EU State Aid Laws and British assumptions: a reality check.

Andy Tarrant[•] and Andrea Biondi[*]

1. Introduction.

EU state aid laws do not prevent a future Labour government from introducing necessary radical reform of the British economy. This article explains EU state aid rules – briefly, their primary purpose is to protect a European scale single market and their genesis lies in avoiding the ruinous beggar-thy-neighbour micro-economic policies of the 1930s. Their design is not intended to promote neo-liberalism[1], but, rather, requires that state aid is channelled to support the kind of social market economy associated in particular with Germany, the Netherlands and Scandinavian countries[2]. Developments in EU state aid law in the last few years have made it much clearer what national governments can do in terms of domestic economic restructuring[3]. These legal refinements make it feasible to assess the likely potential impact of EU state aid rules on the pledges made in 2017 Labour manifesto. We have conducted that assessment with respect to each of Labour's 26 specific economic proposals and find that the effect would likely be negligible. Particular concern has been expressed in some 'Lexit' quarters about state aid rules preventing those parts of the Labour programme which favour nationalisation.[4] This is not the case; nor would Lexit in any event be a mechanism for avoiding State Aid laws. Finally, in illustration of our case, we note how state aid rules affected the recent development of a large scale but little known UK not-for-profit public service, the National Employment Savings Trust ("NEST"). This was a new public service set up to provide workplace pensions by the 2005-2010 Labour administration. There were constraints imposed on NEST by the UK government, allegedly deriving from EU state aid rules- but these were entirely driven by British beliefs about EU state aid law and

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[•] Dr Andy Tarrant is Head of Policy and Government Affairs at the People's Pension, a not-for-profit workplace pension provider. Previously he was adviser to Labour shadow Europe and Pension ministers. He is an EU Competition lawyer by training and was Head of Global Government and Regulatory Affairs at BT Global Services; Regulatory Affairs Director at the European Competitive Telecommunications Association; Senior Competition Lawyer, British Telecommunications PLC; and, Head of the International Section at OFTEL. He qualified at Herbert Smith solicitors.

[*] Professor of European Union Law and Director of the Centre of European Law at King's College London, and academic associate at 39 Essex Chambers

[1] " a radical socialist programme that initiated a different approach to state and state ownership, public procurement and managed trade would be deemed illegal under European law" Larry Eliott "Why the moaning? If anything can beat capitalism's fat cats, it's Brexit." Guardian 21 July 2017.

[2] Amendments to the Treaty on European Union agreed at Lisbon mean that a social market economy has been enshrined as an objective of the EU since 2009.

[3] This is not to say that the system requires no reforms at all. It is the case that the European Commission and the Efta Surveillance Authority have discretion over the timeframes in which they clear national aid proposals. This could be a potential concern to an incoming radical UK government. However, to minimise that concern the Labour Party would be advised to engage early with supranational decision-makers to ensure rapid clearances. Such engagement is likely to be facilitated by the fact that most European policy makers would regard the content of Labour's programme as what any self-respecting European administration should already be doing. It is also worth noting that the UK currently spends less on non-crisis related state aid than almost every other Member State as a proportion of GDP and would have to more than triple its expenditure to reach the levels spent by Germany, see the European Commission, State Aid Scoreboard http://ec.europa.eu/competition/state_aid/scoreboard/index_en.html.

[4] Morning Star, To support public ownership – vote for an EU Left Exit, 21 May 2016

UK domestic interests. When finally asked, the EU Commission said these constraints were not required by EU state aid law.

2. A brief history of the EU state aid rules.

The EU state aid rules have been an integral element of the EU since its inception as the European Economic Community in 1957. Three of the countries which signed the original Treaty had Socialist prime ministers, three had Christian Democratic leaders. The purpose of the Treaty was to create a common economic space within which the mixed economies of Europe could prosper and where the economic drivers considered to have fuelled the rise of populist dictators prior to the war could be controlled. State aid rules were designed to meet both these ends. The greater economic space was intended to create a larger market that would generate increased opportunities for specialisation at firm level and the exploitation of national comparative advantage. State aid rules were intended to ensure that individual states would not try and free-ride on this larger common market by providing aid to their national companies at the expense of unsubsidised rivals in other member countries[5]. In the 1920s and 1930s, just such temptations had led countries to provide export subsidies and provoked both tit-for-tat export subsidies and counteracting tariffs; helping create the ruinous economic conditions that lead to the rise of fascist dictatorships. In the early years of the European Economic Community, the Community's institutions focused on controlling aid to private enterprise. A single market could not be created if inefficient national enterprises were propped up, preventing more efficient enterprises in other member states from expanding[6]. In the 1970s and 1980s as countries reacted to oil crises and lack of competitiveness against Japanese and US manufacturing by nationalising and subsidising loss-making national enterprises, the attention of the Community institutions was refocused away from aid granted to private enterprises to controlling aid to state owned enterprises. If economic activities were nationalised and then subsidised to compete, they would have the same potential effect of eliminating the single market as subsidised private national enterprises.

