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The Economics of European State Aid Control

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(*) Disclaimer: the views expressed in this presentation are those of the authors and are not necessarily those of the European Commission.

Overview

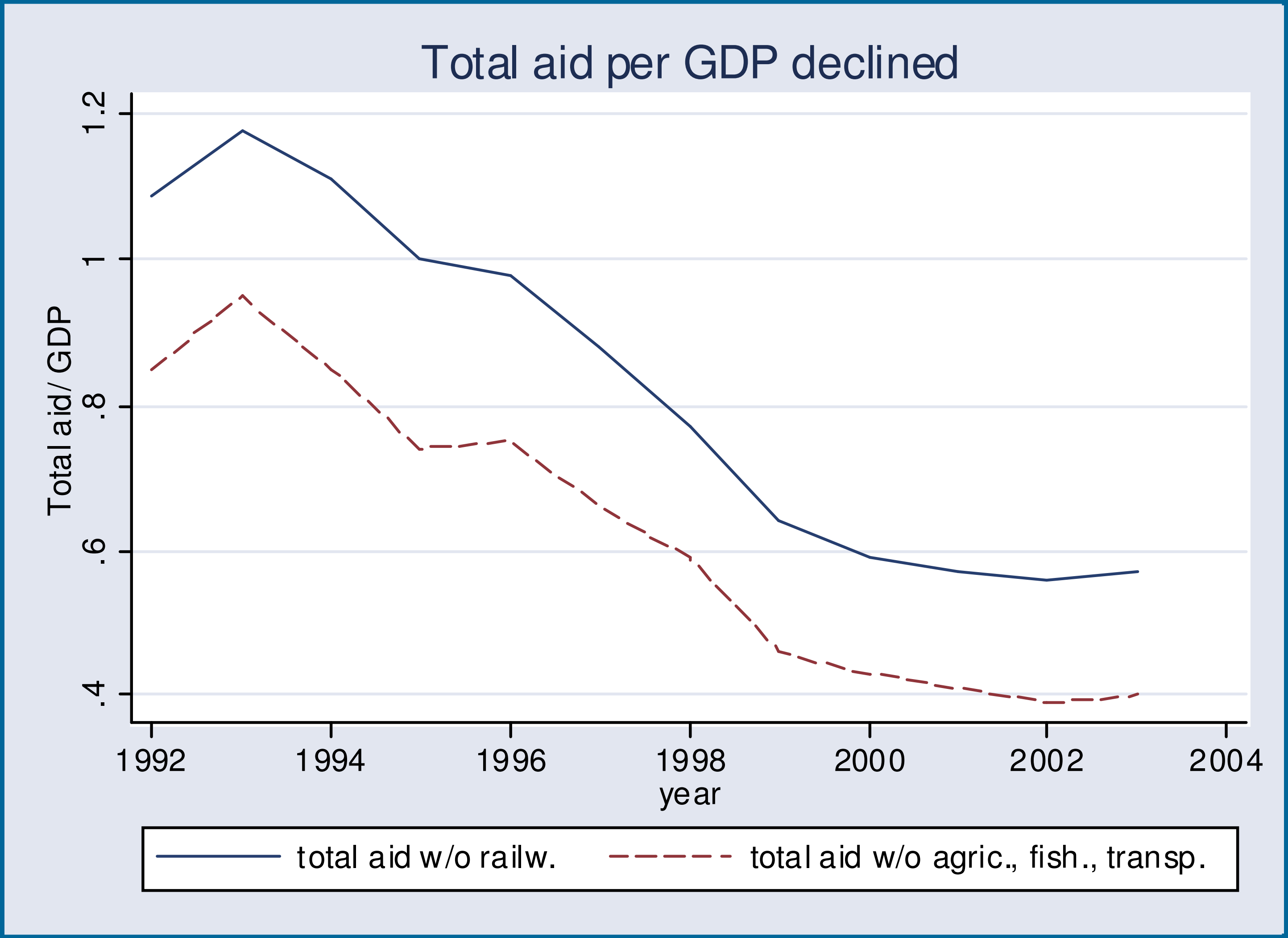
- Introduction
- Recent trends
- Legal framework – room for economic maneuver?
- Economics of State aid: basic concepts
  - Rationale for state aid – equity vs. efficiency
  - Limits of State aid
- European State aid control: an economic approach
  - Justification for European State aid control
  - Policy standard
  - Assessment criteria
- Concluding remarks

