

E.CA Economics

# Regional Aid - observations on welfare and entrepreneurs

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## ERA State Aid Conference

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# Agenda

1. **Capturing effects**: How does regional aid affect welfare?
2. **Comments on assessment principles**
3. **“Practitioner’s” view**: Can we squeeze entrepreneurial decisions into the assessment framework?

## Welfare criterion

### From SAAP...

- Market failure or „social problem“? Is aid targeted? Distortion of competition and trade?

### ... to SAM, the in-depth assessment communication and the new RAG

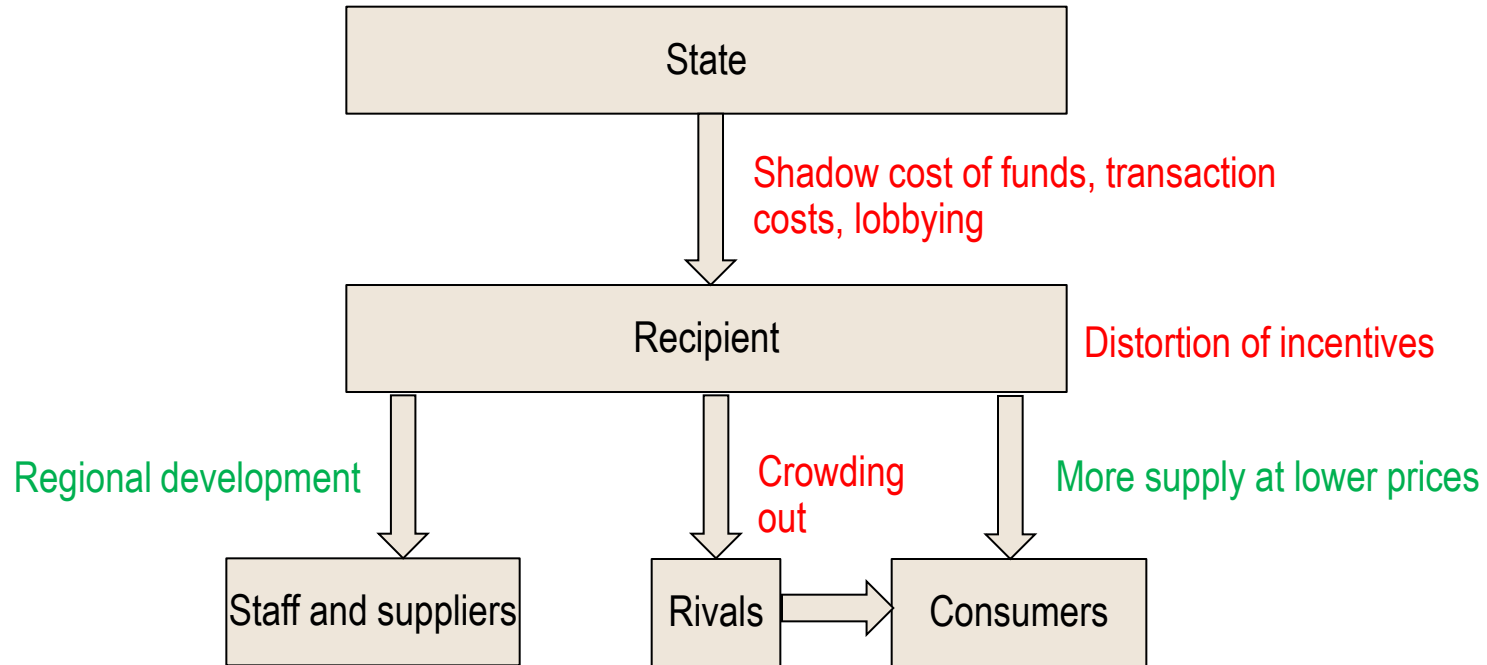
- Well-defined objective? Need for intervention? Appropriateness? Incentive effect? Proportionality? Effects on competition and trade?
- Risk of aid for large investment projects: „...since aid is a costly transfer from taxpayers in favour of aid recipients, net welfare losses, i.e. the cost of the aid exceeds the benefits to consumers and producers“ (in-depth com, Para 3)