3. Control of State Aid Today.

3.1. Structure of the rules

The drafters of the Treaty were aware that the market does not always deliver and wanted states to have scope to provide aid to enterprises where this was justified. The state aid rules are intended to control the provision of state aid to individual companies to ensure that it can be provided where it meets a public policy goal but cannot be provided where it undermines the single market. So the rules in the EU Treaty are structured as (i) a general rule prohibiting aid from the state to individual

[5] Spaak report 1956, at https://www.cvce.eu/en/education/unit-content/-/unit/1c8aa583-8ec5-41c4-9ad8-73674ea7f4a7/dee61d43-7dc3-4383-a3dc-eb1e9f2e78db.

[6] See M Merola, 'The Forces Shaping State Aid Control in the EU', in L. Rubini & J. Hawkins (eds) *'What Shapes the Law? Reflections on the History, Law, Politics and Economics of International and European Subsidy Disciplines'*- e-book, EUI-University of Birmingham, 2016, 101.

enterprises in principle, and then (ii) a series of exceptions[7], some which are always applicable (for example, aid in the event of a natural disaster) and others which are discretionary. Some of the discretionary exceptions are very wide, for example, aid is potentially permissible "…to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest "8. In order for such exceptions not be a mechanism for undermining the general principle, the rules around their operation are policed by the European Commission and the European Courts. Exemptions are delivered either (i) by individual notification of proposals to the Commission from Member States, which the Commission then assesses case by case and assess whether to approve it or not (ii) by "block" ie. pre-defined categories of legitimate aid that can be granted without any prior notification[9].

3.2. State aid is defined to avoid interfering with general regulation

The Member States adopted particular wording to ensure that EU state aid rules would not interfere with general regulation. To give a hypothetical practical example, while a tax break given to a single or several favoured individual multinationals could be caught by state aid rules, a general national economy-wide cut in corporation tax could not be caught. (Any measures with regard to the latter would require harmonization rules agreed by the Member States). It can of course be difficult to distinguish what consists of a selective measure and what is a general measure when categories of enterprise benefit. Nonetheless,the Court of Justice has held that Member States are entitled to apply a different tax system for cooperative societies in general because of their specific characteristics that distinguish them from corporations.[10] State aid rules do not impede general regulation including consumer protection or labour laws. For example, the European Court of Justice refused to endorse the view in a case dealing with German rules prohibiting speculation in land designated for agricultural uses that as a such a rule potentially constituted state aid for farmers, the state as a rational market operator should always take the highest price [11].

3.3. How is aid assessed as acceptable?

Assessment of the acceptability of aid is intended to be a logical reasoned process. In order for an aid which requires notification to be cleared, the applicant has to show that: (i) it is aimed at making a material improvement that the market alone will not deliver; (ii) there is a logical connection between the provision of aid and a change in the behaviour of the undertaking that receives the aid that will bring about the outcome the aid is intended to achieve; (iii) the aid is limited to the minimum necessary to achieve the outcome, and (iv)

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[7] The key provisions are contained in two articles of the Treaty, now Articles 107 and 108 TFEU and have barely changed since 1957.

[8] Article 107(3)(c) TFEU

[9] For example, Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 TFEU, OJ L 187, 26.6.2014, p. 1–78. For instance, research and development and innovation, to risk capital, broadband, regional aid, aviation, energy and the environment, all these are sectors, are all 'block exempted' areas.

[10] Joined cases C-78/08 to C-80/08 *Paint Graphos* ECLI EU 2011 I-07611.

