustrates this. While Germany makes up about a quarter of the EU's GDP, it accounted for some 52% of the total value of the emergency state aid cleared as of May.[13] Given increasing talk of a move towards supporting 'national champions' (big companies designed to dominate particular industries) in Europe, such safeguards could be especially valuable.[14]

A deal with the EU that establishes an effective dispute resolution mechanism – while avoiding handing the final say to the ECJ that would adjudicate on an international agreement by reference to EU law – would at the very least give the UK an opportunity to be able to raise disputes about subsidies that had harmed its interests.

The alternative, in the event of no deal, would be dispute resolution provided by the WTO. Given the WTO system is currently inoperable (in part due to the refusal of the US to approve appointees), this would provide little assistance. In the absence of an effective WTO system, the EU's white paper on foreign subsidies suggests the EU would instead take unilateral action to protect its markets.[15] While the paper is not directly addressed at the UK (it is mainly focused on China), the House of Commons EU Scrutiny Committee notes that the Commission's proposals could impact UK businesses significantly if the UK and EU are unable to reach an agreement that provides an alternative mechanism for addressing subsidies.[16]

The UK should seek to address the Northern Ireland protocol provisions on state aid through a compromise

The state aid provisions in Article 10[17] of the Northern Ireland protocol are so consequential that the House of Lords EU internal market sub-committee recently questioned whether the UK government had understood their full ramifications[18] and concluded that the UK should seek to renegotiate them. The government recognises the possible extent of this article, and is therefore legislating, through the Internal Markets Bill,[19] to give ministers the power to disapply the protocol in instances that they see fit, even if this is in breach of international law. It is not clear that this approach will be successful, and in any case it is an explosive option that risks devaluing the UK's credibility on a global stage. The only reasonable alternative, if the UK wishes to limit the provisions of article 10, is to agree a system with the EU that would supersede them, should the EU accept this.

Under the protocol, Northern Ireland will continue to be subject to the EU's state aid rules after Brexit, although only in relation to goods, not services. The Commission will therefore retain its regulatory role. While Northern Ireland is a relatively small part of the UK, the ramifications could be much broader. The protocol states that EU law will apply "in respect of measures which affect that trade between Northern Ireland and the Union which is subject to this Protocol" (that is, goods trade).[20] As George Peretz and other experts argue, the test for whether a subsidy falls within the scope of this provision is likely to follow EU state aid law.[21] That approach holds that a subsidy can affect trade even if the effect is minor or the case is theoretical.

This means that any aid granted to a business in the UK which also operates in Northern Ireland would be at risk of being caught under the protocol and would therefore need to be notified to and approved by the Commission – meaning the UK government's actions would be subject to review by the Commission even if the UK and EU did not reach a wider agreement on state aid. If the UK adopts its own separate subsidy control system, businesses could in some cases need to have UK aid approved twice, adding complexity and risk.

This could create a disincentive for businesses to operate in both markets simultaneously, and would make the operation of a coherent UK regime difficult. A renegotiation of the protocol, subject to robust commitments around a new UK subsidy control regime, would allow the UK to operate a coherent system and reduce administrative burdens for public bodies and businesses.

Such a renegotiation could also be in the EU's interests because Article 10 will be difficult to interpret and enforce in practice. For a subsidy granted by member states the Commission normally takes into account whether it is in the common interest of the EU as part of the approval process. It is not clear how the Commission can apply this test when considering the impact of a subsidy from Northern Ireland – which is not part of the EU. Would the Commission overrule subsidies in France because it would negatively harm Northern Ireland's interests? And would the Commission judge that a subsidy in Northern Ireland should be allowed because it delivered some offsetting benefits, even if those accrued solely or largely in Northern Ireland? Northern Ireland is not a member state and it is currently bound by rules in which it would not receive the same treatment as member states.

Article 10 could also put the Commission in a difficult political situation. It will need to decide how far to push the "effect that trade subject to this Protocol" test. Does it seek to have aid in Great Britain notified to it on an expansive interpretation – despite the fact that there is a customs border between GB and NI? If the UK chose not to notify the Commission for a measure enacted in Great Britain, the Commission would be in an awkward position where it would either need to declare the subsidy void or not address it. But failing to address would not be straightforward either: competitor firms could appeal to the ECJ if the Commission did not act. There is therefore a risk that Commission action over the protocol could escalate into a political impasse that would further damage the relationship between the UK and the EU.*

If the EU accepts a compromise in which it has assurances that the UK will set up an effective independent subsidy control system, there would be advantages to allowing this system to supersede Article 10 of the protocol. For this to happen, the UK would crucially need to ensure that the Republic of Ireland, in particular, was convinced of the benefits of renegotiation. There is no guarantee this would be possible. But doing so resolves a major potential problem for all sides.

