Financial and legal barriers to the creation and operation of a British national investment bank

Rob Calvert Jump
Department of Accounting, Economics and Finance,
University of the West of England

Natalya Naqvi
Department of International Relations,
London School of Economics and Political Science

UCL Institute for Innovation and Public Purpose

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Contact Details

Rob Calvert Jump:
Department of Accounting, Economics and Finance, University of the West of England, rob.calvertjump@uwe.ac.uk.

Natalya Naqvi:
Department of International Relations, London School of Economics and Political Science, n.naqvi@lse.ac.uk.

1. Summary

There is growing momentum in the UK for the creation of a British National Investment bank (NIB) that would bring the UK into line with other large advanced economies, all of which have NIBs of varying forms and sizes. This is due to both the UK's poor track record in providing patient finance (Mazzucato and Macfarlane, 2017) and because of the threat of Brexit which would involve the European Investment Bank (EIB) winding down its significant UK lending activity (House of Lords, 2019).

The Labour Party introduced plans to create a NIB in its 2017 manifesto, with a supporting document entitled, "A National Investment Bank for Britain: Putting Dynamism into our Industrial Strategy" laying out some of the key characteristics of the policy (Labour Party, 2017). This policy note examines some of the financial and legal barriers to the creation of a NIB along the lines proposed by Labour.

Labour's proposals for the NIB include a two-tier board structure, in which an operating board would be independent of the government and oversee the bank's operations and executive team. The bank would be financed by an initial equity injection of £20bn, entirely held by the government, and would issue its own bonds to increase the size of its balance sheet to approximately £250bn over a ten-year period. This implies a relatively conservative funding strategy, and the bank would cover its cost of capital in the long run by the pursuit of an on-lending strategy, similar to Germany's KfW, which in turn implies that the bank would not be in competition with private banks. Importantly, the proposals taken as a whole imply that the NIB would be fully owned by the UK government, but would be operationally and financially independent subject to its aims and mandate.

Despite relatively detailed proposals concerning the NIB's mandate, funding structure, management structure, and on-lending strategy, current NIB plans neglect two important points: the manner in which the NIB would impact the public finances, and the potential legal barriers to its operation raised by European Union (EU) state aid rules.

This paper discusses these points in some detail, drawing on Office for National Statistics (ONS) and EU documentation alongside the existing policy literature. The manner in which the NIB would impact the public finances is important above all for political reasons: public debt is a key ideological battle ground in the post-2008 landscape, explaining (among other things) why the Labour Party has felt compelled to announce a strict fiscal credibility rule. The manner in which the NIB's actions might be limited by state aid rules is important for obvious operational reasons, but there is also a political aspect to this issue regarding the UK's future relationship with the EU.

Our conclusions regarding the impact of the NIB on the public finances can be summarised as follows:

1. As the NIB will cover its cost of capital in the long run, and borrowers will not be forced to borrow from it, it will likely be classified as a public sector financial corporation rather than as part of general government.
2. As the UK's headline public debt figures currently exclude public sector banks, the NIB's balance sheet will likely not affect the UK's headline debt figure.
3. Although the NIB's balance sheet will affect the overall PSND figure, its impact will be modest.

Our conclusions regarding the impact of state aid rules on the NIB can be summarised as follows:

1. Under current plans, the actions of a NIB will likely be compliant with state aid rules, as it will not compete unfairly with the private financial sector and will not give recipient firms unfair advantage, as defined by the European Commission (EC).
2. If a future government wants to pursue stronger vertical industrial policies through the NIB, this would best be achieved through remaining in, and reform of, the European Union. Comparison with similar cases, like Germany, show the UK is likely to achieve its industrial policy goals due to its strong position within the EU.
3. In the event of a hard Brexit and no free trade agreement with the EU, the British NIB would be subject to the World Trade Organisation (WTO) Agreement on Subsidies and Countervailing Measures (ASCM) which limits financial subsidies, but is in theory less stringent than the EU rules. However, the British NIB would be especially vulnerable to cases brought by the US, EU, or China, as the UK is a relatively small economy and thus has little bargaining power against them in the WTO.

We treat the first of these issues in section 2 of the paper, and the second in section 3.

2. The impact of the National Investment Bank on the public sector finances

2.1 Would the National Investment Bank be classified as a general government unit or a public sector financial corporation?

The UK national accounts are currently compiled in line with the 2010 European System of Accounts and the accompanying 2016 Manual on Government Deficit and Debt. Although in principle the ONS could develop its own guidelines after Brexit, it is unlikely to do so in the near future given the complexity of such a task. Given this, it is safe to assume that classification of institutions in the national accounts will continue to follow the European system for some time.