Introduction

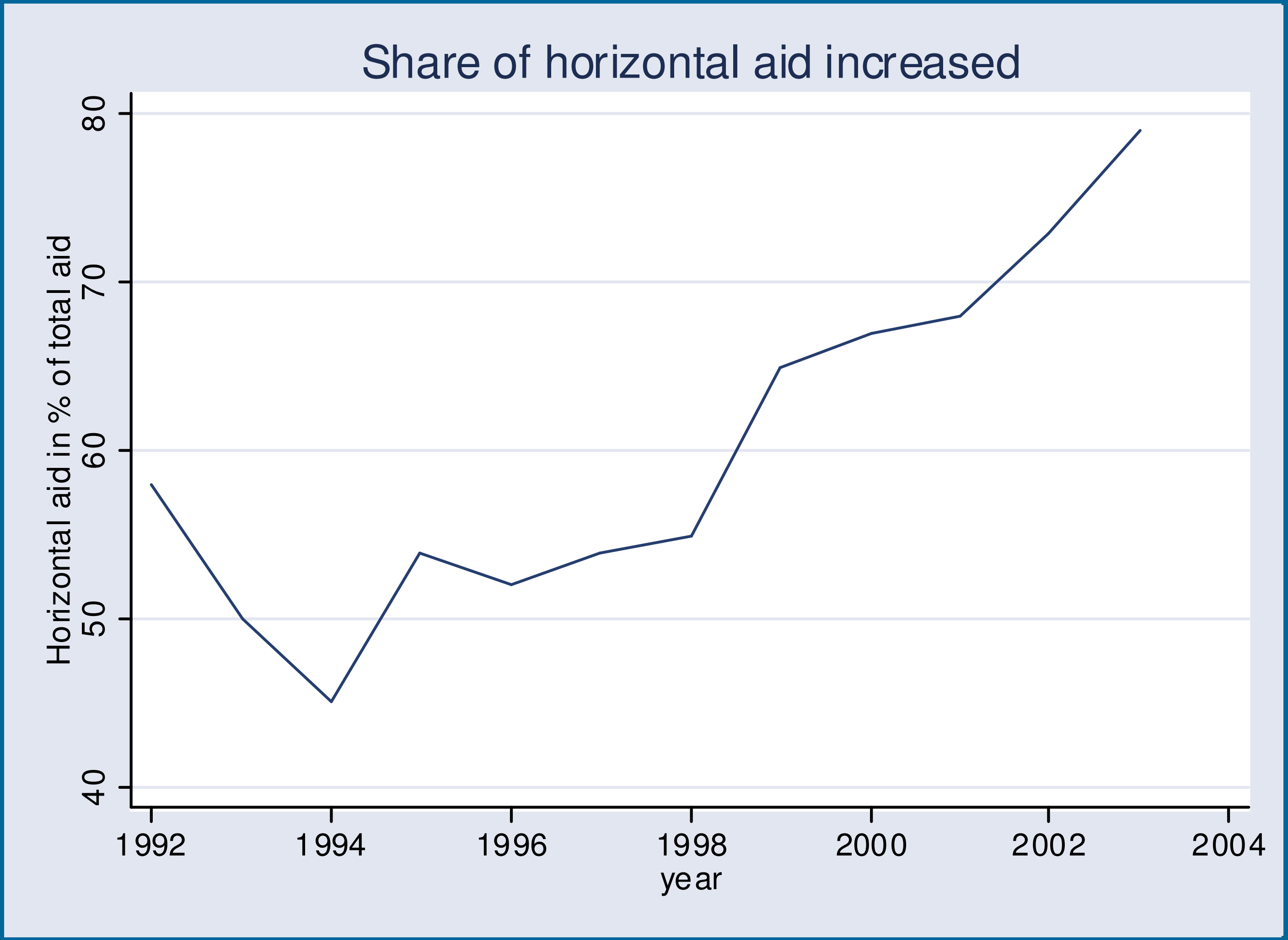
- State aid: a special form of state intervention
    - State aid involves the transfer of state resources (via subsidies, tax breaks, …)
    - 50% of GDP expended by Governments; less than 1% is State aid
    - beneficiaries are companies → potential to distort competition and affect trade
- Characteristic of state aid control:
    - the “actors” are member states
    - state aid control is about competition (‘market power’), but not about competition alone
        - Public economics perspective -> effectiveness; efficiency vs. equity consideration
        - International economics -> strategic trade issues