A UK–EU deal could help resolve the UK's own constitutional difficulties

The UK's publication of a white paper on the Internal Market has not been well received by devolved administrations.[22] The white paper does not provide a full treatment of subsidy control, but it does state that the government intends subsidy control to be a reserved power (that is, for the Westminster government to have sole responsibility for determining whether or not subsidies can be offered in any part of the UK) and that a uniform approach across the four nations of the UK would be desirable.

As already noted, one of the key problems for a domestic subsidy control regime will be to ensure that it is consented to by the devolved administrations. A deal with the EU will not be sufficient to implement a workable domestic system that has this consent. As we discuss in the next chapter, the UK would likely retain relatively broad discretion to make changes to the system of subsidy control, and some of those choices might meet with disagreement from Edinburgh in particular.

* There is a risk of reaching this sort of political impasse as long as Article 10 remains in force – even if the UK and EU manage to reach an subsidy control agreement.

However, if a UK regime were compliant with a UK–EU FTA, the devolved administrations (who have stated their preference to continue to follow rules similar to state aid) are likely to be more willing to comply with the regime. This is for two reasons. First, if the EU accepts the UK regulator as sufficiently independent from political interference it will be difficult for the devolved administrations to argue the contrary. This would especially be the case if there were an enforceable commitment as part of the agreement to prevent the UK system from being close to government. Secondly, if the UK's system is good enough for the EU, it could allay SNP fears that a UK system would make accession to the EU more difficult in the event of a vote for independence.

Ultimately it is for the government to decide whether a deal is in the UK's interest. But there are potential benefits for both sides. Indeed, if the UK were able to secure a deal that did not require that EU institutions arbitrate disputes, a compromise could end up being of greater benefit and use to the UK.

7. Recommendations

The last chapter of this report offers the Institute for Government's recommendations on the future of subsidy control in the UK.

1. The UK should adopt a robust domestic subsidy control regime

Most countries do not have an subsidy control regime – a legal restriction on public bodies' ability to offer subsidies. In many ways, the EU's state aid system is the only example in the world. But the UK's plan to have no domestic regime in January 2021 is a mistake and it should adopt a system that has a similar effect to EU state aid. The biggest benefits would be two-fold.

First, the quasi-federal constitutional structure of the UK means that there is a real risk of the types of subsidy races that have occurred in other federal countries. A robust subsidy control regime would prohibit subsidies that 'stole' activity from one area to another, and thus prevent escalating competitions for business between countries or regions. This applies whether or not the UK agrees a deal with the EU.

Second, if it does want to secure a deal in the short time left, such a regime will likely be a prerequisite. There are many benefits for the UK to reaching an agreement on state aid. There are also broader economic benefits from reaching a free trade agreement, which could be worth several percent of GDP in the medium term.

Adopting a looser advisory regime, as reportedly favoured by Dominic Cummings,[1] would satisfy neither of these objectives. Nor would it offer much in terms of increased flexibility given even the current rules do not prevent entirely subsidies for technology, environment or regional development – the most often cited reasons for wanting to abandon a robust regime. A non-binding system would be just as optional for the devolved administrations as it would be for the UK government. And such a regime is unlikely to be compatible with a compromise deal with the EU.

2. The UK government should put in place a 'parallel regime' in January 2021, deal or no deal

There is no time to develop a new regime at this stage. The government has announced that it will not adopt any domestic regime to replace EU state aid on 1 January 2021, the day after the transition period ends. Rushing the legislation through for a new regime would have been a mistake and would likely have meant a poorly designed regime, and a new regulator would have struggled to implement new rules thrust upon it at short notice.

However, adopting no regime at all, even for a limited period in the event of no deal, is similarly dangerous. It risks a subsidies free-for-all, would likely sour relations with the EU (which will in January still be the UK's largest and most important trading partner), and could have long-term negative effects on competition.

Instead, in either a deal or no deal situation, the UK should adopt an interim 'parallel regime', adopting the EU rules with minor tweaks. The Competition and Markets Authority (CMA) would be responsible for regulating the regime, which it has already been preparing for. The rules would be well-known to public bodies, businesses and practitioners.

3. The UK government should publish a white paper and not rush the design of a subsidy control regime

Adopting an interim regime will give the UK time to consult fully on what the subsidy control system should look like in the longer-term – something the Conservative Party committed to in the 2019 election campaign. This will allow the UK to take an iterative approach, improving its regime over time. The government should publish a white paper setting out what it wants the regime to achieve and inviting responses.

There are some aspects that the subsidy control regime should have regardless of the UK's objectives. These include:

- A regulator with powers of investigation, rather than relying on enforcement through the courts.
- Remedies in the instance that a subsidy is found to be in breach.
- Some form of notification system so that most problematic subsidies will be restricted before they are offered.
- A definition of 'subsidy' very similar or identical to state aid rules.