Classification of institutions in the national accounts under EU guidelines determines their impact on the PSND, and involves a consideration of the following four questions:

1. Does the institution earn a profit?
2. Is the institution subject to public sector control?
3. Does the institution produce financial services?
4. Is the institution a "market" or "non-market" producer?

Of these, the most important is question 4. Question 1 is unimportant in general, and the answer to question 3 is obvious. Regarding question 2, as the UK government will own the entirety of the NIB's share capital, it will be classified as a public sector institution. Again, this is fairly obvious.

Whether or not the NIB will be a "market" or "non-market" producer is more important, as this determines whether or not it will be classified as a general government organisation or a public sector (financial) corporation:

> "The distinction between a public sector unit being part of general government or a public corporation is determined by the market/non-market test . . . Non-market public sector units are classified in general government and market public sector units are classified as public corporations" (Eurostat, 2013, p.458).

The distinction between "market" and "non-market" producers is relatively straightforward, and hinges on whether the institution charges "economically significant prices" or not, which arise when both of the following conditions apply:

1. The producer has an incentive to adjust supply either with the goal of making a profit in the long run or, at a minimum, covering capital and other costs,
2. Consumers have the freedom to purchase or not purchase, and make the choice on the basis of the prices charged (Eurostat, 2013, p.56).

Based on the Labour Party's proposals discussed in the introduction, the NIB will satisfy both of these criteria as it will be required to cover its cost of capital in the long run and firms (or other banks) will always have the choice of borrowing elsewhere.

Whilst Germany's KfW is classified as a "government-controlled entity classified outside general government", the British Business Bank (BBB) is classified as a general government unit. The reasoning behind this decision has been explained as follows, and is worth quoting at length:

> "The ONS . . . made the classification decision concerning BBB itself. The aim of the BBB is to increase the supply of credit to small and medium (SMEs) as well as providing business advice services. It is structured as a public limited company and it is owned by the Department for Business, Innovation and Skills (BIS). The BBB is clearly a Public Sector unit; however, the BBB does not appear to have autonomy of decision and as such it cannot be considered an institutional unit. The BBB does not appear to own goods in its own right, and appears to be simply taking forward the economic policies of HM Government and transacting on behalf of BIS. Additionally, the information available to the Secretariat does not suggest that BBB is able to make its own business decisions, nor that the transactions it engages in are on its own behalf. It seems that it cannot incur liabilities on its own behalf, and when ONS reviewed its financial accounts, they appear to indicate that the body is just a 'pass through' company, as funds appear to just "flow" through the bank without an accumulation of assets" (European Commission, 2017, p.34).

Thus, the decision to classify the BBB as a general government organisation was based on the following observations:

1. It does not have autonomy of decision.
2. It cannot incur liabilities on its own behalf (in fact, all its funding is raised via government share capital - see British Business Bank, 2018).
3. There is no obvious accumulation of assets on the BBB's own balance sheet.

Significantly, it is *not* classified as a general government organisation because it operates as a non-market institution. Thus, we can conclude that the ONS is highly likely to classify the proposed NIB as a public sector corporation as the following criteria apply:

1. Its share capital will be wholly owned by the government.
2. It will charge "economically significant prices".
3. It will have autonomy of decision, will incur liabilities on its own behalf, and will accumulate assets on its own balance sheet.

2.2 Would the National Investment Bank's balance sheet affect the public sector net debt?

As the NIB will likely be classified as a public sector corporation, its balance sheet will affect the public sector net debt (PSND). This overall debt figure used for domestic purposes is the gross outstanding debt of the government itself, plus the outstanding debt of all other public sector institutions, minus any liquid assets held by the public sector. However, the headline figure used to gauge debt sustainability - 'PSND-ex' - excludes the net debt of public sector banks, which is currently dominated by the Royal Bank of Scotland (RBS)[1] . As a result, we can reasonably assume that the balance sheet of the NIB will be excluded from this headline figure. The choice of excluding the liabilities of public sector banks from the headline debt figures is justified by the ONS as follows:

> "Unless otherwise stated, the figures quoted in this bulletin exclude public sector banks (that is, currently only Royal Bank of Scotland (RBS)), as the reported position of debt (and to a lesser extent borrowing) would be distorted by the inclusion of RBS's balance sheet (and transactions). This is because government does not need to borrow to fund the debt of RBS, nor would surpluses achieved by RBS be passed on to government, other than through any dividends paid as a result of government equity holdings" (ONS 2019).

As it is highly likely that the NIB would be classified in the same manner as the Royal Bank of Scotland (RBS) for the reasons given in section 2.1, we can be fairly confident that its net liabilities would be excluded from the headline public debt figures whilst being included in the overall PSND figures. Indeed, if one were to replace the words "Royal Bank of Scotland"/"RBS" with "National Investment Bank"/"NIB" in the above quote, the justification would retain its meaning under the Labour Party's current plans outlined in the introduction.

