Submission from Professor David Bell
Legislative Consent on the UK Subsidy Control Bill
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Introduction

This note discusses the Subsidy Control Bill (the Bill), currently going through the UK Parliament and the response to the Bill contained in the Scottish Government's legislative consent memorandum. It begins by explaining how the Bill came about. It then discusses the historic role of subsidies (state aid) in both Scotland and the UK and their current importance in terms of government spending. It goes on to discuss the implementation of the Bill. The final section concludes.

Part 1: How the Subsidy Control Bill came about

1. State Aid was previously overseen by the European Union. Disputes were resolved by the European Court of Justice (ECJ)[1]. Brexit required a change to these arrangements. These proved a major bone of contention in the negotiations on the Trade and Co-operation Agreement (TCA) between the UK and EU.

2. The UK Government now uses the terminology "Subsidy Control", while the EU continues to use the term "State Aid", though they essentially refer to the same set of issues. In the TCA negotiations the EU wanted to ensure a "level playing field", so that its companies were not undercut by state-subsidised competition from UK companies. The UK was keen not to be bound by decisions of the ECJ. The final agreement embodied much of what was previously in the State Aid regulations, but removed the link to the ECJ at least as far as Great Britain is concerned. Whether the ECJ will have a role in Northern Ireland is dependent on the current negotiations between the UK and EU over the Northern Ireland Protocol.

3. The TCA agreement enjoins the UK and EU to put in place "systems of subsidy control" in which the granting of a subsidy by a public body to a "beneficiary" (usually a firm) respects the following six principles:
   (a) subsidies pursue a specific public policy objective to remedy an identified market failure or to address an equity rationale such as social difficulties or distributional concerns ("the objective");
   (b) subsidies are proportionate and limited to what is necessary to achieve the objective;
   (c) subsidies are designed to bring about a change of economic behaviour of the beneficiary that is conducive to achieving the objective and that would not be achieved in the absence of subsidies being provided;

[1] Because disputes inevitably arise between the signatories of a trade treaty, there must be an arbitration mechanism whose decisions all parties agree to accept. These mechanism work in different ways, some more effective than others. The UK Government has had a particular problem with the ECJ.

(d) subsidies should not normally compensate for the costs the beneficiary would have funded in the absence of any subsidy;
(e) subsidies are an appropriate policy instrument to achieve a public policy objective and that objective cannot be achieved through other less distortive means;
(f) subsidies' positive contributions to achieving the objective outweigh any negative effects, in particular the negative effects on trade or investment between the Parties.

The point of these principles is to use them to identify unfair subsidies, which violate one or more of these principles and which would then give grounds for either the UK or EU to raise a complaint.

4. Since there was no existing "system of subsidy control" within the UK prior to the TCA, the UK Government was obliged to enshrine the six principles in law to ensure that they were respected by all public bodies in the UK. This was the genesis of the Subsidy Control Bill. The UK Government had many options about how it might frame this legislation, in terms of the institutional framework within which adherence to the principles was to be assessed and enforced.

Part 2: How important is State Aid in Scotland and the UK?

1. Before considering the details of the Bill and the Legislative consent memorandum, it is worth setting out what is meant by state aid, what are the arguments in favour and against its use as well as the historical record of state aid provision both in Scotland and the UK as a whole. We begin with a discussion of where state aid fits within industrial policy.

2. Governments have a range of policy options to support industry and economic growth. It is important to distinguish between 'horizontal' and 'selective' industrial policy. Crafts (2017) describes horizontal industrial policy as addressing a

   "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 (R&D), where social returns exceed private returns, by avoiding the imposition of high marginal direct tax rates, by recognizing 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." Crafts(2017)

Spending on education, industry-related training, infrastructure (e.g. transport or IT), research etc. does not violate existing EU state aid rules. Though the principles are very abstract, it is unlikely that they would violate the six principles that underpin the Subsidy Control Bill. This is important because it implies that the Scottish Government will be able to introduce horizontal industrial policy measures, such as those described above, without fear of being in breach of the Subsidy Control Bill.