However, there are also changes that the UK could make that are worthy of serious consideration and would bring benefits to the UK but are not without risks. These include:

- Changes to exemptions, and especially the exemptions that grant automatic approval, including the *de minimis* threshold and restrictions on regional aid.
- A more radical change to the assessment of 'harmful' subsidies based on provable, rather than theoretical, economic distortion.
- A quicker notification mechanism, supported by a properly resourced regulator applying rules designed to minimise the administrative burden on applicants.
- A time limit on investigations by the regulator.
- Changes to the way in which remedies are calculated.

A white paper would allow the government to weigh the trade-offs that many of these decisions present and ensure that the regime, when it does come into practice, achieves what the government intends and minimises uncertainty and administrative costs for public bodies and businesses.

4. The UK government should include the devolved administrations in the development of an subsidy control system

One of the main benefits of a subsidy control regime is to prevent subsidy races between the nations of the UK. The UK government has argued that state aid is 'reserved' and therefore not a devolved responsibility. The regime should be UK-wide and apply in the same way in each part of the UK – or would undermine the benefits of having such a regime. But for the regime to be effective, and for it not to cause further political tensions, it will need to have buy-in from Edinburgh, Cardiff and Belfast. This means that the UK government should explore ways in which the devolved administrations can be included in key processes in the setting up and day-to-day operation of the regime. These include:

- The choice of 'policy priorities' and detailed exemptions
- Setting the mandate of the regulator
- Vetting appointments to the regulator.

The devolved administrations are not, in principle, against a subsidy control regime, and therefore it should be possible for them to work together with the UK government towards common goals on the regime. However, these mechanisms will need to be designed in such a way that the DAs have genuine involvement in the process but are not in a position to veto the regime and prevent its effective implementation.

5. The UK should propose a compromise on state aid to the EU to secure a deal

The UK is right to reject the EU's initial negotiating position on state aid. It would put the UK in a similar position to Ukraine and Moldova – both of whom want to become more integrated, not less – and would give the final say in an international dispute to the ECJ. However, the UK also needs to recognise the errors in its own initial position, too, to strike a compromise

A compromise position is possible that captures only those larger subsidies that are likely to distort trade between the two parties, and allows for disputes to be resolved without requiring an independent panel to overrule the ECJ. As part of an agreement, the UK would likely need to commit to robust domestic enforcement of a subsidy control regime, but would retain flexibility over exactly how that regime could operate.

In practice, such an agreement is unlikely to be unduly constraining on the UK, and would also confer benefits. It would give the UK the ability to appeal EU subsidies as well as vice versa. This could be valuable protection, especially given the EU as a whole makes more use of subsidies than the UK. A strong commitment on subsidies may also allow a domestic UK regime to override Article 10 of the Northern Ireland protocol, which implies that state aid law will in most respects continue to apply to Northern Ireland after transition. This article could affect many UK-wide subsidies, setting up potential political disagreements between the UK and EU making the effective operation of a domestic UK regime more difficult.

Conclusion

The government has been, understandably, distracted by the coronavirus pandemic for much of 2020. This means that it has given less thought to its subsidy control regime than it might have done. Even still, its decision not to make use of any form of controls on subsidies immediately after the transition period ends is a mistake.

If it were instead to follow these recommendations, the UK would retain effective subsidy controls that would yield domestic benefits – especially with regard to the UK's fragile devolution arrangements. It could also break the logjam preventing a valuable UK–EU deal and allow the UK to strike a good deal on subsidies, something that would also be in its long-term interests.

References

1. Introduction

1 Cantner U, Dettmann E, Giebler A, Guenther J & Kristalova M (2019) The impact of innovation and innovation subsidies on economic development in German regions, Regional Studies, 53:9, 1284-1295

2 Comptroller and Auditor General, *The Regional Growth* Fund, Session 2012-13, HC17, National Audit Office, 2012

3 UK State Aid Law Association, Distributed Conservative Party Document, December 2019, http://uksala.org/wp-content/uploads/2019/12/Tory-SA-1.jpg

4 Foster P and Pickard J, 'Cummings leads push for light-touch UK state-aid regime after Brexit', *Financial Times*, 27 July 2020, retrieved 5 September 2020,https://www.ft.com/content/e29430c7-9dae-440e-8093-74f705ce62c3

2. Why do governments use subsidies – and restrict their use?

1 Uwe Cantner, Eva Dettmann, Alexander Giebler, Jutta Guenther & Maria Kristalova (2019) The impact of innovation and innovation subsidies on economic development in German regions, Regional Studies, 53:9, 1284-1295