Suppose that the NIB's net liabilities were indeed included in the overall PSND figures, but excluded from the headline figures, and that its balance sheet grew by approximately £25bn per year as implied by the current Labour Party proposals. The implied impact on the public sector finances are illustrated in figures 1 and 2. These graphs utilise the most recent Office for Budget Responsibility (OBR) forecasts for UK PSND excluding public sector banks, and ONS figures for PSND including public sector banks. If we assume that the current increment to the public sector debt caused by public sector banks, i.e. £283bn, is held constant over the forecast period, then we can calculate an implied forecast for the UK PSND including public sector banks using the OBR forecast. Finally, if we entertain the counterfactual scenario that a NIB is established in 2019 with a one-off £25bn equity instalment funded by government debt, and subsequently issues £25bn per year of its own

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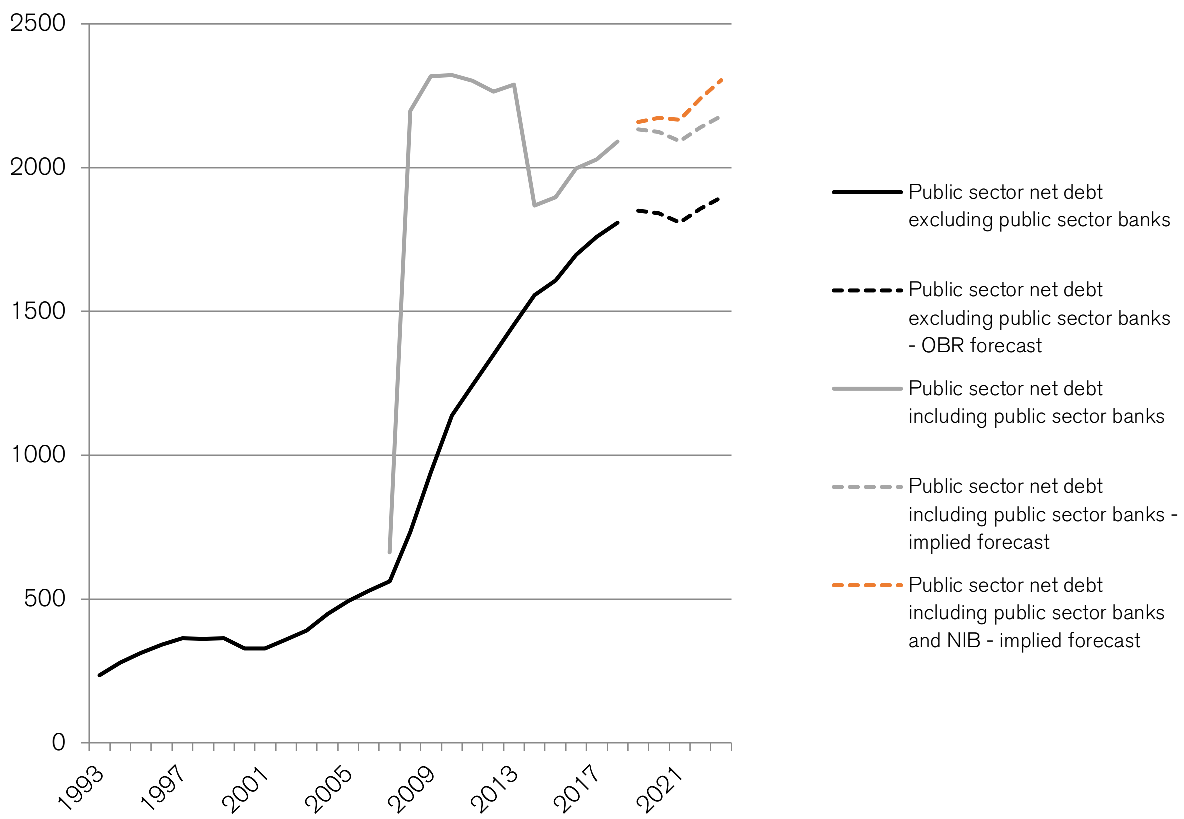
[1] See e.g. any of the ONS public sector finance bulletins, the latest of which is available at https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/january2019. There is a further complication to the UK's manner of public debt reporting, in that its debt target according to the EU's Maastricht criteria is based on "general government gross debt", which excludes the outstanding debt of public sector corporations but does not take into account liquid assets. In the latest release the UK's PSND-ex was 82.9% of GDP, the PSND-ex excluding the Bank of England was 74.4% of GDP, the overall PSND was 96.2% of GDP, compared to Maastricht criteria debt of around 87% of GDP.

bonds until the forecast horizon of 2023, then we can calculate an implied forecast for the UK PSND including existing public sector banks and including the NIB.