→ a distinct perspective, also in terms of economic analysis

Trend 1 – state aid per GDP

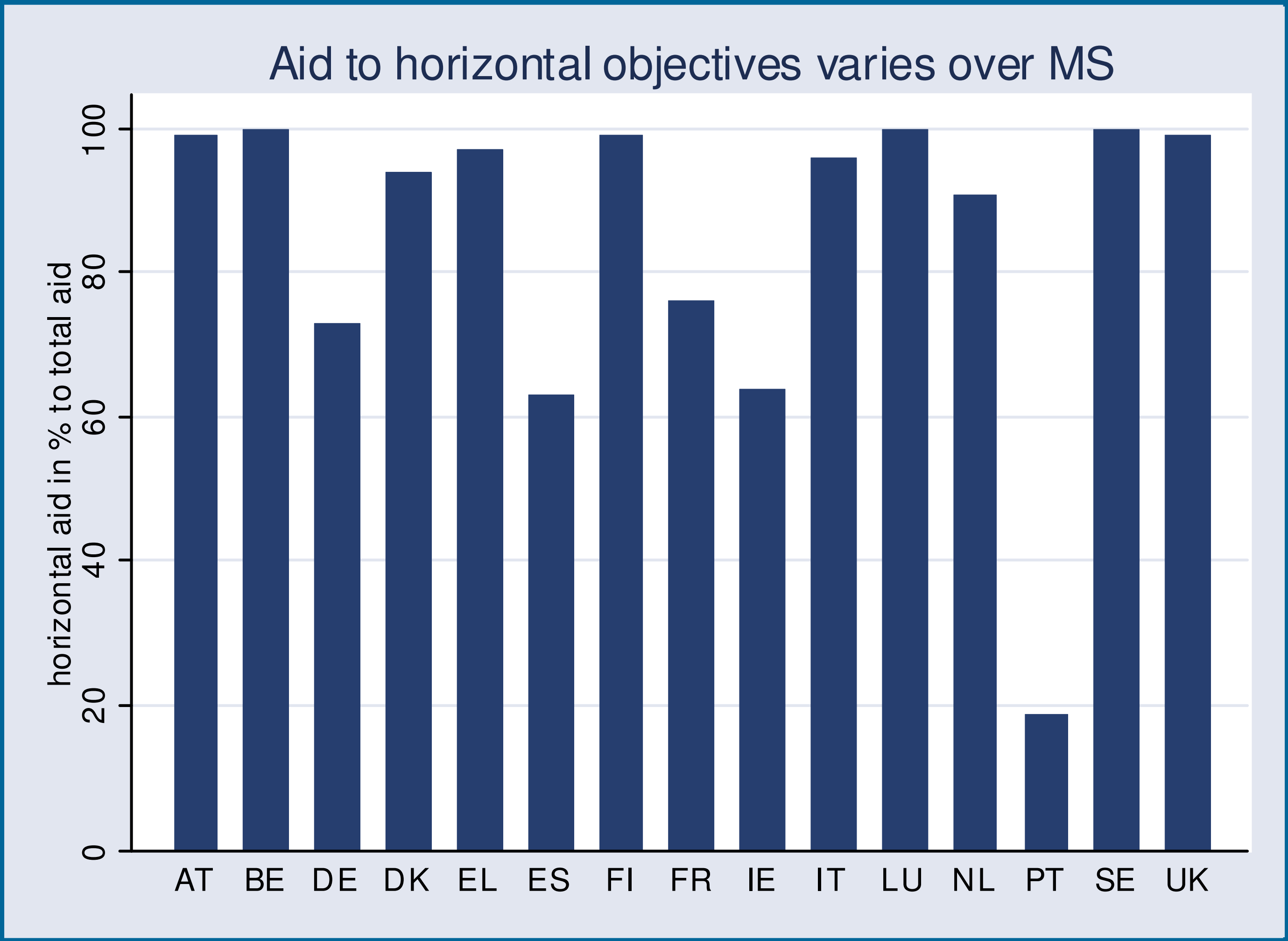


Trend 2 - horizontal objectives



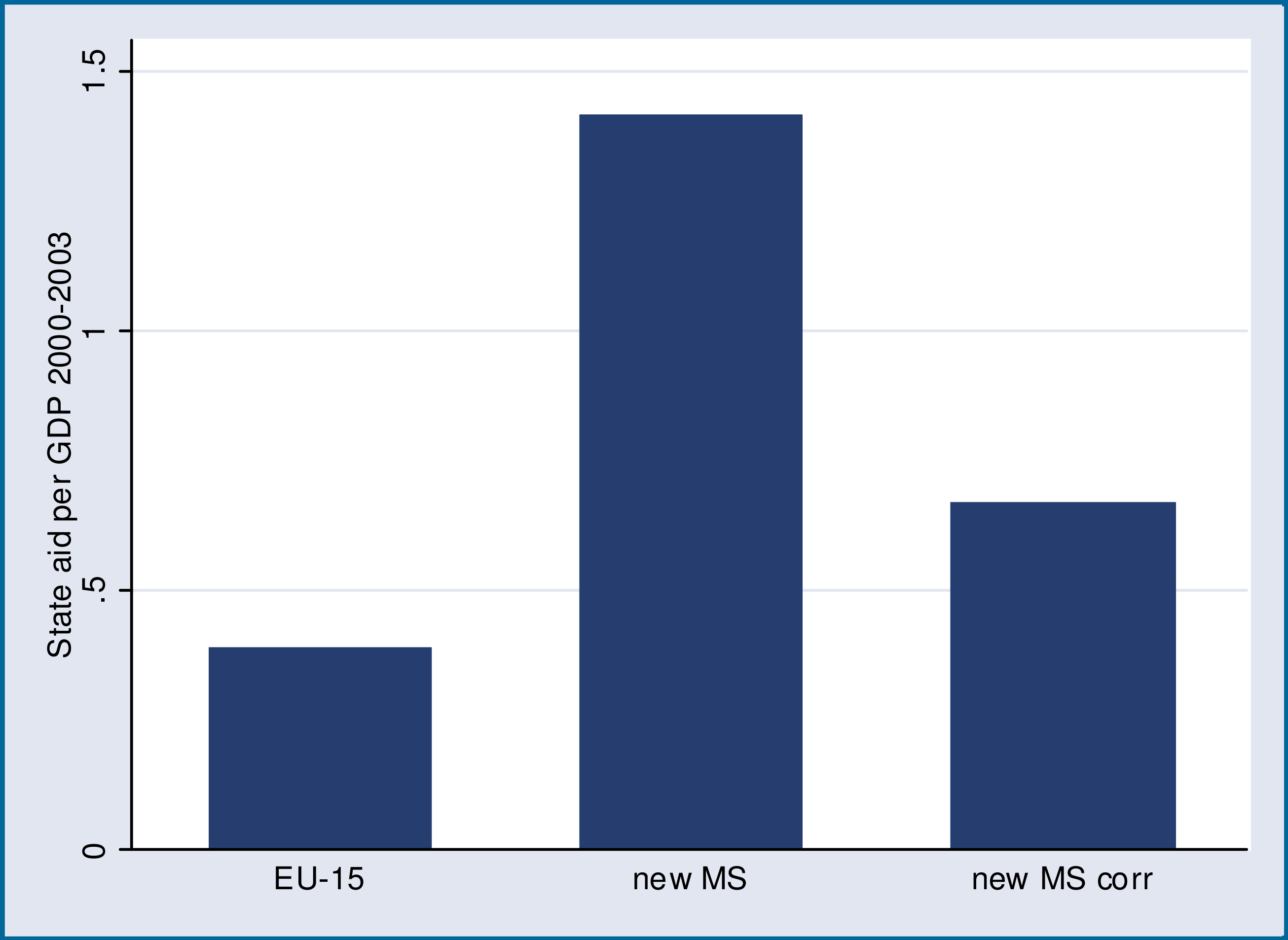
Total aid without agriculture, fishery and transport, EU-15

Trend 3 - country heterogeneity



Total aid without agriculture, fishery and transport 2003, EU-15

New Member States



Annotation:

Corrected value for New MS without sector specific programs phasing out under transitional arrangements or limited in time (state aid in relation to the Czech banking crisis in 2002, the Maltese shipbuilding sector and specific tax exemption programs in Cyprus)

source: scoreboard autumn 2004

The legal framework: what is state aid?