2 Comptroller and Auditor General, The Regional Growth Fund, Session 2012-13, HC17, National Audit Office, 2012

3 Pheruz M and Nicolaides P, *The economics of state aid for the resuce and restructuring of firms in difficulty*, Bruges European Economic Research Papers 27, 2013, https://www.coleurope.eu/system/files_force/research-paper/beer27.pdf?download=1

4 European Commission, *State aid: the Commission approves the restructuring plan for the PSA Peugeot Citroen group,* 30 July 2013, retrieved 10 September 2020,https://ec.europa.eu/commission/presscorner/detail/en/IP_13_757

5 Tetlow G, Owen J Pope T and Rutter J, *Lifting lockdown: how to approach a coronavirus exit strategy*, Institute for Government, 2020, https://www.instituteforgovernment.org.uk/publications/lifting-lockdown-coronavirus-exit-strategy

6 Kattel R Mazzucato M Ryan-Collins J and Sharpe S, *The economics of change: policy appraisal for missions, market shaping and public purpose*, IIPP policy brief, August 2018, https://marianamazzucato.com/wp-content/uploads/2019/01/ipp-pb-02-economics-of-change-03-08-2018.pdf

7 Barry S, 'Steel industry needs support so it can help lead the recovery', *Business Live*, 28 May 2020, retrieved 5 September 2020, https://www.business-live.co.uk/manufacturing/steel-industry-needs-support-can-18323190

8 Lawrie E, 'Flybe collapse: 5 things that went wrong', *BBC News*, 5 March 2020, retrieved 5 September 2020, https://www.bbc.co.uk/news/business-51749882

9 Comptroller and Auditor General, The Regional Growth Fund, Session 2012-13, HC17, National Audit Office, 2012

10 Tyrie A, *How should competition policy react to coronavirus*, IIPR Discussion Paper, July 2020, https://www.ippr.org/files/2020-07/how-should-competition-policy-react-to-coronavirus-july20.pdf

11 Sauvage J, Why government subsidies are bad for global competition, OECD, April 2019, retrieved 5 September 2020, https://www.oecd.org/trade/why-subsidies-are-bad-global-competition/

12 Hess C, *Study on Foxconn deal shows government subsidies don't work*, Wisconsin public radio, 25 November 2019, retrieved 10 September 2020, https://www.wpr.org/study-foxconn-deal-shows-government-subsidies-dont-work

13 May T, 'a new era of cooperation and partnership between the UK and the EU', speech in Florence, September 2017, retrieved 5 September 2020, https://www.gov.uk/government/speeches/pms-florence-speech-a-new-era-of-cooperation-and-partnership-between-the-uk-and-the-eu

14 Schwartz A, *The realities o economic development subsidies*, Center for American progress, November 2018, retrieved 5 September 2020, https://www.americanprogress.org/issues/economy/reports/2018/11/01/457771/realities-economic-development-subsidies/

15 Wilson D, 2009. *Beggar thy neighbor? The in-state, out-of-state, and aggregate effects of R&D tax credits*. The Review of Economics and Statistics, *91*(2), pp.431-436

16 Mast E, *Race to the Bottom? Local Tax Break Competition and Business Location*, American Economic Journal: Applied Economics, 2020, 12 (1): 288-317

17 Fleming S and Espinoza J, 'EU members clash over state aid as richer countries inject more cash', *Financial Times*, 1 May 2020, retrieved 7 September 2020, https://www.ft.com/content/a68bfd0d-47c7-46ec-ac87-20b8b67ddc32

18 Dewatripont, M. and Seabright, P., 2006. "Wasteful" public spending and State aid control. *Journal of the European Economic Association*, *4*(2-3), pp.513-522.

19 Crafts, N., 2017. Brexit and state aid. Oxford Review of Economic Policy, 33(suppl_1), pp.S105-S112.

20 Baybeck, B., Berry, W. D., Siegel, D. (2011). A strategic theory of policy diffusion via intergovernmental competition. Journal of Politics, 73, 232-247,

21 Hinkle A, *Cut corporate welfare: it's time to rein in crony capitalism*, Good jobs first, March 2015, retrieved 5 September 2020, https://www.goodjobsfirst.org/news/cut-corporate-welfare-its-time-rein-crony-capitalism

3. Subsidy control around the world

1 Treaty on the functioning of the European Union, Article 107(1), retrieved 5 September 2020, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107

2 Treaty on the functioning of the European Union, Article 107(3), retrieved 5 September 2020, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107

3 European Commission, Regulation (EU) No 1407/2013 on de minimis aid for state aid, 2013, retrieved 5 September 2020, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=LEGISSUM%3A0802_2

4 European Commission, Commission Regulation (EU) N°651/2014, 2014, retrieved 5 September 2020, https://ec.europa.eu/competition/state_aid/legislation/block.html

5 Gibson Dunn, *L-3 communications corp agrees to pay $1.5m in* fines, Gibson Dunn, November 2006, retrieved 5 September 2020, https://www.gibsondunn.com/landmark-judgments-by-general-court-of-eu-declare-state-aid-for-two-infrastructure-projects-illegal/

6 Blauberger, M., 2009. Of 'good'and 'bad'subsidies: European state aid control through soft and hard law. *West European Politics*, *32*(4), pp.719-737.