As figures 1 and 2 illustrate, the effect of the NIB on the PSND is small. As the forecast horizon is five years, the NIB's liabilities total £125bn at the end of the forecast, raising the implied 2023 forecast of PSND including public sector banks from £2179bn to £2304bn – an increase of around 6%. As the OBR's forecast for nominal GDP in 2023 is £2561bn, the implied 2023 forecast of PSND including public sector banks as a percentage of GDP increases from 85% to 90%, compared to the (unaffected) forecast of PSND excluding public sector banks of 74%. This can be compared to the peak public sector debt of 147% in 2009, following a string of large bank bailouts in the midst of a global recession.

Figure 1: Effect of National Investment Bank on Public Sector Net Debt, £bn



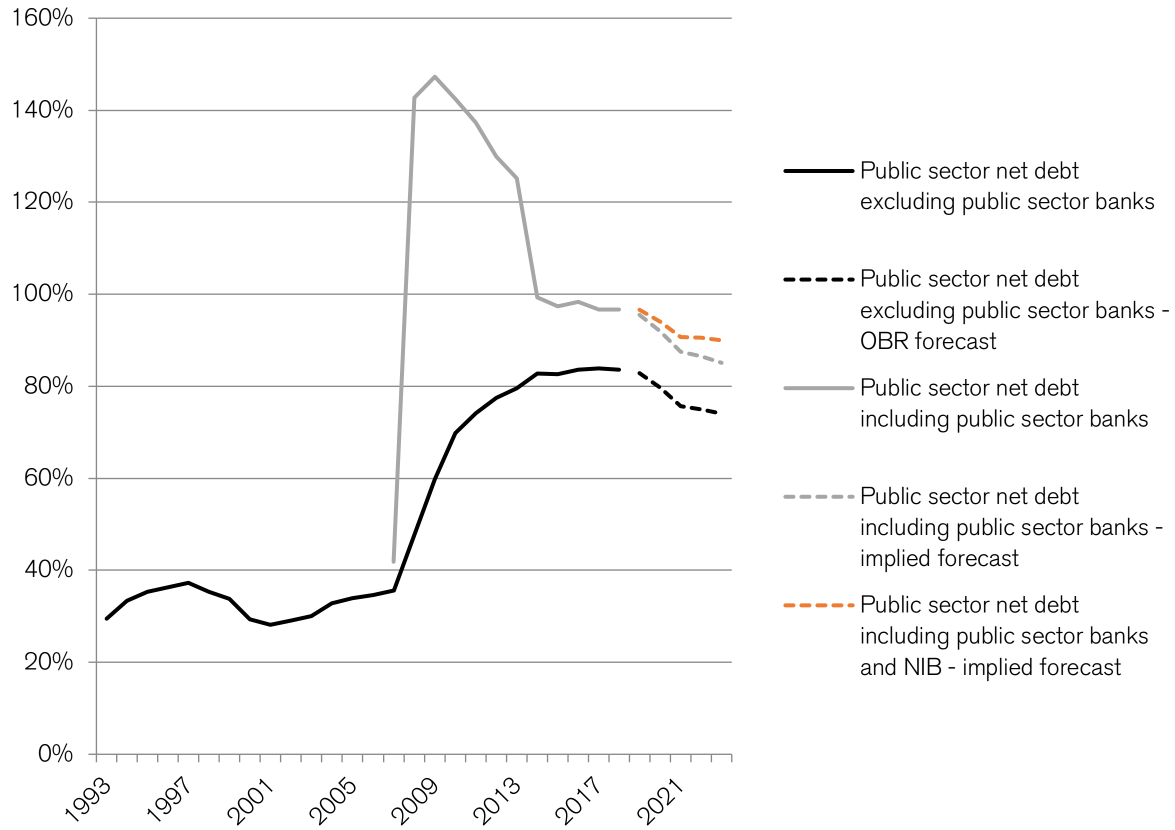
2.3 Summary

Given the foregoing, we can conclude that the Labour Party's current proposals for a NIB would result in the following:

1. Classification of the NIB as a public sector financial corporation in the national accounts;
2. The NIB's liabilities not being included in the headline "PSND excluding public sector banks" figure; and
3. NIB liabilities being included in the PSND figures, but not having a significant impact on this.

Thus, there appears to be no reason to alter current plans at present. As a final point on this subject, however, it is worth noting that the ONS is an independent institution, and the foregoing reasoning and conclusions have not been established in conversation with any employees of the ONS[2] . As the Economic Statistics Classification Committee at the ONS accepts proposals for classification advice on potential future policy, it would therefore make sense for the Labour Party to open a dialogue with the ONS as soon as possible in order to establish exactly the institutional requirements for NIB debt to be excluded from the headline public sector debt figures.