Article 87 (1) identifies four criteria defining state aid:

- Transfer of State resources
- Economic advantage
- ~~Distorts or threaten to distort competition~~ (by favouring certain undertakings or the production of certain goods (selectivity))
- ~~It affects trade between member states~~

Based on case law the last two criteria are assumed to hold in most cases where selectivity is shown

→ Negative presumption

De minimis rule: less than €100.000 for 3 years period is considered no aid

Scope for economic analysis under Art. 87(1)

- Advantage to firms
  - main entry point for economic analysis in the field of Art. 87(1)
  - advantage established on the basis of e.g.
    - Market Economy Investor Principle (MEIP; in the context of state participations / credit lines)
    - Altmark criteria (in the context of Services of General Economic Interest; SGEI)
- Selectivity
  - effects oriented
  - how close is the link between “selectivity” and ”distortion of competition” and “effect on trade”? → More comprehensive analysis under Art. 87(3)

The legal framework: when is it compatible?

General provisions

- Art. 87 (2)

  Compatible: natural disaster, aid of social character to individuals, etc.
- Art. 87 (3)

  Possibly compatible: areas with low living standard or aid to facilitate the development of certain economic activities, etc.

Specific Guidelines

- Horizontal aid
  - Efficiency related
    - for R&D
    - for SMEs
    - for risk capital
    - for employment
    - for training
    - for environmental protection
  - Cohesion related
    - For specific regions
- Non-horizontal aid
  - For specific sectors
  - For rescue&restructuring

Scope for economic analysis under Art. 87(3)

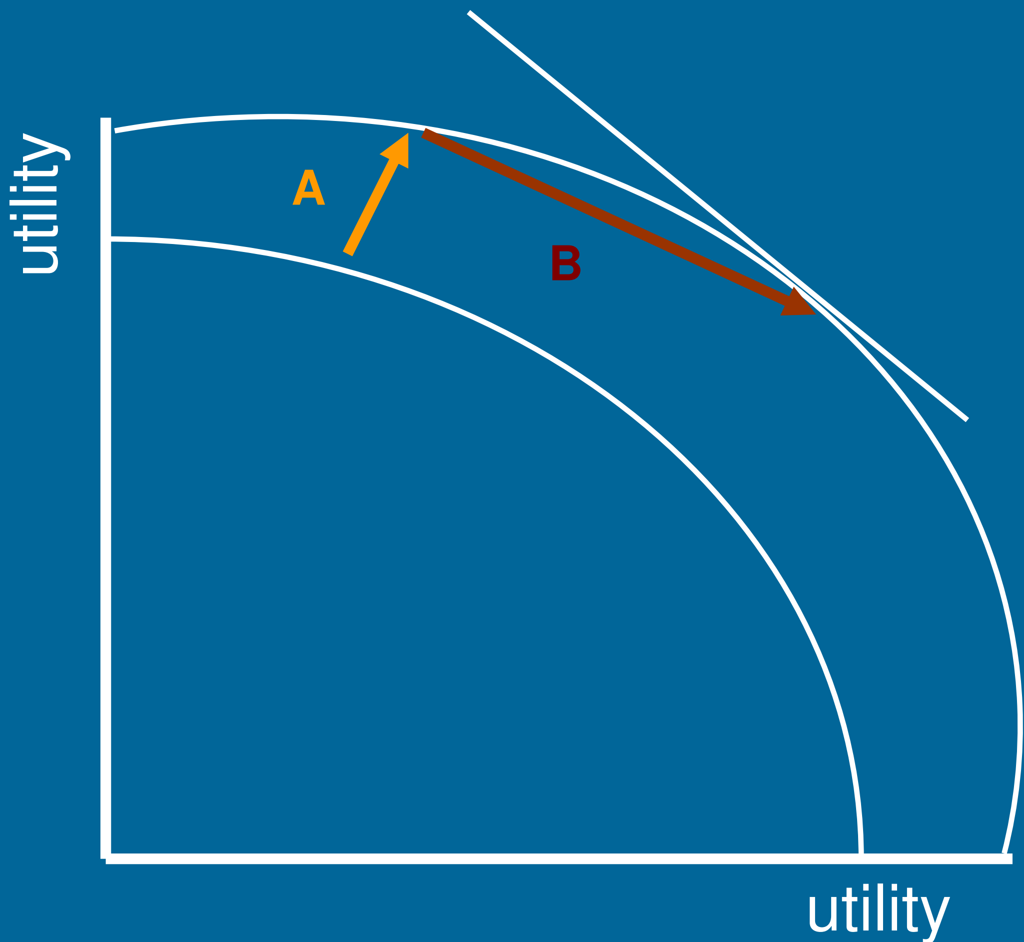
- Guidelines/Block Exemptions/Frameworks
  - Issue of market failure addressed, but not always made very explicit (market failures reflected in “Community objectives”)
    - Sufficient consideration of effectiveness/necessity of the aid?
  - Distortions of competition mainly addressed on the basis of maximum aid intensities
    - “Check list approach”; sufficient attention to market position beneficiary and impact on competitors/ consumers ?
- Direct assessment under Article 87 (3); risk capital guidelines; R&D Guidelines

