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FRAMING THE STATE AID DEBATE FOR THE POST-COVID ERA
THE BREXIT CHALLENGE

ELVIRE FABRY
Senior research fellow,
Jacques Delors Institute

The European Union is determined to obtain guarantees for fair competition in the Brexit negotiations, since the UK is not just any third country. The weight of its economy, geographical proximity and deep integration into the single market make it an unusual partner. The European market could therefore be significantly distorted if the British government decides to adopt an interventionist and discretionary state aid policy at the end of the transition period. Indeed, this is at the very heart of the negotiations.

But here is a twist: even though the conclusion of an agreement is suspended to obtain strict commitments on public subsidies, pandemic response requires significant financial support from the state. While European rules on state aid are generally strict, in March 2020 the European Commission suspended existing limits, on a temporary basis, to support the economy in the face of the pandemic. **All over the world, recovery plans are pouring out unprecedented volumes of state aid. How does this square with the European agenda for a level playing field, which aims to establish fairer conditions of competition with trading partners, particularly for subsidies?**

While the debate around stronger multilateral subsidy rules is closely linked to the evolving conflict between the United States and China, bilateral commitments to reduce subsidies are still either limited or non-existent. But the prospect of extensive public aid that causes significant distortions for competition will characterise the post-Covid era. The EU must leverage the attractiveness of the single market to compel its partners towards commitments on state aid, bilaterally or unilaterally, by speeding up the adoption of the instrument to control foreign subsidies. It is also crucial for future relations with the United Kingdom.

1 ■ A Wild West of emergency measures

State aid is essential to support economic recovery in the short term. In the medium term, it is key to safeguard the competitiveness of national champions that find themselves in the midst of a technological war, which could make them dependent on equipment from major powers. These dependencies will become even more difficult to manage as the geopolitical competition between Washington and Beijing is accelerating and the European Union tries to chart a third way.

But subsidies also introduce considerable distortions to competition. They provide an advantage and create disparities in competitiveness between countries, depending on the availability of public finance. The discrimination is particularly pervasive since it strengthens the competitiveness of enterprises on both the national market as well as on the market of third countries.

More concretely, the unlimited range of direct and indirect subsidies to state-owned enterprises in China's system of state capitalism crowds out competitors and is deemed unsustainable for other economies. The EU's response to this "systemic rival" is based on its spring 2019 strategic plan.[1] One of its first results is the October 2020 implementation of the foreign direct investment control mechanism.[2] But it is also part of a broader agenda for a level playing field, which aims to **complement the opening of markets with fairer competition rules** at all levels of governance–multilateral, bilateral and within the single market. This agenda remains relevant despite the global spike in public debt and reinforces the European objective to achieve "open strategic autonomy".

Certainly, the proliferation of state aid around the world is narrowing the gap that existed between China's investment capacity and that of other major powers. The amount of aid announced in response to Covid-19 is constantly increasing. For the EU, it is already estimated that the planned state aid (including national liquidity measures) has multiplied by a factor of 25 when compared to 2019. They amount to 3045 billion euros which represents almost 22% of the EU's GDP (excluding the United Kingdom), compared to 120.9 billion euros in 2019 (excluding aid to agriculture, fisheries and railways),[3] which were limited to 0.76% of the EU's GDP (including the United Kingdom). But these gaps will also widen with emerging countries and especially with developing countries. In the post-Covid era, the challenge of regulating subsidies has not disappeared–quite the contrary.

Within the EU, the temporary suspension of subsidy rules remains strictly regulated. For example, there is a ceiling on the maximum amount of subsidies, a principle of proportionality which aims to restore pre-Covid conditions, and a prohibition to acquire competitors as a result of subsidies. Moreover, in 2021 it will be necessary to revise some of the European competition rules, which were introduced with the reform of the state aid regime in 2012 and expire at the end of 2020. But the proper use of subsidies is also giving rise to new debates. To stem soaring unemployment, some would be tempted to extend state aid to companies that were already bankrupt before the pandemic. The objective to achieve a sustainable European economy and the related need to reduce over-dependence on strategic value chains create new imperatives for public support measures to stimulate and sustain these transitions. In the era of the fourth industrial revolution, it is also a question of developing "European champions" who can compete in the digital arena.[4]

The extension of temporary subsidy schemes (which has already been decided to extend beyond 2020) and the modernisation of European competition rules are, however, only two of the levers available to Europeans to strengthen the level playing field with their commercial partners.