Figure 2: Effect of National Investment Bank on Public Sector Net Debt, %GDP



[2] Although we would like to thank them for pointing us in the direction of certain classification documents.

3. The impact of EU state aid rules on the National Investment Bank

3.1 EU state aid rules and NIBs in comparative perspective

The EU state aid rules are intended to prevent governments from providing subsidies (including grants, interest and tax relief, guarantees, government holdings, etc.) to specific companies or sectors that could distort competition and affect trade in the single market.[3] They are enshrined in the Lisbon Treaty, and enforced by the Directorate-General for Competition[4] of the European Commission (EC).

The viability of Labour's industrial strategy under EU state aid rules has recently been the subject of considerable debate. It has already been correctly pointed out that the UK gives far less state aid compared to nearly all other EU member states, and that this means that the lack of strategic use of state subsidies to date is a result of domestic economic policy rather than any imposition by the EU (Tarrant and Biondi, 2017; Macfarlane, 2018; Morris and Kibasi, 2019). Significantly, in the post-crisis environment, NIBs are now seen by the EC as key partners for its Juncker Plan (EFSI) (2014, p.20), and future InvestEu plan (2021, p.27). One of the important mechanisms for leverage of these investment plans is for the EIB to collaborate closely with national development banks. Not only does the EC see NIBs – national promotional banks (NPBs) in EU terminology – as 'necessary to enhance its impact on investment, growth and employment due to their particular expertise and their knowledge of the local context, business and investor communities as well as national policies and strategies', but goes so far as to recommend that 'Member States that do not yet have an NPB may consider setting one up' (EC, 2015, p.1). A number of member states already have large and active NIBs, including the German KfW, French BPI and CDC, Italian CDP, and Spanish ICO, and a number of other states including Portugal, Ireland, and Latvia have recently set up their own NIB with help from EU institutions. Amongst large member states, the UK is the exception in not having a serious NIB. It has privatised the Green Investment Bank, while the British Investment Bank remains too small to play a meaningful role.

It is therefore safe to conclude that current state aid rules leave sufficient room to establish and operate a British NIB, and that the lack of public banking in the UK to date is due to domestic factors. However, it is still worth assessing where the limits to a future British NIB's activities lie under state aid rules, as a Labour government would arguably need to go even further than the German KfW or the proposed activities of development banks under the Juncker and InvestEu plans, if it is serious about undertaking fundamental economic reform to rebalance and democratise the economy.

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[3] http://ec.europa.eu/competition/state_aid/overview/index_en.html. The full set of rules is available at: http://ec.europa.eu/competition/state_aid/legislation/compilation/index_en.html

[4] D-G Fisheries and Agriculture also carry out state aid control in their respective areas.

3.2 What do the state aid rules say about national investment banks?

According to the legal opinion of EU competition lawyers Tarrant and Biondi (2017), the creation of a NIB is one of the few policies in the 2017 Labour Manifesto that would have to be notified to the EC under state aid rules. In 2015, the EC issued specific guidelines on NIBs due to their important role in European investment plans. According to this guidance, the establishment of a number of new NIBs, including the UK Green Investment Bank and British Investment Bank, was recently approved on the basis that they would focus their operations in areas underserved by private finance due to market failures, in order to avoid crowding out private lending (EC, 2015, p.6). A future British NIB would have to demonstrate the same in order for the EC to approve its establishment.

While EU state aid rules allow member states to establish NIBs, they do limit the range of activities these banks can undertake.

The EC (2015) considers that since NIBs receive state support, which gives them a competitive advantage over private banks[5] , their interventions qualify as state aid if they confer advantage on a selective basis, distort competition, and affect trade between member states, as laid out in Article 107(1) of the Treaty on the Functioning of the European Union (TFEU). Despite a general prohibition on state aid that meets this criteria, a number of exemptions exist where member states are allowed to provide aid through NIBs, termed 'promotional activities' in EU terminology. The first is the de minimis regulation, where aid granted to any one organisation below €200,000 over three fiscal years is considered too small to be market distorting. The second is the General Block Exemption Regulation (GBER), which designates a number of categories where aid is allowed, including for underdeveloped regions, small and medium enterprises (SMEs), research and development and innovation, and environmental protection (see Mazzucato and Macfarlane, 2017, for a full list of activities allowed under GBER). If state aid falls into the GBER, it still has to fulfil certain conditions, including type of beneficiary, and limits on the total project expense, and the percentage of a project's costs that are resourced via state aid. Finally, there exist a number of specific guidelines issued in response to the 2008 crisis such as the Rescue and Restructuring Guidelines, where state aid is allowed.

