



Industrial Policies, Competition and Efficiency: The Need for State Aid Control

Joanna Piechucka
(joint work with Lluís Saurí-Romero & Ben Smulders)

EAGCP plenary meeting
26 October 2023

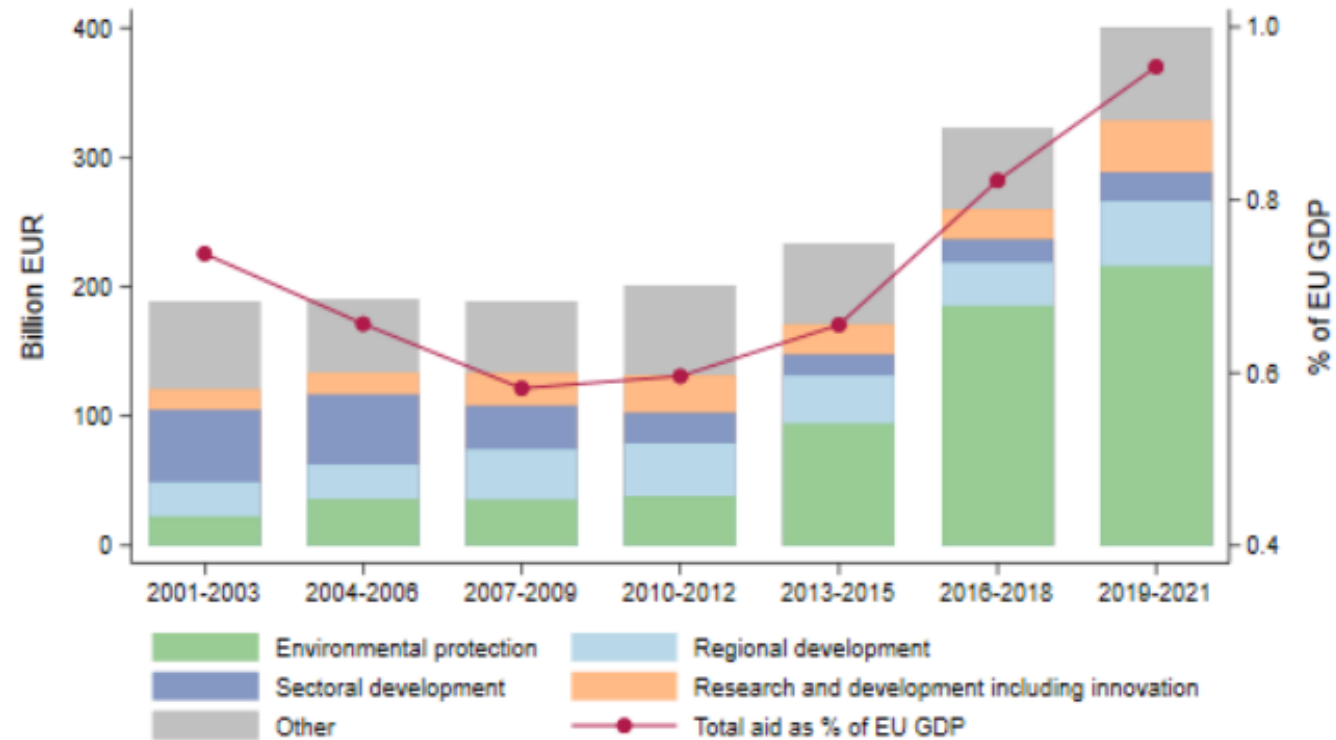
The views expressed in this document are those of the author and may not in any circumstances be regarded as stating an official position of DG Competition or of the European Commission.

Industrial policies at core of public debate...