The primary focus should be on the multilateral level, although with uncertainty surrounding the position of the US in the run-up to the presidential election, the prospects for multilateral cooperation are likely reduced in the short term.

2 ▪ Staying on the multilateral track

The WTO level is the most relevant to set objectives for subsidy disciplines since bilateral commitments also limit the competitiveness of stakeholders. But multilateral rules on subsidies remain very limited and the use of remedies is difficult.

The Agreement on Subsidies and Countervailing Measures (SCM) dates back to the creation of the WTO in 1995. It targets only the goods sector and only a small part of the subsidies that are considered to affect trade (*e.g.* those intended for export or to strengthen local input or to replace imports, for which some support measures, for specific sectors and under conditions, are acceptable). The complainant has the burden of proof for the injury suffered. The lack of transparency on public funding in some countries makes this difficult and discourages complaints. Finally, countervailing measures can be used to fight

1. "EU-China – A strategic outlook", 12 March 2019.
2. "Covid 19: the urgent need for stricter foreign investment controls", Micol Bertolini and Elvire Fabry, JDI Policy Paper 253, April 2020.
3. *State Aid Scoreboard 2019*, European Commission.
4. This would require not only a review of M&A and anti-trust rules, but also a more extensive use of industrial subsidies.

against import subsidies but not against investments in established foreign companies. These weaknesses have long been identified and the review of the SCM agreement was part of the Doha Round agenda.

Multilateral rules can only be strengthened with the commitment of major powers. For a long time, however, there was hesitation to open this discussion for fear of having to challenge key domestic regimes, as illustrated by the Airbus-Boeing dispute. Then there is the geopolitical and technological competition between China and the United States, which has intensified since the pandemic and President Trump's call to reshore manufacturing production to the United States. This greatly undermines the possibility of reaching a consensus to strengthen multilateral rules in the short term.

The trilateral initiative on limiting industrial subsidies, signed by the EU, the US and Japan on 14 January 2020, almost twenty years after the launch of the Doha Round, is designed to put pressure on China so that it agree to sit down at the negotiating table and reforms its system of unfettered subsidies. The trilateral initiative seeks, among other things, to **expand the list of subsidies prohibited by the WTO**. (including disciplines on unlimited guarantees, subsidies to distressed companies without a credible restructuring plan, investments in sectors with overcapacity, subsidies to companies without sustainable financing plans, and debt write-offs). Moreover, it aims to **reverse the burden of proof** by requiring governments to demonstrate that their subsidies do not distort trade or create overcapacity. It also strives to improve **the notification of subsidies**. These much stricter disciplines would make subsidies that support "zombie" companies (causing overcapacity or lower input prices), virtually prohibitive–unless the subsidising country can prove that there is no major injury.

The trilateral initiative sent a strong signal to its main target, China, and an encouraging signal that the US may support WTO reform. The weight of the three major powers should have been able to encourage a plurilateralisation of the agreement with other partners, which would have paved the way for its multilateralisation in the longer term. But the pandemic has put these objectives on hold, at least until results for the US presidential election are in. Whether Donald Trump or Joe Biden emerges victorious will determine if the US goes down a path of unilateralism or if there is hope for at least some US cooperation and commitment at the plurilateral and multilateral level. China has so far not reacted officially to the trilateral. However, there is an internal debate on the place of the state sector in the Chinese economy, which is defended by some in the name of the communist doctrine and criticised by others who emphasise the need to move towards so-called "competitive neutrality".

Europeans are determined to reserve the option to strengthen multilateral rules in the medium term, as they have only recently begun to use the leverage of bilateral negotiations to limit subsidies.

3 ■ The limit of bilateral commitments on state aid

Although 90% of the regional trade agreements notified to the WTO include clauses or chapters on competition, only 43% include commitments on state aid.[5] For the EU, currently only the countries of the European Economic Area (EEA), highly integrated into the single market for services and goods (except agriculture and fisheries), have implemented a **dynamic alignment with European state aid rules**. The EFTA surveillance authority (ESA) is responsible for the implementation of these rules.