### Procedures can reduce in-effective aid (waste of money) as well as distortions

- In regional aid the maps and aid intensity caps largely cater for the first three criteria
- Focus is on the incentive effect and proportionality...
- ...and distortion of competition and trade

### Welfare effect mentioned in in-depth communication

## Relevant effects on welfare

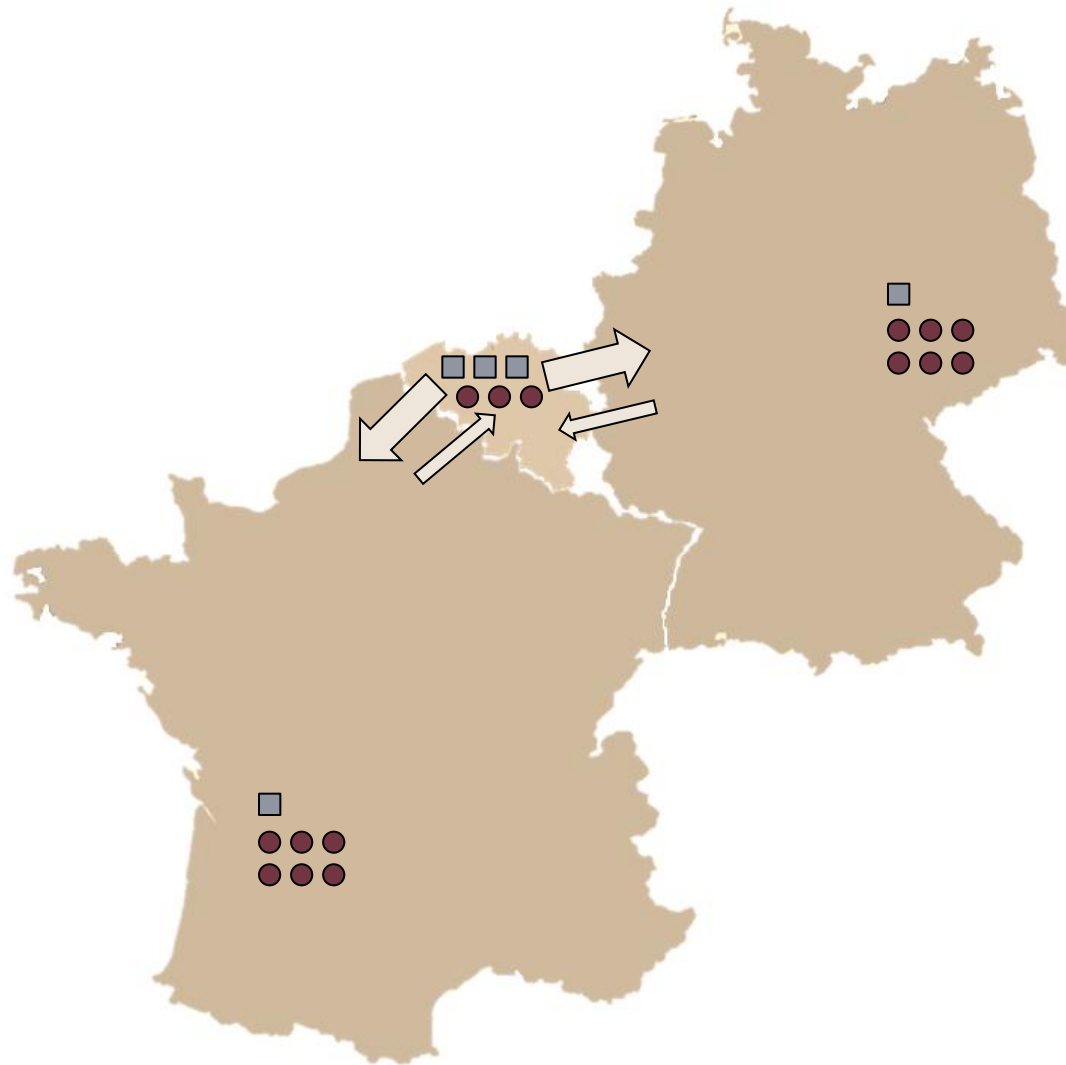


**Waste of money amplifies welfare cost of ineffective aid**

Capturing effects: How does regional aid affect welfare?

