

THE EU-UK RELATIONSHIP:
REGULATORY DIVERGENCE
AND THE LEVEL PLAYING FIELD

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Abstract

Since the United Kingdom's departure from the EU, policy decisions made by both the UK and the EU will, over time, lead to regulatory divergence and create barriers to trade between the two separate regulatory and legal spaces.

The UK government has already undertaken a comprehensive review of all retained EU law, to reap the benefits of its regulatory autonomy, and specific regulatory reforms have been identified in high-growth sectors. Yet there are some constraints. The UK has committed to respecting certain EU and international standards provided for in the Trade and Cooperation Agreement concluded with the EU. Most notably, a common level of protection is secured in certain areas deemed relevant for the level playing field, such as subsidy control, taxation, labour and social standards and environment and climate, although the strength of the level playing field safeguards differs considerably by area. Moreover, regulatory divergence would come at the expense of single market access.

In this setting, certain regulatory measures and subsidies granted to economic operators could be a potential source of political friction between the EU and the United Kingdom and could lead to future legal disputes under the Trade and Cooperation Agreement. At the first meeting of the Trade Specialised Committee on Level Playing Field for Open and Fair Competition and Sustainable Development held on 12 October 2021, EU and UK representatives addressed issues related to subsidy control (the UK's Subsidy Control Bill and the EU's proposed Regulation on foreign subsidies), specific subsidies (the UK's renewable energy schemes and the EU's Brexit Adjustment Reserve) and several regulatory initiatives on labour and social standards and environment and climate. These technical discussions could prove crucial in limiting the risk of EU-UK disputes arising in level playing field issues.

Keywords: Brexit, EU-UK relationship, Trade and Cooperation Agreement (TCA), level playing field (LPF), regulatory autonomy, regulatory divergence.

JEL classification: F53, K33.

Resumen

Tras la salida del Reino Unido de la Unión Europea (UE), las políticas adoptadas por el Reino Unido y la UE irán dando lugar con el tiempo a divergencias regulatorias y a la creación de barreras comerciales entre estos dos espacios jurídicos y regulatorios separados.

Con el fin de aprovechar los beneficios de la autonomía regulatoria, el Gobierno británico ha emprendido una revisión completa de la legislación de la UE conservada, identificando reformas regulatorias concretas en sectores de alto crecimiento. Existen, sin embargo, algunas limitaciones. En el Acuerdo de Comercio y Cooperación concluido con la UE, el Reino Unido se ha comprometido a respetar determinados estándares europeos e internacionales. En particular, se garantiza un nivel de protección común en determinadas áreas consideradas relevantes para el *level playing field*, tales como el control de las subvenciones, la fiscalidad, las normas sociales y laborales, así como el medioambiente y el clima, si bien el alcance de dichas garantías varía considerablemente según el área. Por otro lado, las divergencias regulatorias tendrán lugar a expensas del acceso al mercado interior.

En este marco, determinadas medidas regulatorias y subvenciones a operadores económicos podrían originar fricciones políticas entre la UE y el Reino Unido, y conducir en el futuro a disputas legales. En la primera reunión del Comité Especializado en Comercio en materia de Igualdad de Condiciones para una Competencia Abierta y Justa y el Desarrollo Sostenible, celebrada el 12 de octubre de 2021, los representantes de la UE y del Reino Unido abordaron asuntos relacionados con el control de los subsidios (la normativa británica en materia de control de subsidios o la propuesta de reglamento de la UE sobre subsidios extranjeros) y subsidios específicos (los regímenes británicos de energía renovable y la Reserva de Ajuste del Brexit de la UE), así como diversas iniciativas regulatorias en materia de normas sociales y laborales, y de medioambiente y clima. Estas discusiones técnicas pueden resultar cruciales para limitar el riesgo de disputas entre la UE y el Reino Unido en el ámbito del *level playing field*.

Palabras clave: *brexit*, relación UE-Reino Unido, Acuerdo de Comercio y Cooperación (ACC), igualdad de condiciones (*level playing field*), autonomía regulatoria, divergencia regulatoria.

Códigos JEL: F53, K33.

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1 Introduction

Departure from the EU marked the starting point of policy autonomy for the United Kingdom and opened up the possibility for regulatory divergence between the two areas.

On 1 January 2021, EU regulations were transferred into UK law in order to provide business continuity at the end of the transition period established by the Withdrawal Agreement.¹ Yet sovereignty and, therefore, the freedom to diverge from EU rules and policies was the main reason for the UK's departure from the EU, and the UK government has already undertaken a comprehensive review of all retained EU law to reap the benefits of its regulatory autonomy.