In contrast, the commitments Turkey made in regard to the prohibition of various forms of subsidy and compliance with European rules when it signed the 1995 customs union for industrial goods have not been implemented.

The vast majority of bilateral agreements are limited to a commitment on transparency and the notification of state aid. This simply duplicates the notification obligation that applies to WTO members. However, since 1995 the percentage of WTO members that have notified subsidies has fallen from 50% to 38%[6]. Moreover, only certain sectoral subsidies are subject to a ban (e.g. with Canada export subsidies for agricultural goods, which are also excluded by the WTO since 2015, or with Switzerland on air transport) and there is no dispute settlement mechanism for the chapter on state aid.

5. Competition policy within the context of free trade agreements, François-Charles Laprévote, DAF/COMP/GF(2019)5, OECD, 5 December 2019.
6. "Improving Disciplines on Subsidies Notification", TN/RL/GEN/188, WTO, 2017

Under the framework of the association agreements, for example with Ukraine, the EU is primarily asking its partners to set up a national system of state aid control with an independent monitoring authority.

With the **new generation of European bilateral agreements**, for example those signed with South Korea (2011), Singapore (2018) and Japan (2019), it is nevertheless now possible to develop a "WTO-plus" form of cooperation. This extends the restrictions on subsidies to unlimited guarantees or to distressed companies without a credible restructuring plan. With South Korea and Singapore, it is also planned to extend the disciplines to the services sector. However, there is only a consultation procedure for settling disputes.

It is only recently, in negotiations between the EU and Switzerland, that the EU has started to reinforce its requirements in order to ensure greater coherence between the various bilateral agreements it has signed, and to strike a better balance between the benefits and obligations that the Swiss Confederation derives from broad access to the single market. The 2018 agreement - which has yet to be ratified - establishes an institutional framework for five of the main bilateral agreements negotiated in 1999, including a dynamic alignment with EU state aid rules, the establishment of a dispute settlement mechanism and supervision by the European Court of Justice to ensure a uniform interpretation of EU law. Any new agreement on market access, in particular to the electricity market, should be integrated into this framework.

To fully appreciate the firm position of the EU27 on state aid in the Brexit negotiations, the 2018 agreement signed with Switzerland needs to be given much more attention than the original 1999 agreement. This illustrates that what is in play is not only the future relationship with the United Kingdom but also the European level playing field agenda, for which Brexit is just one piece in the puzzle.

4 ▪ The defining challenge of Brexit

Brussels' initially requested that the UK would dynamically align with European competition rules in order to reach an agreement on Brexit. This was much more demanding than the non-regression clause on social and environmental standards that Europeans have also been asking for. The commitment would be comparable to that of the EEA countries and Switzerland (subject to ratification of the 2018 agreement), although London wouldn't having the same privileged access to the single market, including for goods. Even if an agreement excludes customs duties, the end of regulatory alignment with European technical standards would impose certification checks at the borders (which create additional costs and delays).

In the final stretch of negotiations in mid-October, the EU27 could settle for a clarification of the British government's intentions on the type of regulation and dispute settlement that would be put in place. This could salvage an agreement that mitigates the instability of a no deal scenario in an already difficult economic recovery.

The threat that the UK might break its agreement to withdraw from the EU, which the new UK Internal Market Act would allow, is stirring up suspicion and caution in Brussels. The issue is highly sensitive as it further complicates the management of the Irish border. In the withdrawal agreement, Northern Ireland remains subject to EU competition rules. Companies in the rest of the United Kingdom that benefit from subsidies with an impact on subsidiaries in Northern Ireland could be subject to European rules. However, the UK Internal Market Act permits a unilateral interpretation when UK companies are subject to EU rules. This would allow open the door to ignoring the commitments of the withdrawal agreement.

