A green trade deal can save the Brexit negotiations

*The combination of COVID-19 and the need for a post-Brexit trade deal provides an opportunity to push for the decarbonisation of the economy. It's time for a post-Brexit green trade deal, argues **Dimitri Zenghelis (LSE)**. If done correctly, such a deal could give all of Europe a comparative advantage with regard to resource efficiency and decarbonisation globally.*

One option to break the deadlock over state aid provisions might be to adopt a more flexible approach over support to key sectors which offer significant social returns at a global scale. Sectors which help reduce emissions and address climate change would top the list. Instead of a race to the bottom, undercutting competition through the erosion of standards, this would engender a race to the top, creating new standards and ambitions; a race to deliver significant benefit to society.

There is a growing realisation that policies to enable a green transformation of the global economy must go beyond addressing market failures and focus instead on active market formation. This requires state support to shape markets and induce low carbon innovation. The COVID crisis, combined with a forward-thinking post-Brexit trade deal, provides the ideal opportunity to address structural problems and invest in institutions which actively direct the economy towards decarbonisation.

Post-COVID, it is clear that enhanced public intervention will be required to restore short-term market confidence and avoid a return to an economic model that has proved insufficiently productive, socially and regionally divisive and, even worse, dangerous in terms of vulnerability to climate change, pandemics and the onslaught of new technologies.

On the other hand, the sheer scale of the low-carbon transition has already generated economies of scale in production and discovery, and the scope for productivity-augmenting clean innovation is huge. There has already been an 80% or so decline over the last decade in key renewable costs (such as solar PV and battery storage), largely on the back of state support through subsidies and markets enabled through regulations and pricing. Evidence suggests significant productivity-enhancing knowledge spill-overs into other parts of the economy which are much higher than those from more mature fossil fuel investments.

Of course, delineating what constitutes a green activity may not be easy for the purpose of exempting sectors from state aid restrictions. Should a software company with activities that are naturally zero-carbon be eligible? Or should a steelmaker which invests in cutting-edge low-carbon technologies while transfiguring its supply chain qualify? A post-Brexit agreement might seek to start with more narrowly defined sectors, such as energy or transport, and then broaden out the scope.

This forms the basis of an interesting proposal by Professor Michael Grubb at University College London. He argues that 'Mission-oriented' state aid should be exempt from restrictions. Supporting green investment rather than propping up old industries post-COVID, could form a mutually acknowledged category. This would build on discussions about public support for green investment finance and the impact of asset purchases through quantitative easing.

Done right, such competition would provide Europe with the potential to generate a comparative advantage in resource efficiency and decarbonisation, already one of the fastest-growing global sectors. There is evidence that a firm's choice whether to innovate 'clean' or 'dirty' is influenced by the practice of the countries where its researchers/inventors are located. Moreover, firms tend to direct innovation toward what they are already good at. As a result, low carbon transitions are highly path-dependent: countries and companies that successfully invest early in green capabilities, have greater success in diversifying into future clean product markets.

Because innovation is path-dependent and prone to tipping sets and reinforcing feedbacks, conventional economic models systematically overstate the costs of decarbonisation. They also downplay the importance of early public intervention to tilt the economy onto a new, more productive, path. This means that leadership matters. It also means that rather than predict the future, our efforts are better spent trying to manage and steer transition. Supportive state aid, which induces investment in enabling assets, can spur technology tipping points and generate network externalities that green the economy and promote growth and jobs.

Pulling the world out of recession, and generating a sustainable, inclusive and resilient growth path, requires framing a vision of the benefits of a government-led sustainable recovery. A more enlightened and creative approach to trade and state aid post-Brexit could form an important part of such a vision.

This article gives the views of the author, not the position of LSE Brexit, or the London School of Economics.