Brexit and State Aid

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Abstract

Brexit implies that the UK may move to different rules to control state aid although changes will be minimal if it remains within the EEA and could be minor in the event of an EU/UK trade agreement. With a 'hard' Brexit, there could be much greater scope for selective industrial policy and that might be seductive to a government intent on a new industrial strategy. In this case, however, the risks of 'government failure' are considerable and it would be desirable to devise an institutional framework that strictly limits the scope for politicians to exercise discretion.

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I. Introduction

EU membership entails quite strict regulation of state aid to industry. Selective industrial subsidies are generally not allowed if they adversely affect competition and trade between member states. The rationale is to underpin the efficiency of the Single Market but, at the same time, this represents an important constraint on political discretion in economic policymaking.

Depending on the type of Brexit that is negotiated, the rules with regard to state aid might change very little or quite considerably. To a first approximation, if the UK remains inside the European Economic Area (EEA), the status quo will prevail. If, on the other hand, our relationship with the EU is based just on WTO membership, then there will be much greater scope for pursuing a new industrial strategy and this might indeed be a significant factor informing the design of a 'red, white and blue Brexit'. Obviously, it is quite likely that Brexit will be on the basis of a trade agreement with the EU, in which case the regulation of state aid will be an important aspect to be decided.

This paper focuses on the implications of the future state-aid policy regime for UK industrial policy and productivity performance.[1] This raises the related questions as to whether EU membership has harmed the design of supply-side policy and how this might evolve post Brexit. An important issue which arises is what kind of framework should be put in place to manage UK state-aid policy.

II. Rules on State Aid: Past and Future

State aid is defined by the EU as an intervention by the state which gives the recipient an advantage on a selective basis that has distorted or may distort competition and which is likely to affect trade between member states. Such measures, which are prohibited, can take a variety of forms including grants, subsidies, loans, guarantees, and tax credits. These rules apply to all sectors. There are, however, a number of exemptions which are given in Article 107 of the Lisbon Treaty which include aid of a social character, aid to make good damage caused by natural disasters or exceptional occurrences, aid to promote economic development in areas of low living standards or high unemployment. Beyond this, there is a General Block Exemption for a range of measures which are deemed to address market failures with relatively slight implications for trade. These include aid for research and innovation, regional development, training, risk capital in SMEs etc. State aid has to be notified to and approved by the European Commission whose decisions are subject to scrutiny by the EU courts.

Under this regime, UK expenditure on state aid has been relatively low. In 2014, state aid was 0.33 per cent of GDP in the UK compared with a weighted average of 0.62 per cent across the EU15. Table 1 reports the main categories of expenditure and also notes spending on sectoral development. This was only 8.2 million euros which was about 0.1 per cent of the total. This follows a general pattern since the 1980s that selective industrial subsidies have been conspicuous by their absence. Table 2 puts UK expenditure on state aid in a comparative perspective. This shows that insofar as other countries spend a higher share of GDP on state aid very little of this goes to selective subsidies.

[1] I leave competition policy issues to Vickers (2017).

If, following Brexit, the UK chooses to stay within the EEA, state-aid rules would remain much the same. The detailed arrangements would differ in that the EFTA Surveillance Authority and the EFTA Court would replace the Commission and the EU courts, respectively, and agriculture and fisheries would be outside the scope of the rules. Selective industrial policy would generally remain illegal.

If, as seems more likely, the eventual outcome of Brexit is a trade agreement between the EU and the UK, the implications are somewhat less clear. The recent agreement between the EU and Canada does not include any provisions restricting state aid beyond WTO anti-subsidy obligations but the agreement between the EU and Ukraine requires Ukraine to implement EU rules through an operationally independent domestic authority. Nevertheless, it seems quite likely that the EU would insist on the continuation of the equivalent of EEA rules in the case of the UK (Peretz and Bacon, 2016) and, as is argued below, this might be a concession that the UK would be willing to make.