Some deterrents may nonetheless limit its choices. Regulatory divergences that confer unfair advantages on one of the trading partners are not admissible under the level playing field (LPF) provisions of the Trade and Cooperation Agreement (TCA) which, as from 1 January 2021, following the expiry of the transition period, establishes the new relationship between the EU and the UK on a wide range of areas of economic activity and cooperation. Furthermore, the UK's wish to depart from the EU regulatory framework may prove difficult, taking into account the importance of the EU single market for UK businesses.

In this context, a wide reconsideration of UK policies may be expected, but not necessarily – or at least not for the time being – a large-scale deregulatory exercise.

This paper addresses the issue of regulatory divergence between the EU and the UK in the context of the TCA (section 2) and describes the tools set out to ensure that an LPF exists between the two areas (section 3). It also describes key developments in the implementation and application of the TCA and identifies possible contentious LPF issues. The conclusions drawn are set out in section 5.

¹ The Withdrawal Agreement settled issues associated with the UK's withdrawal from the EU on 1 January 2020 and provided for a transition period up to 31 December 2020 during which the EU would treat the UK as a Member State, but without the right to participate in EU institutions and governance structures.

2 Regulatory divergence

The TCA formally recognises the parties' regulatory autonomy. References to the right to regulate can be found throughout the TCA, which provides for limited regulatory alignment between the EU and the UK, mostly through non-regression clauses in specific areas relevant for the LPF. Dynamic alignment with regard to future standards that could have reduced barriers to trade between the two areas was abandoned during the negotiations. This was primarily the result of the UK's goal to take back control, but also a constraint from the EU side in light of the principle of autonomy of the EU legal order. The EU sought a one-sided alignment, i.e. for the UK to align with any future EU regulations, which was unacceptable to the UK.

Regulatory divergence between the United Kingdom and the EU is expected to increase over time. Likewise, the trade barriers between the two separate regulatory and legal spaces. Even if retained EU law is only partially reviewed, the UK courts will exclusively interpret and apply the relevant regulations, thus contributing to future divergence.

However, it is not yet clear to what extent the UK will use the regulatory autonomy it gained after Brexit. Even though the UK government is committed to maximising regulatory autonomy, there are some constraints.

Some limitations are imposed by the TCA itself. The Agreement includes provisions that oblige the UK to respect certain EU and international standards. Most notably a common level of protection is provided for, as part of the LPF safeguards but also in other fields. The TCA closely reflects the EU energy *acquis*, guaranteeing non-discriminatory access to energy transport infrastructure and an efficient use of electricity and gas interconnectors. It also includes specific provisions aimed at creating a robust LPF in the energy sector. Likewise, in the transport sector, the parties commit to respecting a number of requirements laid down in the TCA and in certain international agreements. These commitments include requirements for road haulage operators, conditions for providing international bus and coach services and specific provisions to ensure an LPF in haulage and air transport. Even in the field of financial services, where the respective regulatory and decision-making autonomy is preserved, the TCA lays down a general commitment to implement international standards in the area of prudential, anti-money laundering and tax avoidance standards.

Moreover, regulatory divergence would come at the expense of single market access. Just like products from every other non-EU country, all UK exports to the EU must comply with EU standards related to safety, health and other public policy purposes. Given the importance of the EU market – by far the UK's largest trading partner for goods – and the EU's role as a global standard-setter, departure from EU regulations could place UK firms at a competitive disadvantage and force them to prioritise the largest market. Similarly, in some areas in the financial services sector and in digital commerce, equivalence or adequacy of UK regulations is required to ensure access to the European markets.

Certain regulatory alignment with the EU could also be influenced by the special status of Northern Ireland. As a last resort, at least in theory, it could lead to certain EU sanitary and phytosanitary (SPS) rules being applied in UK territory in order to reduce checks and controls at the Irish Sea border.

Lastly, the lack of the necessary experience and resources may delay the complex task of replacing EU regulations and having independent UK bodies assume the tasks previously performed at EU level.

Currently, ideas and proposals abound, but key policy decisions have yet to be made. Any change in the regulatory framework will ultimately be a political choice for the United Kingdom. This will be influenced not only by domestic concerns but also by the political relationship with the EU, which could be harmed if frictions related to Northern Ireland are left unresolved.

3 Level playing field (LPF) provisions under the TCA

Not only do regulations create trade barriers, but they may also become a competitive disadvantage for economic operators, which could ultimately result in a race to the bottom between two separate legal spaces. This could occur particularly in the case of relations between the EU and the United Kingdom, in view of their geographical proximity and the high level of economic interconnectedness in terms of trade in goods and services and capital flows.