- Resurgence of industrial policies
 - Green transition
 - Global supply chain disruptions following the COVID-19 pandemic
 - Surge in energy prices that accompanied the Russian aggression of Ukraine
 - Debates around national and European champions
- Scepticism among economists towards their effectiveness and efficiency
 - *Picking winners* in a suboptimal manner: lack of sufficient information make the right choices or result of rent-seeking behaviour and government capture by incumbents
 - Competition distortions and inefficient outcomes

...but not new

Figure State aid expenditure (in current prices) in the EU in the period 2001-2021, by policy objective



Source: Own analysis based on State aid Scoreboard 2023.

Agenda

1. Scope for efficiency-enhancing industrial policies
2. Distortive impact of industrial policies and role for competition policy
3. Case study on climate policies: Energy transition and EU competitiveness

What is the scope for industrial policies?

- Public intervention can improve efficiency of market outcomes when the market on its own is unlikely to deliver efficient outcomes (prices, output, quality, innovation, ...)
 - **Externalities:** Actions of one market participant affect the costs or benefits of another who did not choose to incur that cost or benefit
 - **Coordination failures:** Misaligned interests and incentives among investors preventing the development of a new project or technology
 - **Informational asymmetries:** Discrepancy in the information available to the two sides of a commercial exchange
 - **Market power/failures of competition:** Significant degrees of market power, e.g. related to positions of monopoly, dominance and lack of competitive constraints

Sometimes other objectives can be reformulated as market failures

Certain sectors might develop insufficiently or too slowly, *lagging behind*



Positive externalities?

Firms lagging behind in sectors with lots of *positive linkages* with other domestic sectors

Need for *strategic autonomy*, or security of supply, resilience, reduced dependency or even self-sufficiency, e.g. policies to support chips sector in the EU and the US



Negative externalities?

Firm producing an essential good that is critical in the supply chain is unlikely to fully internalise the damage on other firms and consumers if it were to locate to another geographic area

Mission-oriented industrial policies that create markets instead of just fixing them
[e.g. Mazzucato et al.. (2020)]



Coordination failures, asymmetric information?

Some markets may not emerge or may emerge too slowly without public intervention

Design of industrial policies to enhance efficiency

- Identify and target well-defined market failure
- Consider other policy interventions in place (*residual market failure*)
- Choose (least distortive) policy tool or mix of policy tools
- Ensure incentive effect: change in the behaviour of firms towards more efficient behavior
- Limit support to the minimum necessary
 - Starting point to quantify min. support amount needed to trigger change in conduct (funding gap)
 - Competitive tendering as powerful tool to reveal funding gap and allocate subsidies efficiently

(Not excluding other rationales for public intervention, as equity, regional cohesion, diversity – but they would not correspond to the notion of industrial policies, even if they can interact)

Does the notion of market failure cover the scope for industrial policies?

Is there scope for industrial policies that do not enhance efficiency?

Industrial policies come with costs and distortions

- Direct cost borne by taxpayers
- Costs in terms of potential distortions to competition or theories of harm
 - Undermining effective competition by increasing market power of incumbents and foreclosing actual or potential competitors
 - Inefficiently affecting production of location decisions
 - Global context: risk of subsidy races, protectionist escalades
- Poorly designed State intervention can be the source of anti-competitive perturbations

Why should we be particularly concerned?

- Prominent and growing literature on the rising trends in market concentration, mark-ups, and profits both in the United States and Europe
 - Industrial policies can inefficiently reinforce concentration, for instance by strengthening the market position of incumbents or interfering in the exit and entry process and undermine competition policy
- Concentration can also lead to political power through lobbying activities
 - Incumbents appropriating aid through lobbying
 - Regulatory capture
- Protectionist policies around the world
- Interaction with or undermining other competition policy tools

Design of industrial policies to **limit distortions**

Role for competition policy in preserving competition by disciplining not only undertakings but also the State

- Identify theories of harm
- Limit potential distortion to competition
 - More selective interventions are more likely to distort competition than broader schemes
 - Competitive tendering objectifies selection of most efficient and reduces discretion
- Enhance commitments
 - Benefits provided to beneficiary of public support as much as possible spread towards third parties, e.g. innovation sharing through dissemination of R&D results, commitments to maximize spillovers to third parties, or to ensure the open and non-discriminatory access to supported infrastructure
- Monitor closely and adjust when needed the tools and instruments used