[11] Case C-39/14, *T. Herbs* ECLI:EU:C:2015:470.

the benefits of the aid outweigh any costs in terms of damage to trade; and (v) the grant is transparent. An important benefit of this reasoned process is that it forces states to transparently assess why they are granting an aid and to demonstrate why there is a reasonable basis for concluding that it is in the public interest[12]. In those areas where no prior notification is necessary, Member states are still required to comply with strict rules on transparency and publications of the aid granted. This 'evidentiary' characteristic of state aid control is thus an important corrective to the susceptibility of the modern state either to be held to ransom by multi-national corporations or to indulge the "corporate welfare state"[13] Without the EU framework obliging Member State to direct scare aid resources to impoverished regions or innovation, spending would likely be even more skewed to big corporations and already favoured regions. Multinationals would tour national capitals demanding greater subsidies.

3.4. State aid does not prevent the state from investing in public enterprises.

The EU Treaty enshrines the right of Member States to run public enterprises should they choose. The state aid rules do not interfere with this right. State aid rules shape what Member States do depending on whether there is a functioning market or not, Where there is *a functioning marke*t the state's investment must be a rational economic investment of the type a private investor would also make. This principle is now known as the '*market operator principle*[14]*. I*n the second situation it is important to note that the EU state aid rules do not require that the state only operate profitable public services. Where a Member State decides that a service ought to be provided to meet a need, and it is at liberty to define the need, but where there are no economic actors capable of offering that service, the member state is free to set up a subsidised service[15]. Indeed, the Court has recently set out a set of circumstances which avoids the funding of many public services being brought within the state aid rules at all and therefore avoids the need for notification (see section 4.3 below).

3.5. The political economy of state aid

To summarise, and in general, a Member State cannot subsidise a private enterprise operating on an existing market but can invest in one, it cannot subsidise (but can invest) in a public service operating on an existing market, and, it can subsidise a public service operating where there is no viable market. These general rules do not sound much like neo-liberalism[16]. They do fall within what is usually considered the classic exposition of European

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[12] Note the standard of proof a balance of probabilities one whereas, at least in the NEST case, UK officials seemed to apply the criminal evidential test of beyond reasonable doubt, making the case more difficult.

[13] K Farnsworth (2013) "Public Policies for Private Corporations: the British Corporate Welfare State" 21(4) Renewal 51.

[14] Notice C-2016 Commission Notice on the notion of Aid ex Art 107 (1) TFEU OJC 262, 19.07.2016, p.18.

[15] Joined Cases C-341/06 P and C-342/06 *UFEX* ECLI:EU:C:2008:375.

[16] Neo-liberalism can be defined in many ways. Nicol in part uses the following definition " a model of societal relations in which government regulation and social welfare guarantees are reduced in order to foster the play of market forces driven by private enterprises pursuing profit maximisation" and "an almost doctrinal fixation on free trade, privatization and small government, and unfettered markets to foster economic growth and wealth generation, as opposed to government action and collective bargaining to promote social and economic equality." Nicol (2009) The Constitutional Protection of Capitalism, p.3.In practice in his book he

social democracy, encapsulated in the German Social Democratic Party's 1959 Bad Godesberg formulation: "The market where possible; the state where necessary"[17].

4. More recent developments in the EU state aid rules.

There have been a number of important refinements of the state aid rules during the last few years and they underline that state aid rules do not prevent government spending but channel it in particular ways. Indeed, in one important respect these developments protect government spending generally by targeting state sponsored tax evasion. These developments have been at the behest of the Member States which renegotiated the Treaties to make it clear, not least to the Commission and the European Court of Justice, that competition was a tool, not a goal of the European Union[18].

4.1. Industrial policy.

The approach of the EU has followed the direction taken by northern European countries like Germany, which have never taken the Anglo-Saxon view that industrial policy was a mistake[19]. What has changed in the northern European countries since the 1970s has been a move from what is described as "vertical" to "horizontal" industrial policy. Instead of picking individual "national champions", it is about setting policy frameworks (which can include aid, but aid available to any qualifying applicant, for example, aid for research and development) and then letting arm's length agents compete within the frameworks.[20] Horizontal does not necessarily mean economy-wide, policies are tailored to specific sectors. EU industrial policy, for example, particularly seeks to support advances in advanced manufacturing technologies for clean production; key enabling technologies for all industrial production (micro- and nanoelectronics, advanced materials, industrial

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narrows it down to "…above all the choice between markets and public sector monopoly." Ibid,p.1. While public monopolies could be preferable to private monopolies (depending on the availability of other regulatory tools), few would argue that they were an appropriate tool for the ubiquitous pursuit of social and economic equality on all markets and this has generally been the dividing line in political economy between communists and social democrats since the late nineteenth century, see, for example, Bernstein, E. "*Evolutionary Socialism: A Criticism and Affirmation*, Random House, 1961 (originally published in German in 1899).