If the activities of the NIB do not fall within any of these categories, then it may still be permissible, but the member state is required to notify the Directorate-General for Competition ex ante, which will then investigate whether there is a legitimate market failure to be addressed[6].

It should also be noted that if a public bank makes loans on a purely commercial basis[7], this is not considered state aid, and not subject to any state aid rules. It is however required that NIBs'

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[5] In EU terminology, NIB's resources constitute 'state resources', the first of the four state aid criteria laid out in Art 10(1).

[6] This includes consideration of whether there is additionality i.e. the aid should not subsidise activities that would have taken place regardless, and that the aid should not have undue negative effects on competition and trade such as leading to subsidy races. See Morris and Kibasi 2019 for the full range of factors the EC takes into account in its investigation

[7] Loans are considered to be commercial if the NIB can show a commercial entity has made a similar investment at the same terms and time, in line with the Private Market Operator principle, or if the interest rate of loans are above a benchmark reference rate or guarantee fee calculated by the EC (Delloite and Touche GmbH, 2004). See

commercial activities are kept legally separate from promotional activities in order to prevent cross subsidisation. In 2002, following a negotiation on this subject between Germany and the EU institutions, which resulted in the Understandings I and II (*Verstandigung I and II*), KfW was required to hive off its commercial activities into a legally independent subsidiary without state support (KfW-IPEX). The restructuring turned out to be mainly cosmetic in nature, and did not make any significant difference to the range of activities the new KfW Group could undertake, nor to IPEX's funding costs. This was possible because KfW was able to retain tight control of IPEX's activities through representation on its board, and negotiate complex funding arrangements between parent and subsidiary, in order to keep IPEX's cost of funds as low as those of a publicly owned entity (Naqvi et al, 2018). There is no reason why a British NIB couldn't structure its operations and funding arrangements with any subsidiaries in a similar manner to the KfW Group which would guarantee compliance with state aid rules

NIBs are encouraged, though not compelled, by the EC to lend to beneficiaries through commercial intermediaries such as private banks, rather than directly (EC, 2015). This could cause problems if Labour wanted the British NIB to act as a direct lender, given that large and highly concentrated UK commercial banks have not performed well in previous on-lending programmes such as the Funding for Lending Scheme.

Another potential pitfall of state aid rules is that they allow private firms to raise complaints against member states' aids directly to the EC. The 2002 Understandings I and II between Germany and EU institutions mentioned earlier was the direct result of a complaint made against KfW and other German public banks, not by another member state with competing industries, but by the association of German private banks. Similarly, any British NIB would be especially vulnerable to complaints raised by the powerful UK private financial lobby if it perceived the NIB to pose a competitive threat. Ironically then, a key threat to a British NIB's activities could come from the UK's own private financial sector rather than any EU institutions or member states.

3.3 Horizontal and vertical industrial policies under state aid rules

As a general principle, state aid rules allow NIBs to conduct 'horizontal' industrial policies, stipulated in the GBER, which claim to provide public goods that benefit all industries equally, but not 'vertical' or 'selective' ones which focus on promoting or upgrading specific sectors or firms, usually through sector specific subsidies combined with investment related or export performance requirements. Vertical policies have also been called picking winners, or national champions, and were most famously used successfully by the 'East Asian Tigers': Japan, Korea, Taiwan, and Singapore.

The 2017 Labour Manifesto outlines mainly the need for horizontal policies to upgrade manufacturing, such as promotion of R&D and innovation, renewable energies, skills training, SMEs, and infrastructure, all covered under the GBER. A future British NIB should be able to follow this

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http://ec.europa.eu/competition/state_aid/legislation/reference_rates.html for guidance on how reference and guarantee rates are calculated.

mandate and lend on a promotional basis for these priority areas subject to the conditions of GBER, and also across other sectors on a commercial basis, all while being compliant with state aid rules.

However, in order to successfully rebalance the economy towards manufacturing, a British NIB might arguably need to engage in vertical policies, for example through subsidised lending programs targeting the specific high value added, manufacturing sub-sectors identified as important for the economy. If framed in this way, such programs could be non-compliant with state aid rules. For example, while it would be compliant under the GBERs for a British NIB to provide subsidised loans for R&D – as long as it was open to any sector – if the UK were to provide subsidised loans for R&D that were available only for the aerospace or pharmaceutical industries or for specific firms like Rolls Royce or GlaxoSmithKline, it would need to notify the EC, which would then decide whether this was compliant or not.