While the preceding options would probably maintain something very like the status quo, if post-Brexit trade is on the basis of WTO rules under the auspices of the Agreement on Subsidies and Countervailing Measures (SCM), there would be significant changes with regard to state aid (Sykes, 2003). The SCM agreement applies only to trade in goods. It bans export and import-substitution subsidies which entail a financial contribution by a government. Specific subsidies which damage other countries are 'actionable' and can be challenged. Damage in this context includes the notion of 'serious prejudice to the interests of another WTO member' as well as the impairment of market access. The enforcement of this agreement is via the state-to-state disputes settlement mechanism. In practice, there is much greater scope for selective industrial policy under WTO rules than EU rules, as is reflected in the recent surge of 'murky protectionism' (cf. Table 3). Obviously, it would be possible for the UK to augment WTO rules with its' own structure of surveillance and control of state aid possibly through a domestic agency or perhaps by making an arrangement to 'borrow' the EEA institutions.

These permutations of Brexit plus state aid regime are summarized in Table 4.

III. Industrial Policy

'Industrial policy' can be defined as 'a public sector invention aimed at changing the distribution of resources across economic sectors and activities' (Caves, 1987). It is conventional to distinguish between 'horizontal' and 'selective' industrial policy. The former addresses economy-wide issues with a view to correcting market failures and removing policy distortions. Well-designed policies can improve productivity and perhaps have a small positive impact on the rate of economic growth. This implies governments can have a positive role by making investments that complement private sector capital accumulation, for example in infrastructure, by supporting activities like education and research and development where social returns exceed private returns, by avoiding the imposition of high marginal direct tax rates, by recognising that regulations can undermine productivity, and by fostering competitive pressure on management to develop and adopt cost-effective innovations. All of these activities are allowed under EU state-aid rules. As was reported in Table 2, a very high proportion of state aid in the EU15 goes to horizontal industrial policy.

The UK has based its supply-side policy almost entirely on horizontal industrial policies in recent times, at least until the coalition government of 2010-15. It can certainly be argued that there is room for considerable improvement in the details of those policies. Areas of concern include under-spending on infrastructure, a badly designed tax system, very restrictive land-use planning rules, schools that deliver low-quality education, and innovation policies that result in low levels of R & D (Crafts, 2015). Reforms to these policies are not, however, precluded by EU membership. The obstacles are to be found in Westminster not Brussels and are related to British politics rather than constraints imposed by the EU.

Selective industrial policies were favoured in the 1960s and 1970s but with very disappointing results. Although 'picking winners' may have been the aspiration, "it was losers like Rolls Royce, British Leyland and Alfred Herbert who picked Ministers" (Morris and Stout, 1985, p. 873). There was a very clear tendency for selective subsidies to be skewed towards relatively few industries, notably aircraft, shipbuilding and, latterly, motor vehicles (Wren, 1996a). More generally, there was quite a strong bias towards shoring up ailing industries which is well reflected in the portfolio of holdings of the National Enterprise Board (Wren, 1996b). Moreover, policies to subsidize British high-technology industries were notably unsuccessful in this period in a number of cases including civil aircraft, which by 1974 had cost £1.5 billion at 1974 prices for a return of £0.14 billion (Gardner, 1976), computers (Hendry, 1989) and nuclear power (Cowan, 1990).[2] A horizontal policy such as an R & D tax credit would surely have been more appropriate than vain attempts to create 'national champions'.

The distinctive feature of industrial policy under the Coalition was the 'industrial strategy' which aimed to promote growth through boosting eleven selected sectors and to stimulate the advance and commercialization of eight selected technologies (Rhodes, 2014). The government tried to develop 'strategic partnerships' in key sectors with growth potential to address market failures, especially with regard to innovation, and to underpin investment. These entailed a high-level forum, skills improvement initiatives, and public support for research centres. Expenditure was about £2 billion per year. This was a modest shift towards selective industrial policy but could perhaps be described as 'soft industrial policy' with the government seeking to address coordination failures rather than to 'pick winners' (Warwick, 2013). In particular, the aim was to address market failures associated with the so-called 'valley of death' in terms of the phase of technology platform research (which often entails high risk, high cost and provision of public goods) that comes between basic research and applied R and D (Tassey, 2014).