Moreover, until now London has made only limited use of state aid. For example, it accounted for only 0.4% of GDP in 2017 compared with 0.8% for France and notably 1.3% of GDP for Germany (which represents 30% of all state aid paid in the EU28). However, Boris Johnson built his political campaign in autumn 2019 on the promise to return to an interventionist state with a proactive policy of state aid. Aside from being an issue of bilateral negotiations with the EU, this position is a profound transformation for the conservative party and notably prompted a warning from the former Chancellor of the Exchequer, Philip Hammond.[7] This could also call into question the devolution of competences that are recovered from the EU to the sub-national level. There is a risk that the British government would apply state aid in a highly discretionary manner, which could create distortions of competition even within the British market. The Prime Minister's influential

7. "Hammond warns of return to '70s misery' if post-Brexit state aid not controlled", George Parker, FT, 31 August 2020.

adviser Dominic Cummings advocates a regulatory body that is limited to subsidy notifications and an advisory role, rather than the enforcement of clear and binding rules.[8] In addition to regaining full legal sovereignty, a minimum of commitments would have to be made to third countries as well as to devolved governments (Scotland, Wales, Northern Ireland) to preserve Her Majesty's Government room for manoeuvre.

It should be noted that the bilateral agreement signed by the UK and Japan in September 2020 is limited to the same restrictions that Japan has with the EU and includes subsidies with unlimited guarantees or subsidies to distressed companies without a credible restructuring plan. But while the launch of the British policy on state aid has been postponed until 2021, following a public consultation, the latest bilateral negotiations between London and Brussels would only lay down general principles and a dispute settlement mechanism.

Although the EU has four years after the end of the transition (31 December 2020) to file a complaint and obtain a judgement that can be applied retroactively, it only concerns illegal subsidies paid before the end of this period. This leaves the question, if a clarification of general principles for the regulation of subsidies can be enough to unblock the Brexit negotiations or if the surveillance capacity of the EU would mainly come from its unilateral control of foreign subsidies.

5 ■ Towards unilateral response capacity

To support the commitments on state aid that the EU negotiates in bilateral agreements, the European Commission proposed in a June 2020 White Paper to **give the EU the capacity to respond unilaterally to competition distortions from countries whose subsidy rules are markedly different from European rules**.[9] The instrument would specifically target distortions that are linked to the acquisition of companies and access to public procurement markets within the single market.

Retaliatory measures could be determined based on an assessment of the distortions that are created in the single market. There are several criteria: the amount of applied subsidy, the situation of the beneficiary, the state of the concerned market and the impact of the subsidy, the level of activity of the beneficiary within the single market. The assessment would also include a **principle of proportionality** to evaluate the beneficial effect of a subsidy on the single market compared with the effect of distortions. Retaliatory measures could lead to the cancellation or prohibition of an investment, to financial compensation from the EU or a member state, or to the publication of R&D results to the benefit of other companies. The Commission could be entrusted with the implementation of these controls, while member states would be informed of the final decision in the event of an in-depth investigation. The notification obligation would require information on funding over the last three years, so that cumulative effects can be assessed.

The details of the instrument will not be specified until the end of the consultation period. It is clear that there is a strategic dimension to quickly adopt this instrument. While it targets first and foremost China as a "systemic rival", it can also **facilitate the governance of future relations with the United Kingdom, by reversing the burden of proof on the British side that is has not engaged in unfair practices**.

The post-Covid era encourages unlimited public intervention and we should anticipate the risk that there could be significant new distortions of competition. Beyond the multilateral and bilateral objectives to which the EU remains committed, as well as the requisite medium- and long-term guarantees, the rapid adoption of a unilateral response instrument to control the impact of foreign subsidies now deserves the active support of all member states. Whether or not the EU27 and the United Kingdom reach an agreement on their future relations will certainly affect the capacity of both parties to revive their economies. But **Europeans can still mitigate the risk of unfair competition from an offensive British state aid policy if they speed up the implementation of foreign subsidy controls**. Such an initiative could also be taken up by other partners and in the medium-term lead to the negotiations for a multilateral framework on state aid.

8. "Cummings leads push for light-touch UK state-aid regime after Brexit", Peter Foster, FT, 27 July 2020.
9. White paper on levelling the playing field as regards foreign subsidies, COM(2020) 253 final, European Commission, 17 June, 2020.

Institut Jacques Delors
Penser l'Europe • Thinking Europe • Europa Denken
18 rue de Londres 75009 Paris, France • www.delorsinstitute.eu
T +33 (0)1 44 58 97 97 • info@delorsinstitute.eu