In order to preserve fair competition between the EU and the UK and prevent distortions in trade or investments that could derive from regulatory divergence or subsidisation, the TCA sets out several tools in selected areas deemed relevant for the LPF: competition policy, subsidy control, State-owned enterprises, taxation, labour and social standards, environment and climate, and trade and sustainable development.

These tools involve safeguards and remedies, such as establishing a common level of protection, admitting future increases in levels of protection and laying down special enforcement procedures. The strength of these measures differs considerably depending on the area.

A common level of protection is secured by specific requirements and non-regression clauses. Under these clauses, neither party shall weaken or reduce the relevant standards below the levels in place at the end of the transition period (31 December 2020) in a manner that affects trade or investment, including by failing to effectively enforce its laws and standards.

Non-regression clauses are provided for in the areas of labour and social standards and environment and climate. In the field of taxation, non-regression clauses are limited in scope. They refer to standards and rules agreed at the OECD level on the exchange of information, interest limitation, controlled foreign companies and hybrid mismatches and also to the legislation applicable in the EU and the UK on public country-by-country reporting by credit institutions and certain investment firms.

As well as non-regression clauses, the TCA also lays down specific obligations in some areas. In particular, it includes general environmental principles such as the precautionary approach and the polluter pays principle, as well as commitments to an effective system of carbon pricing and to multilateral agreements in the area of trade and sustainable development. As regards subsidy control, the TCA establishes binding principles that subsidies must comply with and specific binding principles applicable to key sectors (such as air transport, energy and financial services) or certain types of aid (for instance, rescue and restructuring of ailing companies, unlimited guarantees, export subsidies, services of public economic interest and large cross-border projects). In the field of taxation, the EU and the UK commit to implementing global standards on tax transparency, exchange of information and fair tax competition. They also reiterate their support for the OECD's

Action Plan on Base Erosion and Profit Shifting (BEPS) and affirm their commitment to implementing the OECD's minimum standards against BEPS. Moreover, the TCA sets out obligations for effective domestic implementation in some of these areas (although not in taxation). These include the control of subsidies by domestic authorities and courts and a role for an independent authority or body, as well as appropriate administrative and judicial proceedings in the areas related to labour and social standards and environment and climate.

Having secured common level standards, the TCA allows for future increases in levels of protection, even though this may result in the adoption of rebalancing measures by the other party, as indicated below.

The LPF safeguards described above are enforced by special procedures and remedies. In particular, the TCA envisages a dispute settlement mechanism through consultation and dialogue and the possible involvement of a tailored panel of experts or an arbitration tribunal, leading to sanctions such as the imposition of tariffs or quotas on goods or other market access barriers. It also includes specific unilateral measures: unilateral remedial measures, regarding a subsidy that causes – or risks causing – a significant negative effect on trade or investment; and unilateral rebalancing measures, for cases where significant divergences arise in the areas of labour and social, environmental or climate protection or with respect to subsidy control, resulting in material impacts on trade and investment.

The rebalancing mechanism aims to maintain open and fair competition where significant divergences arise over time, not only due to decisions that lower standards but also where one party decides to strengthen the levels of protection, as this may entail an increase in production costs and hence a competitive disadvantage. In such cases, the party concerned would be able to adopt “appropriate measures” (not specified in the TCA) to “rebalance” the other party’s competitive advantage. As regards its application, much will depend not only on the interpretation of “significant divergence” and “material impacts on trade or investment”, but also on the political use the parties make of the mechanism.

Remarkably, the rules on competition law other than subsidy control, taxation and trade and sustainable development do not provide for remedial measures and are not covered by the rebalancing mechanism. This is in line with the limited scope and relative weakness of the specific obligations envisaged in the TCA in these areas. As regards taxation, in particular, it reveals the EU’s limited ability, through the Agreement, to prevent the United Kingdom from becoming a low-tax jurisdiction should it so wish.

4 Developments in the implementation and application of the TCA and possible contentious level playing field (LPF) issues

4.1 TCA governance provisions

In accordance with the TCA, the EU and the United Kingdom have established a joint body, the Partnership Council, responsible for the oversight and the effective implementation, application and interpretation of the Agreement. The Partnership Council, co-chaired by a member of the European Commission and a representative of the UK government at ministerial level is assisted in its work by the Trade Partnership Committee – which supervises the work of the ten Trade Specialised Committees (including goods, customs cooperation and rules of origin, technical barriers to trade, regulatory cooperation and level playing field committees) – and by eight non-trade specialised committees (such as the energy, air transport, aviation safety, road transport and law enforcement and judicial cooperation committees).