3. It is “selective” industrial policy that is more contentious because it involves governmental support for individual firms – a process sometimes described as “picking winners”. At a UK level, the history of such selective support has not been littered with success stories – British Leyland is a notable example of failure. In Scotland, the Auditor General (2021) in his review of the Scottish Government Consolidated Accounts pointed out that the “Scottish Government has taken an increasing role in providing financial support to private companies”. Pointing to the financial difficulties of Prestwick Airport, Bifab and Ferguson Marine, he argues that “The Scottish Government needs to clearly outline its plans for future investment in private companies to ensure there is greater transparency over financial support provided and the value of public funds committed.” Whereas one might wish to have the power, in principle, to provide support for individual companies, the inevitable implication is that, in so doing, the Scottish Government is taking on additional risk and there is no guarantee of a successful outcome either financially or in terms of jobs.

4. However, it is also important to consider selective assistance to “beneficiaries” in the round. There will be some failures, but there may also be successes. Mazzucato (2011) argues that history suggests that the state has a vital role in risk-taking and bringing forward innovation. Thus, essential aspects of modern life from the iPhone to the internet to touchscreen displays and a plethora of drugs were all built on government-funded research. However, much of this research may have been “horizontal” in the sense that it was not aimed to benefit a single beneficiary.

5. The scale of subsidies/state aid provided by UK public bodies in 2014 is shown in Table 1 below (in €000s). The total value of subsidies was €7.5bn, still small relative to total UK public spending.

Table 1: UK expenditure on state aid, 2014 (€m)

Environmental protection and energy saving	2714.3
R&D and innovation	1594.8
SMEs	1346
Regional development	782.3
Sectoral development	8.2
Other	1085
Total	7530.6

Note: Total excludes agriculture and
transport.
Source: European Commission (2016)

6. The Scottish Government will have committed spending under most, if not all, of the categories of expenditure shown in Table 1. It also spends more per head on economic affairs than the UK average. This is shown in Table 2, which gives expenditure per head on components of economic affairs relevant to state aid for 2019-20 in the home nations. The expenditures are shown relative to a UK value of 100. Thus, for example, Scotland spent 39 per cent more per head on economic affairs than the UK average in that year.

Table 2: Expenditure Per Head on Economic Affairs 2019-20 (UK=100)

	Economic affairs	… of which				
		enterprise and economic development	science and technology	employment policies	agriculture, fisheries and forestry	transport
England	96	92	104	97	79	98
Scotland	139	146	95	118	186	137
Wales	98	117	71	101	183	81
Northern Ireland	119	173	43	137	343	70
UK	100	100	100	100	100	100

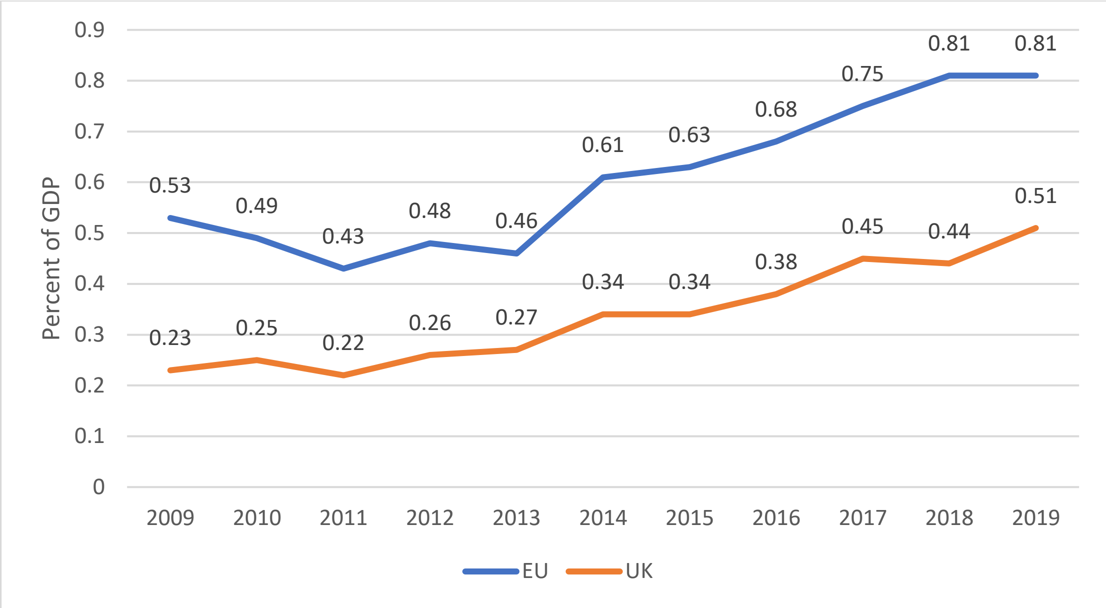
Source: Public Expenditure Statistical Analysis, HM Treasury