The post-referendum Conservative government under Theresa May has indicated that it intends to develop a new industrial strategy. As yet, it is quite unclear what this will comprise. Perhaps the clearest statement of intent was made in a press release to announce a new Cabinet Committee for industrial strategy which summarized the Committee's priorities as follows (Rhodes, 2016): "to drive forward an industrial strategy that will aim to put the UK in a strong position for the future, promoting a diversity of sectors and ensuring the benefits of growth are shared across cities and regions up and down the country. In particular, it will focus on addressing long-term productivity growth, encouraging innovation and focusing on the industries and technologies that will give the UK a competitive advantage".

[2] Concorde and the Advanced Gas-Cooled Reactor were egregious policy errors (Henderson, 1977).

This could mean something along the lines of the Coalition's approach but it could also signal a substantial shift towards selective industrial policies. If that turns out to be the direction of travel, this could be, of itself, a reason to stay outside the EEA or even to operate under WTO subsidy rules without a trade agreement with the EU.

The pressure to adopt selective industrial policies will be intensified by the adverse effect of leaving the Single Market on foreign direct investment (FDI). It is a standard result in the literature that EU membership has a strong positive effect on FDI for market-access reasons. There is also evidence in a number of papers that the presence of FDI raises productivity levels in domestic firms through both intra- and inter-industry spillover effects (Harris and Robinson, 2004; Haskel et al., 2007). A recent estimate suggests that Brexit implies a potential reduction of 22 per cent in inflows of FDI (Dhingra et al., 2016). If so, the UK government would probably want to make a policy response but might well find horizontal policy too expensive.[3] A straw in the wind is the secret deal that has been made with Nissan apparently to indemnify the company against costs from Brexit presumably through tax breaks and/or other sweeteners. This arrangement may be politically expedient given the jobs at risk if Nissan were to leave the UK but it would surely be illegal under EU state aid rules and it sets a dangerous precedent.

IV. Containing Government Failure

'Government failure' occurs where the choice or implementation of policy leads to outcomes that are inefficient. The standard reasons for government failure include inadequate information, principal-agent problems (inability to incentivize officials to work effectively), asymmetric lobbying, inability to make credible commitments, and vote-seeking by politicians. All these problems are likely to matter in the context of selective industrial policy conducted outside the EEA with adverse implications for productivity performance.

In particular, it has been widely remarked that, as in the 1970s, support is disproportionately given to declining rather than new industries and some economists argue that this is an inherent aspect of the political economy of industrial policy which slows down the process of creative destruction. Recently, Baldwin and Robert-Nicoud (2007) have used a variant of the well-known 'protection-for-sale' model to argue that the asymmetric appropriability of rents implies losers lobby harder while earlier explanations include the 'social insurance' explanation of Hillman (1989) and the suggestion by Krueger (1990) that known losers in ailing industries are more visible than unknown gainers in expanding industries. They are also likely to be voters who were pro-Brexit and will be expecting that it leads to protection against international competition.

In other aspects of public policy but not so far with regard to industrial policy, it is accepted that politicians cannot be trusted to deliver efficient outcomes. Recent examples include the delegation of monetary policy to an independent Bank of England, the establishment of NICE to consider the costs and benefits of new drugs, the de-politicization of competition policy by removing the ministerial prerogative to over-rule the competition authorities in the 'public interest', and the

[3] For example, on the basis of the central estimate of the semi-elasticity of FDI flows of 3.7 in OECD (2007), to offset Brexit through reducing the corporate tax rate would require a cut of 6.5 percentage points which has an annual cost of about £16 billion.

Office of Budget Responsibility to evaluate macroeconomic forecasts and the implications of government policy for fiscal sustainability.

Outside the EU, it is desirable that the UK develops an effective mechanism to control the use of state aid and strictly limit ministerial discretion in the area of selective industrial policy.[4] The best solution, if it is available, would probably be to sign up to EEA discipline and surveillance even if the UK is outside the EEA. This might be a helpful concession for the UK to make in negotiating a trade agreement with the EU in which case it might be presented politically as part of a package deal that is good for the UK rather than as a constraint on the policy space available to a democratically elected government.