The first meeting of the Partnership Council took place on 9 June 2021. It addressed sanitary and phytosanitary (SPS) measures and customs controls, among other issues. The UK expressed concern about trade restrictions for UK exporters and called for an SPS equivalence agreement, both in the Northern Ireland context and for trade between the UK and the EU. The EU emphasised that in the absence of UK alignment with EU SPS rules (similar to arrangements the EU has with Norway and Switzerland), it could not authorise the import of certain products, stating that equivalence in the SPS area was not an option for the EU and that an equivalence agreement with the United Kingdom would not allow for the waiving of controls.

The Trade Specialised Committee on Level Playing Field for Open and Fair Competition and Sustainable Development (Trade Specialised Committee on LPF) met on 12 October 2021. The EU and the UK discussed issues related to subsidies, labour and social standards, environment and climate and other instruments for trade and sustainable development. The meeting allowed both parties to have technical exchanges on issues of their concern, some of which were further addressed by the Trade Partnership Committee at its first meeting on 16 November 2021.

Since these committees provide a forum for exchanging information, sharing views and identifying possible common solutions, the preliminary technical discussions held in this context might prove crucial in limiting the risk of LPF disputes arising between the two parties.

4.2 TCA subsidy provisions: subsidy control regimes and possible contentious measures

In accordance with the United Kingdom's obligations under the TCA, on 20 June 2021 the government tabled a Subsidy Control Bill, to establish a new subsidy control regime replacing the EU State aid regime.

The Subsidy Control Act sets out several broad principles to be considered by public authorities when deciding whether to grant a subsidy or establish a subsidy scheme. The Subsidy Advice Unit of the Competition and Markets Authority (CMA) will assess whether or not the proposed subsidy complies with the applicable principles, at the voluntary request of the relevant public authority or under a mandatory referral process. In either case, the Subsidy Advice Unit can only issue a non-binding opinion on whether a subsidy is fair, but it does not have the power to approve the subsidy. Nor does the CMA have the authority to handle complaints. The responsibility for enforcement lies with the Competition Appeal Tribunal.

The Subsidy Control Act deviates widely from the EU State aid regime, under which there are limited exceptions to mandatory notification and public authorities must wait for the Commission's decision before they can put the measure into effect. A simpler and nimbler system than the EU State aid regime might entail less rigorous scrutiny and create uncertainties for economic operators as to whether a subsidy is lawful, until this question has been tested in the courts. Yet compliance with the TCA's subsidy commitments should be assessed independently.

As regards the EU subsidy control, at the first meeting of the Trade Specialised Committee on LPF the UK expressed concern about the proposed Regulation on Foreign Subsidies and about how parallel processes for assessing possible distortion under the TCA and the proposed Regulation might be reconciled. For the EU, effective domestic subsidy control in a third country would decrease the likelihood of distortive subsidies and thus the need to apply the Regulation.

Beyond subsidy control regimes, specific subsidies could be a potential source of political friction and of future legal disputes under the TCA. Even though the United Kingdom is not traditionally interventionist, there may be an incentive for the UK government to favour State support in order to gain competitive advantages in trade, in the context of the strategic review of its policies and, probably even more so, in the context of the UK government's levelling up policy which, similarly to the EU's regional and social policies, aims to reduce the imbalances between different areas and social groups in the United Kingdom.

At the first meeting of the Trade Specialised Committee on LPF, the UK's renewable energy schemes were discussed. In this respect, the UK made some clarifications about the Local Content Requirements, i.e. the requirement concerning the percentage of UK content in the supply chain, emphasising that this requirement was non-binding and explaining that the information requested was for statistical and other informational purposes. This requirement was a source of concern for the EU, which did not find the UK's explanations completely satisfactory. The issue was further discussed by the Trade Partnership Committee at its first meeting. The EU expressed concerns that additional explanations received from the UK following the meeting of the Trade Specialised Committee on LPF did not alleviate the EU's legal concerns about the

compatibility of these support schemes with the UK's international commitments under the World Trade Organization (WTO) and the TCA.²

For its part, at the above-mentioned meeting the UK expressed concern about the possible distortive effects of the Brexit Adjustment Reserve and about how the impact on EU-UK trade would be assessed when allocating resources under the scheme. This issue was taken up again at the meeting of the Trade Partnership Committee, where the EU stated that funding under the Brexit Adjustment Reserve would be subject to State aid control by the Commission and assessed under the TCA subsidy control provisions.