In practice however, as horizontal and vertical industrial policies are very hard to distinguish, many vertical policies can in fact be legally conducted under current horizontal state aid framework. In a world of scarce resources, supposedly neutral horizontal policies inevitably benefit certain activities or sectors over others, especially if they were designed with those sectors in mind (Chang et al, 2013). For example, under the environmental protection GBERs, Germany successfully promoted its wind and solar renewable energy manufacturers, including large firms like Siemens, Nordex, and Enercon, to become world leaders in the sector, despite Danish firms having the first mover advantage. KfW's special credit programs for renewable energy, all compliant with state aid rules, played an important role in this process of catch up, by providing both domestic investment finance and credit to foreign buyers to create a market for German renewable energy plant and technologies abroad (Naqvi et al, 2018). Similarly, it is also possible to promote manufacturing sub-sectors under the R&D and innovation and SMEs GBERs. Going back to the example used above, even if R&D programmes are not officially limited to a specific sector, advanced manufacturing sectors like aerospace or pharmaceuticals are far more likely than low-tech manufacturing or non-manufacturing sectors to take advantage of such programmes. SME programmes can be designed in such a way that manufacturing SMEs are mostly likely to benefit. This also indirectly subsidises larger manufacturing firms who might be customers of, or sellers to, the SMEs. Physical infrastructure is always location specific: for example, sectors producing bulky goods like iron ore and wheat will be helped by development of seaports and railways, while sectors producing light or perishable goods like flowers or fish will be helped by the development of airports (Chang et al, 2013, p.9). Finally, if they do not fall under the GBERs, sector specific programs can still be compliant with state aid rules if they are notified and the EC agrees that there is a legitimate market failure. The UK has already had a number of sector specific policies approved by the EC, including a large support package for Hinkley Point C nuclear station, and has a high rate of success in getting notified policies approved (House of Lords EU Committee, 2018).

Furthermore, the EU's commitment to horizontal industrial policies has recently been called into question, with the German and French governments calling for amendments to the state subsidies and competition rules to enable them to create 'European champions' to compete against China. EU level industrial policy could potentially move to become more openly vertical, now that this is backed by key member states.

3.4 State aid and power relations within the EU

State aid rules are not set in stone, but rather change over time as a reflection of powerful member states' preferences. State aid rules were not strictly enforced before the 1990 period, when member states were still conducting selective industrial policies. A period of stricter enforcement followed only after member states' domestic politics turned increasingly pro-market. The various GBERs were added over time, influenced by powerful member states' policy priorities. For example, GBERs negotiated after 1998 in the areas of renewable energies and SMEs coincided with those areas to which KfW was already lending at the time. Since the 2008 crisis, state aid rules have seen another shift towards allowing increased intervention, as member states found it desirable to bailout specific sectors including finance, automotives, steel etc. This led to the 2012 State Aid Modernisation Agenda (SAM) which aimed to make granting aid easier and simpler, issued guidelines on rescue and restructuring aid, and expanded the scope of the GBER to include additional categories like broadband, new forms of exempted aid, and increased aid intensities and notification thresholds[8] . The UK, holding a similar position to Germany within the EU, could negotiate for its priority sectors to be included in the GBERs. It could negotiate specific deals governing the activities of the British NIB, as Germany did for its own public banks under the Understandings I and II. It could also push for a more fundamental reform of state aid rules allowing for stronger and more vertical industrial policies. Arguably, this should not encounter heavy resistance from key member states given the recent moves made in this direction in any case with the SAM Agenda and the Juncker and InvestEu Plans' increasing reliance on working in partnership with NIBs.

Any assessments of what kind of constraints a future government would face under state aid rules should be made only with regards to comparator countries like Germany or France, not countries that are in a structurally different position with regards to bargaining within the EU due to their small economies, like Greece or the central and eastern European countries. While state aid law might be applied more harshly to these peripheral member states, powerful ones are less constrained: they are not only able to exert pressure on the design of the rules according to their own preferences, but also circumvent the rules when they do not suit them. Although the EC has a degree of control over the design of the state aid law, it is often unable to issue and enforce these laws over strong member state opposition (Clift, 2012). The example of Germany is instructive in this regard. Not only has Germany managed to shape state aid rules according to its own industrial policy priorities, and exploited room for manoeuvre within the rules to the maximum, it has also been a serial violator of these rules when they do not suit it. While Germany is a serial violator of EU rules[9], UK policymakers often take an overly cautious approach, sometimes even hiding behind state aid rules as a reason for not pursuing interventions, for example, in the recent steel crisis (House of Lords, EU Committee 2018).