Otherwise, ideally, control of state aid would be by an independent agency with safeguards against either political pressure or private-sector lobbying. The minimal requirements for such an agency to be effective are clear enough from previous experience (Banks, 2015). Its remit should be to examine costs and benefits in terms of economy-wide effects on the basis of a transparent evidence-based process whose results are in the public domain both on an ex-ante basis and also through ex-post evaluation of policy interventions.[5] Ideally, the agency's approval should be required for state aid but this design may be infeasible given the current political climate. A second best would be for the agency's recommendations to be public and that government is required to explain any decision to over-rule them.[6]

V. Conclusions

It is quite possible that Brexit will make little or no difference to the rules governing the use of state aid by the UK government. This will definitely be the case if the UK is in the EEA and is highly likely in the event of a trade agreement with the EU. If, however, the UK government gives a high priority to introducing a proactive selective industrial policy, a hard Brexit and resort to WTO subsidy rules might well be the outcome.

Given the likelihood of serious government failure in implementing a selective industrial policy, it would be wise in any case to establish an effective mechanism for state-aid control that strictly limits the scope for ministerial discretion. Outside the EEA, that might require institutional innovation.

The bottom line is that Brexit potentially increases the scope for bad selective industrial policies driven by rent- and vote-seeking while doing nothing to facilitate improved horizontal industrial policies which are not currently constrained by EU membership.

[4] This includes the prevention of subsidy races between devolved administrations within the UK.

[5] The contrast with the way the Nissan deal has been handled is stark.

[6] Control of state aid could be added to the remit of the Competition and Markets Authority (CMA) but this may be unwise in the context of the expanded workload of competition cases that Brexit will imply (Vickers, 2017). It might also risk the politicization of the CMA, especially given current populist attitudes to a rules-based society.

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Table 1. UK Expenditure on State Aid, 2014 (million euros)

Environmental Protection and Energy Saving	2714.3
R & D and Innovation	1594.8
SME	1346.0
Regional Development	782.3
Sectoral Development	8.2
Other	1085.0
Total	7530.6

Note: total excludes agriculture and transport.

Source: EU State Aid Scoreboard 2015. Brussels: European Commission, 2016

Table 2. EU15 Expenditures on State Aid in 2014

	Total (%GDP)	*Sectoral (%GDP)*	*Horizontal/Total (%)*
Austria	0.40	0.004	99.0
Belgium	0.40	0.03	93.5
Denmark	0.94	0.08	91.9
Finland	0.74	0.06	91.4
France	0.67	0.07	89.8
Germany	1.32	0.01	99.6
Greece	0.94	0.09	90.7
Ireland	0.29	0.01	97.6
Italy	0.30	0.01	97.4
Luxembourg	0.27	0	100
Netherlands	0.27	0.04	85.8
Portugal	0.42	0	100
Spain	0.26	0.07	73.4
Sweden	0.74	0.04	94.4
United Kingdom	0.33	0.0004	99.9

Note: % 'horizontal' equals (100 - % sectoral)

Source: EU State Aid Scoreboard 2015. Brussels: European Commission, 2016

Table 3. G20 Protectionist Measures Recorded by GTA (2009-2016)

State Aid	1456
Trade Defence	1141
Tariff	600
Public Procurement Local Content	382
Trade Finance	373
Other Localization	352
Other	561
Total	4865

Source: Evenett and Fritz (2016)

Table 4. Different Brexits and State Aid

	Regime	*Enforcement*
Stay in Single Market	EU State Aid rules	European Commission and European Court of Justice
Join EEA	Virtually the same	EFTA Court and EFTA Surveillance Agency
Trade Agreement with EU	EEA state aid rules or new deal to control state aid	EEA mechanisms and/or new domestic agency
WTO	SCM agreement ... plus domestic rules?	WTO disputes settlement and countervailing measures ...plus domestic agency?