Economic principles of state aid control

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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
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

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
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

Rationale for state aid

- Two rationales for state intervention usually distinguished in economics:
  - efficiency rationales (correcting market failures)
    - in certain circumstances, free markets do not 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
Market failures (efficiency rationale)

• Possible market failures:
  – Externalities
    – Positive externalities: e.g. R&D spillovers, 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

Equity

• Social cohesion

• Regional cohesion
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)

“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
“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

![Diagram showing overlap of efficiency and equity objectives]

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
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”).

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)
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?
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)
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)

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”