7 UK State Aid Law Association, *Written evidence to House of Lords Select Committee*, September 2017, retrieved 5 September 2020, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-internal-market-subcommittee/brexit-competition/written/69979.html

8 Tweet by Nick Macpherson, September 2017, retrieved 5 September 2020, https://twitter.com/nickmacpherson2/status/911980873209319426

9 Albert, Michel. 1993. *Capitalism against capitalism*. London: Whurr

10 UK State Aid Law Association, *Written evidence to House of Lords Select Committee*, September 2017, retrieved 5 September 2020, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-internal-market-subcommittee/brexit-competition/written/69979.html

11 World Trade Organisation, *Agreement on subsidies and countervailing measures*, Article 1.1(1), retrieved 7 September 2020, https://www.wto.org/english/docs_e/legal_e/24-scm.pdf

12 Ward M, *Statistics on UK-EU Trade*, House of Commons Library Briefing paper number 7851, June 2020, retrieved 7 September 2020, https://commonslibrary.parliament.uk/research-briefings/cbp-7851/

13 Tetlow G and Stojanovic A, *Understanding the Economic Impact of Brexit*, Institute for Government, 2018, https://www.instituteforgovernment.org.uk/sites/default/files/publications/2018%20IfG%20%20Brexit%20impact%20%5Bfinal%20for%20web%5D.pdf

14 World Trade Organisation, *Disputes by agreement*, retrieved 7 September 2020, https://www.wto.org/english/tratop_e/dispu_e/dispu_agreements_index_e.htm?id=A20#selected_agreement

15 European Commission, *EU, US and Japan ageee on new ways to strengthen global rules on industrial subsidies*, European Union, January 2020, retrieved 7 September 2020, https://trade.ec.europa.eu/doclib/press/index.cfm?id=2101

16 OECD, *Competition, State aids and subsidies*, OECD roundtable write-up, 2010, http://www.oecd.org/daf/competition/sectors/48070736.pdf

17 Valockova B, *EU competition law: a roadmap for ASEAN?*, EU centre in Singapore Working paper 25, November 2015, http://aei.pitt.edu/97414/1/WP25-EU-Competition-Law.pdf

18 Government of Canada, *A new Canada-United States-Mexico agreement*, July 2020, retrieved 7 September 2020 https://www.international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/cusma-aceum/index.aspx?lang=eng

19 Kotyk A, 'Tensions over time: a primer on the Canada-US softwood lumber dispute, *The Globe and Mail*, 9 May 2017, retrieved 7 September 2020, https://www.theglobeandmail.com/news/british-columbia/tension-over-timber-a-primer-on-canada-us-softwood-lumber-trade/article34942091/

20 Japan External Trade organisation, *Incentive Programs*, retrieved 7 September 2020, https://www.jetro.go.jp/en/invest/incentive_programs/

21 OECD, *Competition, State aids and subsidies*, OECD roundtable write-up, 2010, p 11, http://www.oecd.org/daf/competition/sectors/48070736.pdf

22 *Ibid.*, p24

23 Badger E, 'In the end Amazon didn't win its own subsidy game', *The Irish Times*, 15 February 2019, retrieved 7 September 2020, https://www.irishtimes.com/business/technology/in-the-end-amazon-didn-t-win-its-own-subsidy-game-1.3794968

24 Good Jobs First, *Subsidy Tracker*, retrieved 7 September 2020, https://www.goodjobsfirst.org/subsidy-tracker

25 OECD, *Competition, State aids and subsidies*, OECD roundtable write-up, 2010, p 10, http://www.oecd.org/daf/competition/sectors/48070736.pdf

26 OECD, *Competition, State aids and subsidies*, OECD roundtable write-up, 2010, p 28, http://www.oecd.org/daf/competition/sectors/48070736.pdf

27 Chung E, 'Video game subsidy battle heats up', *CBC News*, 10 September 2010, retrieved 7 September 2020, https://www.cbc.ca/news/business/video-game-subsidy-battle-heats-up-1.877686

28 Canadian Free Trade Agreement, April 2020, https://www.cfta-alec.ca/wp-content/uploads/2020/04/CFTA-Consolidated-Text-Final-English_April-24-2020.pdf, Article 321

4. What should a UK subsidy control regime look like?

1 Gove M, Evidence to House of Commons Committee on the Future Relationship with the EU, 11 March 2020, https://committees.parliament.uk/oralevidence/162/pdf/ , p8