Balancing test: resolving trade-offs through design choices

ENHANCE EFFICIENCY

Achieving efficiency by effectively addressing well-identified market failures

LIMIT DISTORTIONS

Minimising unintended inefficiencies introduced by the intervention in the form of competition distortions

State aid control for efficiency-enhancing industrial policies

- The compatibility assessment under State aid control closely follows the design principles for efficiency-enhancing industrial policies
 - **Necessity**: need to address a market failure and improve the efficiency of the market outcome
 - **Incentive effect**: ability of State aid to modify firms' behavior
 - **Appropriateness**: form of State aid that is most effective at addressing the identified market failure
 - **Proportionality**: minimum support needed to incentivise companies to change behaviour
 - **Selectivity of aid**: assessing and minimising the undue distortions to competition caused by aid
 - **Balancing test**: balancing of the net contribution of State aid in addressing the market failures against the competition distortions and welfare losses it may unintendedly cause
- At EU-level, coordination is provided by State aid rules and similar rules could inspire an efficient and collaborative approach to global industrial policies

Can we think about
State aid as we think about mergers?

Can we separate
pro- and anti- competitive subsidies?

How to quantify the
balancing test?

Climate policies in the EU

European Climate Law sets a legally binding target: climate neutrality by 2050, achieving net zero greenhouse gas emissions for EU countries as a whole

- **Energy transition:** transitioning to a decarbonised energy system, transforming economic activities to gain energy efficiency, significant investment in innovation, technology adoption, infrastructure, transports modes, human capital
- **EU competitiveness:** energy costs as significant driver of industrial competitiveness, where the current energy crisis amplifies the cost differentials between the EU and other regions

Connection between energy transition and EU competitiveness

Climate policy: efficiency-enhancing policy

- Climate market failures: markets on their own are unlikely to trigger the necessary behaviours to address the threats and consequences of greenhouse gas emissions and climate change
 - Textbook example of negative environmental externalities
- Since 2005 in the EU: ETS puts a price on pollution. Is this enough?
 - Environmental externalities not the only market failure undermining efficient decarbonisation
 - Information asymmetries, coordination problems affecting incentives to invest in innovation and infrastructure
- Variety of policy tools needed
 - Direct innovation effort towards new clean technologies through subsidies, followed by incentivising through taxes a gradual switch of production [Acemoglu et al. (2012)]
 - Combination of corporate taxes and R&D subsidies as optimal policy mix in a dynamic setting with positive externalities of innovation and innovation asymmetries [Akcigit et al. (2022)]

Competition, competitiveness & energy transition

- Once market failures are addressed, key role of competition policy
 - Ensure that climate targets are achieved in the most efficient, cost-effective and timely manner
 - State aid control ensures the complementarity between climate and competition policies
- Narrow assessment of climate policies would not take into account downstream markets that use energy as important input
 - **Long term**: reduction the dependency of the EU economy from foreign fossil fuels, relying more on renewable sources of energy with lower operational costs
 - **Short term**: increase in cost of energy as input in industrial processes
- Feasibility of long term objectives requires preserving competitive markets and industries throughout the transition
 - As of 2026: Carbon Border Adjustment mechanism phased in gradually
 - Reduction in levies for electricity-intensive users exposed to international trade (CEEAG)

How to preserve efficient competitive markets while supporting the energy transition?

What role for competition policy in shaping energy market regulation and subsidies?

Conclusion

- Scope for industrial policies that enhance the efficiency of market outcomes by addressing well-defined market failures
- Scope for competition policy minimising distortions of competition caused by the State
- EU State aid control rules reflect the economic principles of efficiency-enhancing industrial policies and provide a blueprint that could be applied more broadly

Growing need for State aid control and for more research