4.3 Regulatory developments following the UK's departure from the EU

The UK government has undertaken a comprehensive review of all retained EU law to reap the benefits of its regulatory autonomy. In this context, specific regulatory reforms have been identified by the Taskforce on Innovation, Growth and Regulatory Reform (TIGRR)³ in high-growth sectors such as financial services and investment, data protection, smart energy grids, net zero emission technologies, transport technologies, clinical trials, digital health, agri-environmental innovation, agricultural genomics, satellites and nutraceuticals.

As identified by "UK in a Changing Europe",⁴ some changes to the UK's regulatory framework already put forward since the end of the transition period may lead to significant divergences between the two areas. These include the UK's proposals on data protection, fintech, gene editing, State aid and environmental regulations, mostly designed to reduce the administrative burden on businesses and increase trade and/or innovation. According to the same analysis, the EU's proposals on carbon emissions, chemicals, medical devices and copyright could also lead to significant divergences between the two areas.

However, not all regulatory divergences will be relevant under the TCA provisions on LPF. At its first meeting, the Trade Specialised Committee on LPF discussed several regulatory initiatives on labour and social standards (the UK initiative for a Single Enforcement Body and the EU's Occupational Health and Safety Strategy 2021 and European Social Charter) and on the environment and climate (the UK's climate agenda and Environmental Bill and the EU's Fit for 55 package and 8th Environmental Action Plan).

The UK's planned Freeports are another possible source of friction that was not discussed by the Trade Specialised Committee on LPF. These are specially designated economic zones within UK territory but outside the country's customs borders where normal tax and customs rules do not apply. Their aim is to make the UK more attractive to foreign investment. They are intended to act as national hubs for global trade and innovation, and

² As the first step in WTO dispute settlement proceedings, on 28 March 2022 the EU requested consultations at the WTO with the United Kingdom on the UK's discriminatory practices when granting support for green energy projects.

³ The TIGRR was created in February 2021 to seek out opportunities to take advantage of regulatory autonomy to support innovation and growth.

⁴ See the UK-EU Regulatory divergence tracker which compiles the most significant cases of divergence in regulatory standards between the UK and the EU.

to stimulate the local economy through increased investment and business activity. The UK government's Freeports policy includes a comprehensive package of measures, comprising tax reliefs (such as enhanced capital allowances, relief from stamp duty, and employer national insurance contributions for additional employees), customs measures (allowing businesses operating inside designated areas in and around the port to manufacture goods using imports entering the Freeport custom sites, before exporting them again without paying the tariffs and benefiting from simplified customs procedures), business rates retention, planning, regeneration, innovation and trade and investment support. Eight locations have now been selected in England and the UK government is committed to establishing at least one Freeport in each of Scotland, Wales and Northern Ireland as soon as possible. Although special economic zones are also allowed in the EU under some conditions and the impact of the UK's Freeports may be limited (as they essentially redirect investments to the areas concerned), these planned measures could be relevant under the TCA's LPF provisions.⁵

⁵ The planned measures could also be significant under the EU-UK Withdrawal Agreement if the UK Freeports – especially those located on the UK's west coast – involved aid that had an impact on trade between Northern Ireland and the EU. In that case, EU State aid rules would apply and competence would lie with the European Commission and the European Courts.

5 Conclusions

The LPF provisions were a major obstacle to reaching an agreement on EU-UK relations and substantial discrepancies arose during negotiation of the TCA in the areas of subsidies, labour and social, environmental law and climate change. The outcome of those negotiations is a complex set of safeguards and remedies aimed at ensuring open and fair competition among economic operators from both economic areas.

In this respect, both regulatory autonomy and State aid regimes will have to be tested under the TCA's provisions. Some controversial issues have already emerged that are yet to be resolved. In particular, the explanations received at the meetings of the Trade Specialised Committee on LPF and the Trade Partnership Committee did not alleviate the EU's or the UK's respective concerns about the UK's renewable energy schemes and the Brexit Adjustment Reserve.

Inevitably, other contentious issues will arise in the future as regulatory divergence increases. From the EU side, UK projected regulations and other measures relevant under the TCA's provisions will be closely monitored by the EU-UK Relations Service of the European Commission and through the EU's complaints mechanism for the enforcement of trade agreements.

However, it is unclear to what extent plain discrepancies will result in real disagreements and how often the EU and the UK will turn to the dispute settlement mechanisms provided for in the TCA. In any event, continuous consultations and negotiations can be expected, in light of the broad LPF commitments made by the EU and the UK and the complexity of the TCA's dispute settlement provisions.

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