2 Sharma A, 'Government sets out plan for new approach to subsidy control', Department for Business Energy and Industrial Strategy, 9 September 2020, retrieved 10 September 2020, https://www.gov.uk/government/news/government-sets-out-plans-for-new-approach-to-subsidy-control

3 Foster P and Pickard J, 'Cummings leads push for light-touch UK state-aid regime after Brexit', *Financial Times*, 27 July 2020, retrieved 5 September 2020,https://www.ft.com/content/e29430c7-9dae-440e-8093-74f705ce62c3

4 Fleming S and Espinoza J, 'EU members clash over state aid as richer countries inject more cash', *Financial Times*, 1 May 2020, retrieved 7 September 2020, https://www.ft.com/content/a68bfd0d-47c7-46ec-ac87-20b8b67ddc32

5 Welsh Government, *Written evidence to House of Lords EU Select Committee,* 10 March 2020, https://committees.parliament.uk/writtenevidence/665/pdf/

6 Scottish Government, *Written evidence to House of Lords EU Select Committee,* 27 February 2020, https://committees.parliament.uk/writtenevidence/596/pdf/

7 Department for Business Energy and Industrial Strategy, *UK Internal Market*, CP278, July 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/901225/uk-internal-market-white-paper.pdf, p69

8 Foster P and Pickard J, 'Cummings leads push for light-touch UK state-aid regime after Brexit', *Financial Times*, 27 July 2020, retrieved 5 September 2020, https://www.ft.com/content/e29430c7-9dae-440e-8093-74f705ce62c3

9 Ibid, p26

10 Foster P and Pickard J, 'Cummings leads push for light-touch UK state-aid regime after Brexit', *Financial Times*, 27 July 2020, retrieved 5 September 2020, https://www.ft.com/content/e29430c7-9dae-440e-8093-74f705ce62c3

11 European Commission, Commission Regulation (EU) N°651/2014, 2014, retrieved 5 September 2020, https://ec.europa.eu/competition/state_aid/legislation/block.html

12 House of Lords EU Committee, *Brexit: competition and state aid*, 12th Report of 2017-19 session, February 2018 https://publications.parliament.uk/pa/ld201719/ldselect/ldeucom/67/6705.htm#_idTextAnchor016

13 Webber J, *All change? UK state aid after Brexit: What law? What courts?*, Politeia, February 2020, retrieved 7 September 2020, https://www.politeia.co.uk/all-change-uk-state-aid-after-brexit-what-law-what-courts-by-james-webber/

14 Thomas S, *The Leipzig-Halle judgment of the CJEU*, European Law Blog, January 2013, retrieved 7 September 2020, https://europeanlawblog.eu/2013/01/18/the-leipzig-halle-judgment-of-the-cjeu-is-the-financing-of-a-transport-infrastructure-an-economic-activity-subject-to-state-aid-rules/

15 Department for Business Innovation and Skills, *Review of the Balance of Competences between the United Kingdom and the European Union*, 2014, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/332779/Review_of_the_Balance_of_Competences_between_the_United_Kingdom_and_the_European_Union.pdf ransport-infrastructure-an-economic-activity-subject-to-state-aid-rules/

16 Ashfords, *State Aid*, retrieved 7 September 2020, https://www.ashfords.co.uk/business-legal-services/products/brexit/state-aid

17 Webber J, *Compromise position for subsidy control in UK/EU FTA*, UK State Aid Law Association, July 2020, https://uksala.org/compromise-position-for-subsidy-control-in-a-uk-eu-fta/

18 Advocate General, Opinion in Finanzampt B v A-Brauerei, September 2018, retrieved 7 September 2020, http://curia.europa.eu/juris/document/document.jsf;jsessionid=61CC9049C7F4C0876E155577D5954005?text=&docid=205886&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=17567569

19 Treaty on the functioning of the European Union, Article 107(2), retrieved 5 September 2020, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107

20 Local Government Association, *Written evidence to House of Lords EU Select Committee*, September 2017, retrieved 7 September 2020, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-internal-market-subcommittee/brexit-competition/written/70212.html

21 Department for Business Innovation and Skills, *Review of the Balance of Competences between the United Kingdom and the European Union*, 2014, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/332779/Review_of_the_Balance_of_Competences_between_the_United_Kingdom_and_the_European_Union.pdf ransport-infrastructure-an-economic-activity-subject-to-state-aid-rules/

22 Industrial Communities Alliance, *State aid: its role in rebuilding the regions*, August 2019, https://static1.squarespace.com/static/5bb773c49b7d1510743e696f/t/5d27661089183d000166d699/1562863171327/State_Aid_brochure.pdf

23 Bronzini, R. and De Blasio, G., 2006. Evaluating the impact of investment incentives: The case of Italy's Law 488/1992. *Journal of urban Economics*, *60*(2), pp.327-349.