→ Economic analysis of minor importance for most cases

Economics of State aid: basic concepts

- Rationale for state aid – equity vs. efficiency
- Limits of State aid

Back to basics…



A: Efficiency rationales (correcting market failures)

B: Equity rationales (redistribution/cohesion)

For policy purpose distinction important!

→ Transparency

Policy objectives – efficiency and equity

Potential negative trade-off (State aid redistributes input goods!), i.e. support for technology centre in the core, not in the periphery

→ There is a price to be paid for equity

But positive overlap may exist, i.e. supporting risk capital schemes in the periphery

← But: Not every lack of political 'desirable activity' should be labeled market failure;

- be careful not to work against regional comparative advantages
- endogenity of market rigidities, etc.

…and redistribution may solve market failure itself („efficient redistribution")

Limits of State aid

- Negative effects on competition/Internal market
  - Loss of (dynamic) efficiency
- “Regulatory failures”
  - information problems regarding market failures
  - lobbying as a driver for state aid decisions/ picking winners
  - commitment problems (time inconsistency)
- Opportunity cost of state funds
  - a euro can only be spent once

European State aid control: an economic approach

- Justification for European State aid control
- Policy standard
- Assessment criteria

Rationales for EU (supranational) state aid control

- Externalities across Member States
  - Member States pursue their own goals; do not take into account possible negative impact on other countries (spill-over effects);
  - Internal Market objective
- Potential commitment problem at the Member State level
  - Time inconsistency / soft budget constraints

The policy standard debate

- Total welfare standard the economically right standard from a normative perspective (for efficiency considerations)
- Consumer Standard implemented in antitrust/ merger, however.
  - Lobbying by consumer less than by firms
  - Information and selection advantage of merging parties

  -> given the regulatory environment consumer standard welfare maximizing

The policy standard debate

- Is there a high probability of type II errors (i.e. approval of welfare decreasing measures) in State aid control?
- Can a consumer standard counterbalance such a bias (i.e. is a consumer standard a 'tougher' standard)?

The policy standard debate

- Informational and selection disadvantages

- Lobbying efforts
  - Enterprise->national government->EU Commission
  - “Me too”-type of lobbying
  - Competitors have to complain against governments (conflict of interest: procurement contracts, etc)

⇒ Type II errors are at least as likely as under merger control…

The policy standard debate

- Effect on consumer standard positive in most cases

-> take ‘net’ consumer surplus including opportunity cost of taxation

- Many negative effects on consumer surplus are realized in a dynamic context only

-> dynamic perspective more important

Need to make State aid rules tougher may be reasonable

but unclear whether consumer standard can serve the purpose…

Assessment criteria

An economic approach – the test (1)

a. existence of well-defined market failures / social objective
   - difficult to measure on a case-by-case basis
   - define broader areas - could lead to block exemption

b. targeting of state aid towards market failures / social objective
   - <u>Incentive effect:</u> does the aid solve the problem?
   - <u>Best placed policy instrument</u>
   - <u>Proportionality:</u> Is the aid at minimum (as regard the amount and the time horizon)?

c. the ‘distortions of competition’ and ‘effect on trade’ should be limited so that the aid measure is not on balance contrary to the common interest.

An economic approach – the test (2)

c. minimize/ avoid “distortion of competition” and “effect on trade”

- strong selectivity (i.e. target is individual firms, or specific industries)
- what is the market position of the firm (dominant?)?
- markets affected are trade intensive or potentially trade intensive?
- Aid intensity and type of aid (operational aid, horizontal, financial instrument)
- procedure for selecting beneficiaries

Concluding remarks

- Main benefit of economic analysis: making things more explicit (cost/benefit; problem/solution)
  - important for priority setting;
  - writing Guidelines/Block exemptions;
  - analysis in individual cases

- Reform of state aid control may increase demand for theory and fact based economic advice