7. It is understandable that Scotland spends more per head on agriculture, given its greater relative importance to the Scottish economy. Also its relatively larger land area per head of population explains higher spending on transport. But in other areas of spending the reasons for differences compared with other parts of the UK are more difficult to explain. Scotland now spends 9 per cent less per head of population on science and technology than England, but 18 per cent more on employment policies. It is not clear why this is the case, and this finding is certainly worthy of further investigation, though beyond the scope of this inquiry, but it is also important to realise that policies to support R&D and employment are likely to be “horizontal” i.e. they support the economy, or even particular sectors, in general, rather than individual firms.

8. It is spending on “enterprise and economic development” that is more likely to be targeted on individual companies and is therefore more likely to have to be registered as a “subsidy” under the Subsidy Control Act. And spending in this area is 46 per cent higher in Scotland than the UK average. The relatively high level of spending on “enterprise and economic development” in Scotland suggests that there will be significant scope for conflict between the Scottish Government and the UK Government in relation to subsidy control.

9. The UK spends less than most EU countries on state aid. Figure 1 compares the percent of GDP spent on state aid in the UK and EU as a whole from 2009 to 2019. It is clear that UK spending on state aid is consistently and significantly lower than that of the EU as a whole. The new regime for subsidy control is, in some ways, more rigorous than the previous EU regulations. It will be interesting to see how more rigorous subsidy control can be made compatible with the UK Government's levelling up agenda.

Figure 1: Percent of GDP Spent on State Aid UK and EU 2009-2019



Source: European Commission

Part 3: How will the Subsidy Control Bill be implemented?

1. Under the TCA, the UK must notify the EU of subsidies to firms that have an actual or potential effect on trade and investment between the UK and EU. Grants to firms of less than £315,000 are exempt. In the short-term, as far as the EU is concerned, bodies that provide subsidies (e.g. enterprise agencies) "will barely differ from the assessment that they would have had to carry out when granting support that had to be assessed under the EU State aid rules" (White and Case 2021). This suggests that, as far as registering state support with the EU is concerned, there should be little effect on reporting by Scottish public bodies. However, this is by no means the whole story.

2. The Competition and Markets Authority (CMA) has a central role in the implementation of the Bill. The CMA therefore now has a central role in UK market regulation. The Internal Market Act created the Office for the Internal Market (OIM), which will sit within the CMA. Its role will be to monitor and report on the health of the UK internal market, providing technical and economic advice to all four governments of the UK on the effects of

regulations that they pass. Its role will be advisory, but the Act limits the powers of the devolved authorities where these have an adverse effect on traders from other parts of the UK. This a new role that has been placed on the CMA as a result of Brexit.

3. The Subsidy Control Bill places a further duty on the CMA. Specifically, it is required to determine whether a request to provide a subsidy is consistent with the six principles of subsidy control. The Secretary of State (BEIS) may direct public bodies to request a report from the CMA in relation to proposed subsidies. But, as the legislative consent memorandum points out, the devolved administrations have had no response to a request that they also should have the power to request a CMA report on proposals for subsidies made by departments of the UK government that might adversely affect companies within their jurisdictions. Neither is it clear how the devolved administrations in Scotland and Wales could prevent public subsidies paid to firms in Northern Ireland undercutting companies located within the devolved administrations.