24 Department for Business Innovation and Skills, *Review of the Balance of Competences between the United Kingdom and the European Union*, 2014, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/332779/Review_of_the_Balance_of_Competences_between_the_United_Kingdom_and_the_European_Union.pdf p67

25 Webber J, *All change? UK state aid after Brexit: What law? What courts?*, Politeia, February 2020, retrieved 7 September 2020, https://www.politeia.co.uk/all-change-uk-state-aid-after-brexit-what-law-what-courts-by-james-webber/

26 Treaty on the functioning of the European Union, Article 107(1), retrieved 5 September 2020, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E107

27 UK State Aid Law Association, *Written evidence to House of Lords Select Committee*, September 2017, retrieved 5 September 2020, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-internal-market-subcommittee/brexit-competition/written/69979.html

28 House of Lords EU Committee, *Brexit: competition and state aid,* 12th Report of 2017-19 session, February 2018 https://publications.parliament.uk/pa/ld201719/ldselect/ldeucom/67/6705.htm#_idTextAnchor016

29 Department for Business Innovation and Skills, *Review of the Balance of Competences between the United Kingdom and the European Union*, 2014, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/332779/Review_of_the_Balance_of_Competences_between_the_United_Kingdom_and_the_European_Union.pdf , p25

30 Blockx J, 'New EU State aid recovery notice strengthens Commission's hand', *Kluwer Competition Law Blog*, 27 July 2019, retrieved 7 September 2019, http://competitionlawblog.kluwercompetitionlaw.com/2019/07/27/new-eu-state-aid-recovery-notice-strengthens-commissions-hand/?doing_wp_cron=1597831671.3625190258026123046875

31 Blockx J, 'New EU State aid recovery notice strengthens Commission's hand', *Kluwer Competition Law Blog*, 27 July 2019, retrieved 7 September 2019, http://competitionlawblog.kluwercompetitionlaw.com/2019/07/27/new-eu-state-aid-recovery-notice-strengthens-commissions-hand/?doing_wp_cron=1597831671.3625190258026123046875

32 Department for Business Innovation and Skills, *Review of the Balance of Competences between the United Kingdom and the European Union*, 2014, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/332779/Review_of_the_Balance_of_Competences_between_the_United_Kingdom_and_the_European_Union.pdf , p45

33 UK State Aid Law Association, *Written evidence to House of Lords Select Committee*, September 2017, retrieved 5 September 2020, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-internal-market-subcommittee/brexit-competition/written/69979.html

34 Competition and Markets Authority, *A quick guide to merger assessment*, March 2014, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/288677/CMA18_A_quick_guide_to_UK_merger_assessment.pdf

35 European Commission, *Commission Notice on the recovery of unlawful and incompatible state aid*, 2019, retrieved 7 September 2020, https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:C:2019:247:FULL&from=LT

5. A regime for January 2021

1 Sharma A, 'Government sets out plan for new approach to subsidy control', Department for Business Energy and Industrial Strategy, 9 September 2020, retrieved 10 September 2020, https://www.gov.uk/government/news/government-sets-out-plans-for-new-approach-to-subsidy-control

2 UK State Aid Law Association, Distributed Conservative Party Document, December 2019, http://uksala.org/wp-content/uploads/2019/12/Tory-SA-1.jpg

3 Marshall J, *Fast-tracked legislation*, Institute for Government, February 2020, retrieved 7 September 2020, https://www.instituteforgovernment.org.uk/explainers/fast-tracked-legislation

4 Branton J and Rose A, *The future of state aid law in the UK – should the UK adopt strong or weak rules?*, UK State Aid Law Association, August 2020, retrieved 7 September 2020, https://uksala.org/the-future-of-state-aid-law-in-the-uk-should-the-uk-adopt-strong-or-weak-rules/

6. Reaching a deal on subsidies with the EU

1 European Union, Negotiating Mandate, February 2020, https://ec.europa.eu/info/sites/info/files/communication-annex-negotiating-directives.pdf

2 [CETA]

3 Frost D, Letter to Michel Barnier, 19 May 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/886168/Letter_to_Michel_Barnier_19.05.20.pdf

4 Baczynska G, 'EU eyes softening key state aid demand in Brexit talks – sources', *Reuters*, 3 August 2020, retrieved 7 September 2020, https://uk.reuters.com/article/uk-britain-eu-stateaid/eu-eyes-softening-key-state-aid-demand-in-brexit-talks-sources-idUKKBN24Z1MF

5 Baroness Donaghy, *Letter to Paul Scully on behalf of EU Internal Market Sub-Committee*, 3 April 2020, retrieved 7 September 2020, https://committees.parliament.uk/publications/574/documents/2319/default/, p10

