IBC Conference Brussels
28.01.2005

Economic principles of state aid control

Dr. Vincent Verouden
European Commission,
DG COMP Chief Economist Team

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

Overview

1. Introduction
2. Rationale for state aid control
3. "Less and better targeted aid"
4. Application of Art. 87 EC – scope for economic analysis
5. Concluding remarks

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1. Introduction

- State aid: a special form of state intervention
  - State aid involves the transfer of state resources (e.g. subsidies)
  - 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 (internal market), but not about competition alone
    - a distinct perspective, also in terms of economic analysis

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2. Rationales for state aid control

- Economic rationales for (supranational) state aid control:

  A. 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

  B. Potential commitment problem at the Member State level
     - Time consistency / soft budget constraints

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Rationale vs. objective (state aid control)

- Should national state aid measures that lead to negative spill-over effects always be prohibited ...?! Answer: no
  - Spill-over effects may be small
  - State aid measures, as all state intervention in the economy, serve a purpose (good or bad • rationale of state aid)
  - If the purpose is "good" enough, a trade-off should be possible

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Rationale for state aid

- Two rationales for state intervention usually distinguished in economics:
  - efficiency rationales (correcting market failures)
    - in <u>certain</u> circumstances, free markets do <u>not</u> result in an efficient (i.e. welfare maximising) outcome: there is a "market failure". State intervention may be appropriate to correct the market failure.
  - equity rationales (redistribution/cohesion)
    - the outcome of the market process is efficient, but may not be socially acceptable. State intervention may be appropriate for redistributive purposes

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Market failures (efficiency rationale)

- Possible market failures:
  - Externalities
    - Positive externalities: e.g. R&D spill-overs, training
    - Negative externalities: e.g. environmental pollution
  - Asymmetric/imperfect information
    - e.g. imperfect information in financial markets may give rise to incomplete/missing markets (in particular in the context of SME's)
  - Public goods provision
    - e.g. public broadcasting / SGEI
  - Market rigidities
    - e.g. labour market rigidities, imperfect factor mobility
  - Market power
    - e.g. due to entry barriers

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Equity

- Social cohesion
- Regional cohesion

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3. “Less and better targeted aid”

- Main policy aim as expressed by the European Council is
  - to reduce the overall level of State aid per GDP
  - to redirect it to horizontal measures (including economic and social cohesion)
  - to better target it to identified market failures

(European Council, Barcelona, 2002)

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“Less and better targeted aid” (2)

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

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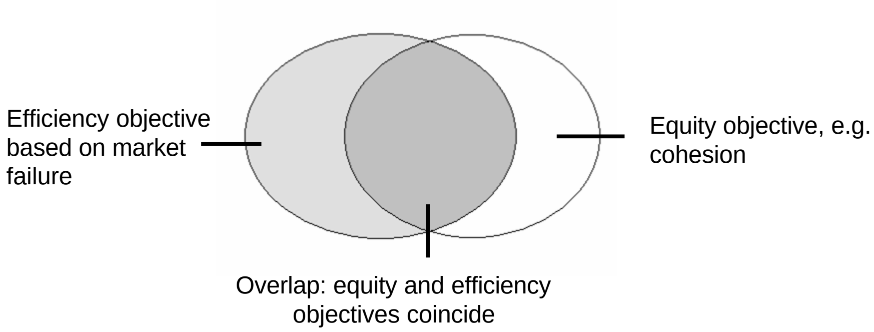
"Less and better targeted aid" (3)

- Efficiency ("making the cake bigger") and equity ("dividing the cake better") may involve a trade-off, but not necessarily



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4. Application of Art.87 EC

- Existing framework in Art. 87 EC: a two step approach
  - Jurisdiction: Is the measure aid within the meaning of Article 87(1) EC?
    - State aid within the meaning of Article 87(1) EC is in principle incompatible with the internal market and thus prohibited (negative presumption)
  - Compatibility (balancing of positive and negative aspects)
    - State aid may be exempted under Article 87(2) or Article 87(3) EC when it is aimed at certain Community objectives

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What is state aid ? (jurisdiction)

- Article 87(1) EC identifies four criteria defining State aid:
  - Granted through State resources
  - Favours certain undertakings or the production of certain goods (advantage + selectivity)
  - ~~Distorts or threaten to distort competition~~
  - ~~It affects trade between member states~~

The last two criteria are often taken to hold where selectivity exists

(save “de minimis”)

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What is state aid (2)

- 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
    - rather broadly interpreted: in line with rationale of EU state aid control (externalities across Member States)
    - how close is the link between “selectivity” and ”distortion of competition” and “effect on trade”? • More comprehensive analysis under Art. 87(3)

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When is aid compatible ?

- Art. 87(2) EC
  - Compatible: individual social measures; aid in case of natural disaster; certain aid to East-Germany
- Art. 87(3) EC
  - May be compatible: economic development of areas with low living standard/serious underemployment; projects of common European interest; development of certain economic activities / areas; culture and heritage conservation "Community objectives"

- Block Exemptions:
  - SMEs
  - employment
  - training
- Guidelines, Frameworks, etc.:
  - R&D
  - environmental protection
  - Regional aid
  - Large investments (regional aid)
  - Risk capital
  - Rescue & Restructuring

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When is aid compatible (2)

- 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 ? (does the aid solve the problem and is it the best way to solve the problem?)
  - 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 ?

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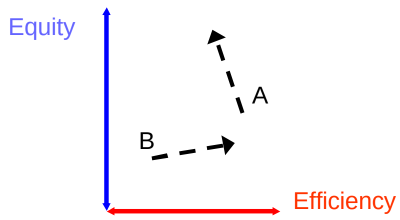
Balancing – an economic approach

Benefits: achieve Objectives (+)

- **Correcting Market Failures = improve efficiency**
  - Externalities
  - Asymmetric information
  - Provision of public goods
- **Equity / Social reasons**
  - Social and Economic Cohesion
  - Economic adjustment

Distortion of Competition (-)

- **Create Market Failures = reduce efficiency**
  - Create market power
  - Reduce dynamic efficiency
  - Subsidy / tax competition
  - Opportunity cost of aid
- **Reduce fairness**



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An economic approach – ingredients

- Focus on the problem of market failures essential in search for "less but better targeted aid"
  - What is the market failure?
  - Does the aid solve the problem?
  - Is it the best (least distortive) way to solve the problem?
- Analysis of "distortion of competition"
  - Strong selectivity (i.e. target is individual firms, or specific industries)
  - What is the market position of the firm (dominant?)
  - Who are the affected competitors?
  - Intensity and type of aid (operational aid, horizontal, financial instrument)

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An economic approach – ingredients (2)

- Claim: market analysis difficult in state aid
  - Answer: less so when selectivity is high, and this is precisely when distortions are likely to be high as well
  - Other cases (most cases) would continue to fall under Block Exemptions and Guidelines (with increased emphasis on link between aid and market failure / equity objective)

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5. 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
- Emphasis on market failures essential in search for “less but better targeted aid”

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