[8] http://ec.europa.eu/competition/state_aid/modernisation/index_en.html

[9] https://www.independent.co.uk/news/uk/politics/angela-merkel-germany-breaks-more-eu-rules-worst-bottom-class-a8198271.html

3.5 The British National Investment Bank and Brexit

Currently, as part of the Juncker Plan, the EIB channels significant financial resources to member states' NIBs, guarantees their activities, and provides assistance in the form of technical expertise, especially in infrastructure and SME lending. These co-financing and guarantee arrangements are only expected to increase in importance with the new InvestEU Plan. The EC has also committed to put a special fast tracking process in place to assess state aid compatibility for projects co-financed between NIBs and the EIB within six weeks of receiving notification (EC, 2015). Given that a major complaint of UK policymakers is that the notification process is cumbersome due to long delays, having the option to fast track its activities through co-financing with the EIB would be a valuable option for the British NIB. The British NIB might lose these benefits in the event of Brexit, even though it may be mutually beneficial for a British NIB to independently retain membership in the EIB, as the UK is an important contributing member (Griffith-Jones and Naqvi, 2018).

It has already been pointed out that the UK would still need to abide by state aid or similar rules after Brexit, if the UK were to retain any form of special trading relationship with the EU, including a limited bilateral trade agreement (House of Lords EU Committee, 2018; Macfarlane, 2018; Moriss and Kibasi, 2019). This would be the worst of both worlds, as the UK would be bound to obey state aid rules without having any say in shaping them.

In the event of a no-deal Brexit and no trade agreements with the EU, the British NIB would then be subject to the WTO ASCM which restricts export subsidies and also in principal domestic subsidies to import competing industries. Although the WTO rules are in theory more limited and less easily enforceable than EU state subsidies rules[10], if a case was brought against the UK due to the NIB's activities, it might have much less room for manoeuvre on its own than as part of the EU single market[11] . Given the threat of bilateral retaliation is the underlying means of compensation in WTO dispute settlement negotiations, market size is vital in ensuring favourable outcomes[12]. KfW has narrowly escaped two disputes brought against the EU by the US and Korea because Germany could leverage the threat of countervailing measures closing off the entire EU domestic market to the complainant. Within the EU, the UK is one of the most powerful member states. At the WTO – without being part of the EU common market, which is one of the two largest domestic markets in

[10] See https://publications.parliament.uk/pa/ld201719/ldselect/ldeucom/67/6709.htm for a full list of differences between state subsidies and WTO rules. Most importantly, as the WTO does not have an investigative body like the DG Competition, complaints have to be brought by other member states, and the threshold for removal of a subsidy is higher: complainants must prove the existence of serious threat to the interests of another WTO member as well as the impairment of market access.

[11] Because EU member states are a single market, they are considered a single entity (the 'European Communities') at the WTO.

[12] Because it has no power to impose fines like the EC, the WTO can only punish countries that violate the rules by allowing the complainant country to impose countervailing measures such as tariffs on the exports of the violating country in order to shut off their domestic markets and cause the violator economic harm. Whether the complainant country is able to cause significant harm depends on their domestic market size. A small country can close off access to its domestic market, but if exports to that market are not significant for the violating country, this will have no effect.

the world – the UK is a relatively small domestic market, vulnerable to threats from much larger markets like the US or China.

The best option for allowing a future British NIB the greatest amount of flexibility in its operations would therefore be a remain and reform strategy. While state aid rules undoubtedly place limits on the scope of industrial policy and make it more cumbersome, there is sufficient flexibility under current rules, including for some vertical industrial policies. As it stands, Labour's plans for the NIB as laid out in the 2017 Manifesto seem compatible with the current rules if the UK uses its room for manoeuvre under these rules to the maximum, as Germany does.

However, some might rightly argue that constantly circumventing the rules of the EU state aid system which the UK has agreed to is not a viable long-term strategy, and that being part of a system which disadvantages less developed member states and is biased towards powerful ones is unjust. Indeed, while state aid rules aim to prevent subsidy wars, which the larger member states with greater resources would win, the system remains biased against peripheral countries, as these are less able to shape the rules in their favour and circumvent them when necessary.

These legitimate concerns would also be best addressed through a remain and reform strategy. A future government within the EU could and should push for state aid rules to be fundamentally reformed so that they allow for legitimate vertical industrial policies that are necessary to improve living standards, while preventing excessive competitive subsidisation of private companies, as the state aid rules were originally designed to do. A future government should also make sure that state aid rules do not unfairly disadvantage peripheral member states, and allow them to undertake much needed industrial policies. For example, it could argue for exempting these states from certain state aid regulations, along the principles of the WTO Special and Differential Treatment which specifies a much more flexible set of trading rules for least developed countries, and pushing for a coordinated common industrial policy that benefits not only powerful member states, but also peripheral ones. Given the UK's track record of having a strong influence in shaping EU institutions in a pro-market direction, initiatives to push it in a more progressive direction should have a similar high likelihood of success.

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Gower Street, London, WC1E 6BT

Enquiries:
For any queries or comments on the paper,
please contact: iipp-research@ucl.ac.uk