[17] Fletcher, R. (1987) "Bernstein to Brandt. A short history of German social democracy", p.197.

[18] In the negotiations over the Lisbon Treaty, the UK lost an argument over the content of the objectives of the EU. Article 3(1)(g) was removed. Article 3(1)(g) included as a primary objective: "(g) a system ensuring that competition in the internal market is not distorted." President Sarkozy explained: ". This perhaps gives a little more humanity to Europe. Because as an ideology, as dogma, what did competition give to Europe? It has given less and less to the people who vote at the European elections, and less and less to the people who believe in Europe. There was perhaps a need to reflect. I believe in competition, I believe in markets, but I believe in competition as a means and not an end in itself. This may also give a different legal direction to the Commission. That of a competition that is there to support the emergence of European champions, to carry out a true industrial policy. It was not question of making an economic Treaty or a liberal Treaty and explain it to the citizen. It was a question of turning our backs to ideology, dogma and naivety." Cited in Riley, A. (2007) The EU Reform Treaty and the Competition Protocol. Undermining EC Competition Law. CEPS Policy Brief, No.142, September 2007

[19] A Tarrant (2012) "Interview with Mathias Machnig – a modern economy must be green and hot" Policy Network

[20] P.A Buiges, and K Sekkat, (2009) Industrial Policy in Europe, Japan and the USA. Amounts, Mechanisms and Effectiveness. Basingstoke: Palgrave Macmillan.

biotechnology, photonics, nanotechnology); bio-based products; encouraging the construction industry to becoming more sustainable; clean vehicles and vessels; and smart grids[21]. The EU has also set itself the objective of increasing the level of overall EU GDP coming from manufacturing by 2020. The role of state aid rules in this context is two-pronged (i) to prevent Member States propping up unsuccessful national firms so that resources go to those which are capable of delivering the goods and services of the future, and (ii) to remedy any market failures, such as insufficient support for research development in priority areas, inadequate flows of capital to SMEs, or inadequate infrastructure which jeopardise the ability of any firm to participate: "State Aid rules provide a framework that directs Member States' investments to address identified market failures"[22]. The EU has also, like Germany, put sustainability as an organising principle for industrial policy[23]. For example, in order to accelerate the flow of state investment in this area, Member States do not have to seek authorisation for aid to the private or public sector which assists enterprises to meet standards which Member States wish to set and which go further than mandatory EU environmental standards[24].

4.2 State aid rules against corporate tax evasion.

Since June 2013, the Commission has been investigating the tax ruling practices of Member States. A dedicated Task Force Tax Planning Practices was set up in summer 2013 to follow up on public allegations of favourable tax treatment of certain companies voiced in the media and in national Parliaments. "Sweetheart deals" for individual companies fall within the definition of state aid since a measure by which the public authorities grant certain undertakings favourable tax treatment places them in a more favourable financial position than other taxpayers. In a series of investigations, the Commission found against individual tax rulings granted by Ireland, Luxembourg and the Netherlands.[25]

4.3 A Market with limits: Public Services Obligations

The definition of State aid - and consequently the scope of State aid rules - has boundaries. The Court of Justice has held that compensation for the discharge of public service obligations would not be considered as aid. In the *Altmark* case[26], the Court of Justice set out specific criteria to be met when subsidy for when funding for public services falls outside state aid:

"(...) First, the recipient undertaking must actually have public service obligations to discharge and those obligations must be clearly defined (...) :

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[21] Commission (2012) 'A Stronger European Industry for Growth and Economic Recovery — Industrial Policy Communication Update (COM(2012) 0582).

[22] EU Commission Communication, (2010) "An Integrated Industrial Policy for the Globalisation Era Putting Competitiveness and Sustainability at Centre Stage", p.10.

[23]. Ibid. See the similarities with the SPD's Green Industrial Policy, B Mikfield, (2011) Ecological Industrial Policy .A Strategic Approach for Social Democracy in Germany Friedrich Ebart Stiftung.

[24] COMMUNICATION FROM THE COMMISSION Guidelines on State aid for environmental protection and energy 2014-2020 (2014/C 200/01) 28/6/2014.