4. The CMA now has a central role in market regulation and its operation will come under closer scrutiny than has been the case in the past. Its board currently comprises a mixture of economists and lawyers. Like the Monetary Policy Committee (MPC), it comprises a group of technical experts, none of whom would appear to have specific knowledge of the devolution settlements. But its new roles are much more geographically specific than are those of the MPC. In an Institute for Government paper, Pope and Shearer (2021) argue that the devolved administrations should have representation on the CMA Board. This has not yet happened and appears unlikely. Instead, the Bill places the devolved authorities under a regime that, in terms of the regulation of subsidies, appears more restrictive than was the previous EU regime. This will inevitably create resentment and pressure that the CMA board be constituted differently, given its new roles.

5. However, it should be noted that the CMA now has a substantial presence in Scotland, with over 50 staff in its Edinburgh office. It has also contributed to the activities of the Scottish Parliament as, for example, in its provision of evidence to the Economy, Energy and Fair Work Committee on the establishment of Consumer Scotland (Competition and Markets Authority 2015).

6. The devolved governments are opposed to the Bill partly because it extends beyond the areas previously covered by EU State Aid legislation. Thus, for example, agriculture, which was regulated through the Common Agricultural Policy (CAP), will now be included within the UK Subsidy Control framework even though agricultural subsidies did not form part of the TCA.

7. The Scottish Government legislative consent memorandum opposes this inclusion, perhaps because the inclusion of agriculture within the Bill limits its options for developing a replacement for the CAP. For example, it is not clear

whether a Scottish Government proposal to subsidise sheep farmers in less favoured areas might require referral to the CMA. It might be argued that subsidies to individual farmers would not exceed the £315,000 de minimis limit, but this seems a tenuous argument to enable what might be a multi-million pound subsidy to farmers in the less favoured areas.

8. It is also not clear how the Bill might interact with policies that are intended to move the economy towards net zero. For example, if the Scottish government proposed to subsidise industrial plants to reduces their carbon footprints, would it be forced by the Secretary of State (BEIS) to request a CMA assessment of this action. And what would be the implications for net zero if the CMA found that the subsidy violated one or more of the six principles?

9. Both the Internal Market Act and the Subsidy Control Bill could have been framed to include a role for the devolved governments. In neither case has this happened. For example, both pieces of legislation envisage a substantially increased role for the Competition and Market Authority (CMA). Source: European Commission (2016).

Conclusion

This note has examined some of the issues relating to the Subsidy Control Bill and the Scottish Government's legislative consent memorandum. It begins by drawing a standard distinction between those type of support for industry that are unlikely to run foul of the Bill and those that are not.

It points out that Scotland has spent well above its population share on economic development, some of which may have been directed to individual "beneficiaries". In the future, any such spending above £315,000 would likely require an assessment by the CMA, which has been charged with policing the policy, even though it has no prior experience of such regulation.

It also suggests that Scotland spends more than its population share on economic development which may well involve subsidies to "beneficiaries" and less than its population share on science and technology. The latter is less likely than the former to require scrutiny by the CMA under the Subsidy Control Bill. This has the potential to change the nature of spending on economic affairs in Scotland, towards "horizontal" interventions. Whether or not such a change is beneficial to the Scottish economy, the introduction of the Bill by the UK Government will modify the powers of the Scottish Parliament against its wishes and may force it to change policy direction.

In its requirements, the Bill goes beyond previous EU State Aid regulations and also beyond those contained in the TCA. Thus, for example, the inclusion of agriculture within the Bill may force the Scottish Government to amend its plans for CAP replacement.

Finally, though there may be a principle involved in whether the Scottish Government has the powers to provide support to individual beneficiaries, the practical implementation of these powers must be judicious. Neither the UK nor Scotland have a particularly auspicious record in their selection of firms for financial support, which is a general argument that the balance of industrial support should shift in the direction of “horizontal” policies.

Professor David Bell

Stirling Management School

University of Stirling

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