6 *Ibid*

7 *Ibid*

8 *Ibid.*

9 Webber J, *Compromise position for subsidy control in UK/EU FTA*, UK State Aid Law Association, July 2020, https://uksala.org/compromise-position-for-subsidy-control-in-a-uk-eu-fta/

10 Webber J, *Compromise position for subsidy control in UK/EU FTA*, UK State Aid Law Association, July 2020, https://uksala.org/compromise-position-for-subsidy-control-in-a-uk-eu-fta/

11 List of free zones in the EU, 6 April 2020, https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/customs/procedural_aspects/imports/free_zones/list_freezones.pdf

12 Baroness Donaghy, *Letter to Paul Scully on behalf of EU Internal Market Sub-Committee*, 3 April 2020, retrieved 7 September 2020, https://committees.parliament.uk/publications/574/documents/2319/default/, p10

13 Fleming S and Espinoza J, 'EU members clash over state aid as richer countries inject more cash', *Financial Times*, 1 May 2020, retrieved 7 September 2020, https://www.ft.com/content/a68bfd0d-47c7-46ec-ac87-20b8b67ddc32

14 Heim M and Midoes C, *European Champion-ships: industrial champions and competition policy*, Breugel, July 2019, retrieved 7 September 2020, https://www.bruegel.org/2019/07/european-champion-ships-industrial-champions-and-competition-policy/

15 European Commission, *White Paper on levelling the playing field as regards foreign subsidies*, June 2020, https://ec.europa.eu/competition/international/overview/foreign_subsidies_white_paper.pdf

16 House of Commons European Scrutiny Committee, https://committees.parliament.uk/publications/2002/documents/19399/default/

17 Revised protocol to the Withdrawal Agreement, October 2019, Article 10, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/840230/Revised_Protocol_to_the_Withdrawal_Agreement.pdf

18 Baroness Donaghy, *Letter to Paul Scully on behalf of EU Internal Market Sub-Committee*, 3 April 2020, retrieved 7 September 2020, https://committees.parliament.uk/publications/574/documents/2319/default/, p14

19 Section 43 of UK Internal Market Bill, https://publications.parliament.uk/pa/bills/cbill/58-01/0177/20177.pdf

20 HM Government, *Protocol on Ireland/Northern Ireland,* October 2019, retrieved 7 September 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/840230/Revised_Protocol_to_the_Withdrawal_Agreement.pdf

21 Peretz G and Artley A, *State aid under the Northern Ireland protocol*, Tax Journal, May 2020, retrieved 7 September 2020, https://www.monckton.com/george-peretz-qc-and-alfred-artley-tax-journal-state-aid-under-the-northern-ireland-protocol/

22 Department for Business Energy and Industrial Strategy, *UK Internal Market*, CP278, July 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/901225/uk-internal-market-white-paper.pdf

7. Recommendations

1 Foster P and Pickard J, 'Cummings leads push for light-touch UK state-aid regime after Brexit', *Financial Times*, 27 July 2020, retrieved 5 September 2020, https://www.ft.com/content/e29430c7-9dae-440e-8093-74f705ce62c3

About the authors

Thomas Pope

Thomas is the senior economist and works across the Institute's programme areas. He was previously an economist at the Institute for Fiscal Studies, working on tax and the public finances. He has an MSC in Economics from UCL and a BA in Philosophy, Politics and Economics from the University of Oxford.

Alex Stojanovic

Alex is a researcher at the Institute, working in the Brexit team. He joined the organisation in March 2017 from the University of Sussex where he completed an MA in Philosophy. Alex has worked for the Department for Culture, Media and Sport in the youth policy team.

Acknowledgements

The authors would like to thank Andrea Biondi, Jonathan Branton, George Peretz, Alexander Rose and James Webber for very helpful discussions and comments throughout the project. At the Institute, we would like to thank Bronwen Maddox, Emma Norris and Gemma Tetlow for their comments and advice, and Will Driscoll, Melissa Ittoo, Susha Ireland and Sam Macrory for their work in producing the report. All views expressed, together with responsibility for any errors or omissions, are those of the authors.

The Institute for Government is the leading think tank working to make government more effective.

We provide rigorous research and analysis, topical commentary and public events to explore the key challenges facing government.

We offer a space for discussion and fresh thinking, to help senior politicians and civil servants think differently and bring about change.

instituteforgovernment.org.uk
enquiries@instituteforgovernment.org.uk
+44 (0) 20 7747 0400 +44 (0) 20 7766 0700
@instituteforgov
Institute for Government, 2 Carlton Gardens
London SW1Y 5AA, United Kingdom

© Institute for Government 2020
The Institute for Government is a registered charity in England and Wales (No.1123926) with cross-party governance. Our main funder is the Gatsby Charitable Foundation, one of the Sainsbury Family Charitable Trusts.