[25]Ireland for Apple Sales International and of Apple Operations Europe; the Netherlands for manufacturing activities of Starbucks Manufacturing EMEA BV Luxembourg for the financing activities of Fiat Finance and Trade Luxembourg for the activities of Amazon, at http://europa.eu/rapid/press-release_IP-14-663_en.htm. The recovery decision against Apple is at http://europa.eu/rapid/press-release_IP-16-2923_en.htm

[26] Case C-280/00, *Altmark Trans and Regierungspräsidium Magdeburg* (*Altmark*), ECLI:EU:C2003:415.

(...) Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner (...)
(...) Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public services obligation, taking into account the relevant receipts and a reasonable profit[27] (...)
(...) Fourth, where the undertaking which is to discharge public service obligations , in a specific case, is not chosen pursuant to a public procurement procedure, which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs, which a typical undertaking, well run and adequately provided within the same sector would incur, taking into account the receipts and a reasonable profit from discharging the obligations."
The Altmark judgement has now been fully incorporated in a series of Commission instrument aimed at clearly sheltering public services obligations (the so called "Almunia package"). Thus measures aimed at funding 'social' services (schools – hospitals – sports centres and so on) can be exempted ex ante from any control[28]. Even if funding did not meet all the Altmark criteria, an aid can nonetheless obtain clearance from the European Commission if the aid is to provide a service of general economic interest ("SGEI") and prohibition of the aid would obstruct the performance of the particular public service assigned to the body. SGEIs are not defined. It is within the scope of the Member State's discretion to decide that a service is of general economic interest and should be publicly provided if private undertakings will not provide to the same "extent or under the same conditions" as the Member State considers to be in the public interest[29]. Lifting the prohibition on an aid must not affect the development of trade between Member States to an extent which would be contrary to the interests of the Union.

4.4. Targeting of controls

The widespread observance of EU state aid rules is in practice relatively recent. It really only began to be taken notice of by many national public services in the later 1990s. Experience of reviewing a much greater number of cases since then has led the Commission to conclude that there are many forms of state aid that do not need to be notified and can be assumed to be in conformity with the rules as long as they meet criteria in the state aid block exemption[30]. These include national public investments in roads, inland waterways, rail, and water distribution networks, local public investments in broadband, research and energy infrastructures, hospitals, old age homes and regional urban development funds,

[27] Note this is an upper boundary. The state is not required to ensure any profit. The rule is there to prevent over compensation.
[28] Commission Decision of 20 December on the application of Article 106(2) of the Treaty on the Functioning of the European Union to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest [2012] OJ L7 p 3.
[29] European Commission "Communication from the Commission on the application of the European Union state aid rules to compensation granted for the provision of services of general economic interest", OJC 8/4 of 11.1.2012, para 47
[30] http://europa.eu/rapid/press-release_MEMO-17-1342_en.htm

culture and heritage conservation, audio-visual works, sports and recreational infrastructures[31].

5. Labour Party manifesto and state aid rules

Our assessment is that of the 26 specific economic measures set out in Labour's manifesto at the 2017 Election, most (17) do not even potentially fall within the scope of the State Aid rules. Of those that could, 7 are likely to fall within block exemptions, for example, infrastructure spending is not an aid unless it directly competes with already existing privately funded infrastructure. This likely leaves only two measure which might have to be notified: the state investment bank/regional bank proposition and the state funded regional energy suppliers. This assessment is of course provisional, as the analysis depends on the precise content of Labour's plans. Nonetheless, the provisional analysis suggests that Labour has plenty of scope to act in these areas without any impediment from state aid rules. With respect to the banks, it is worth noting (i) that the UK has already had clearance for state banks to provide investment to SMEs and for renewable energy, and (ii) that EU's general policy is to increase state aid, where justified, to SMEs and for renewable energy. With regards to regional energy suppliers, the proposed reason for intervention is to reduce excessive profits, so there would appear to be ample scope to operate profitable public enterprises which did not require aid. The recent European Commission Guidelines on environmental protection and energy exempt aid for renewable energy projects below certain thresholds altogether and set out the conditions under which it can be cleared if it is above the threshold.[32]

[31] Commission press release, State aid: Commission exempts more aid measures from prior notification, 21 May 2014

[32] Communication from the Commission — Guidelines on State aid for environmental protection and energy 2014-2020 *OJ C 200, 28.6.2014, p. 1–55*