## Incentives to provide excessive aid

In some cases there should be no incentive to provide excessive aid



## Conclusion

**Effect on welfare is the right criterion...**

**...waste of money amplifies effects of in-effective and excessive aid (with and w/o subsidiarity)**

**Simple tests needed to prevent in-effective and excessive aid: in-depth assessment com and RAG**

# Common assessment principles and regional aid

**Well-defined objective**

**Need for intervention**

**Appropriateness**

**Incentive effect**

**Proportionality**

**Effect on competition and trade**

## Objective and need for intervention

### **Well-defined objective is given: cohesion and equity...**

- Schemes part of regional development strategy
- Direct and indirect jobs and training (business plan)
- Clustering effect and knowledge spill-overs
- Duration

... all desired, but does this ensure consistency at an EU level?

### **Need for intervention is given by regional aid maps...**

- Balancing „within“ and „across“ MS

... but is smoothing required?



# Appropriateness and incentive effect

## Appropriateness...

- Investment aid vs infrastructure development, education/training, business environment
- Impact assessment and ex-post evaluation
- Type of measure (direct pecuniary advantage, repayable loans...)

... important but difficult to assess due to complementarity?

## Incentive effect...

- Incentive to invest
- Incentive to locate in the region
- Need to define counterfactual („credibility check“, „realistic basis“)

... critical as it affects likelihood of distortion as well as waste of money effect?

# Proportionality and effect on competition and trade

## Proportionality...

- Aid limited to the minimum: difference between NPV target area and NPV in „the alternative location“
- All relevant costs: admin, transport, training, wages...
- To ensure predictability: maximum aid intensities (save harbour for SMEs; cap depends on region/firm size/project size)

... can create tension with incentive effect?

## Effect on competition and trade...

- Avoidance of „undue“ negative effects which „manifestly outweigh“ any positive effects
- Less pressure on least efficient producers; complacency or unduly risky behaviour
- Overcapacity may increase or maintain market power of recipient and crowd out rivals (or their investment)

... is dealt with if there is a proportionate location incentive?

## Effect on competition and trade continued

### „Manifest effects“ ...

- Above maximum aid intensity (no go)
- Investment incentive – market structurally in absolute decline (unlikely)
- Location incentive – alternative location in region with greater or equal allowable aid intensity (unlikely)
- Close down of same or similar activity (unlikely)
- Schemes: watch out for cumulative effects

... provide useful guidance

## Conclusions on assessment principles

**Assessment principles capture main objectives of State aid control...**

**... but how are they implemented in practice?**

**In what follows, we look at incentive effect and proportionality in more detail**

## Incentive effect and proportionality in practice: risk and uncertainty

### „Calculation used for the analysis of the incentive effect can also be used to assess if the aid is proportionate“ ...

- Consider location incentive: compare NPV in target area with NPV in the alternative location
  - Often several locations considered (high complexity)
  - Suitable benchmark: best alternative to no aid area
- Probability: base case, high case, low case
  - Base case spot-on? (credibility?)
  - Then low case by definition without incentive effect...
  - ...and high case without proportionality
- Uncertainty: entrepreneurial decision on non-quantifiable issues (analogous issue with private investor test)
  - NPV calculation only informative on quantifiable aspects

... but entrepreneurs are entrepreneurs because of uncertainty

“Practitioner’s” view: Can we squeeze entrepreneurial decisions into the assessment framework?

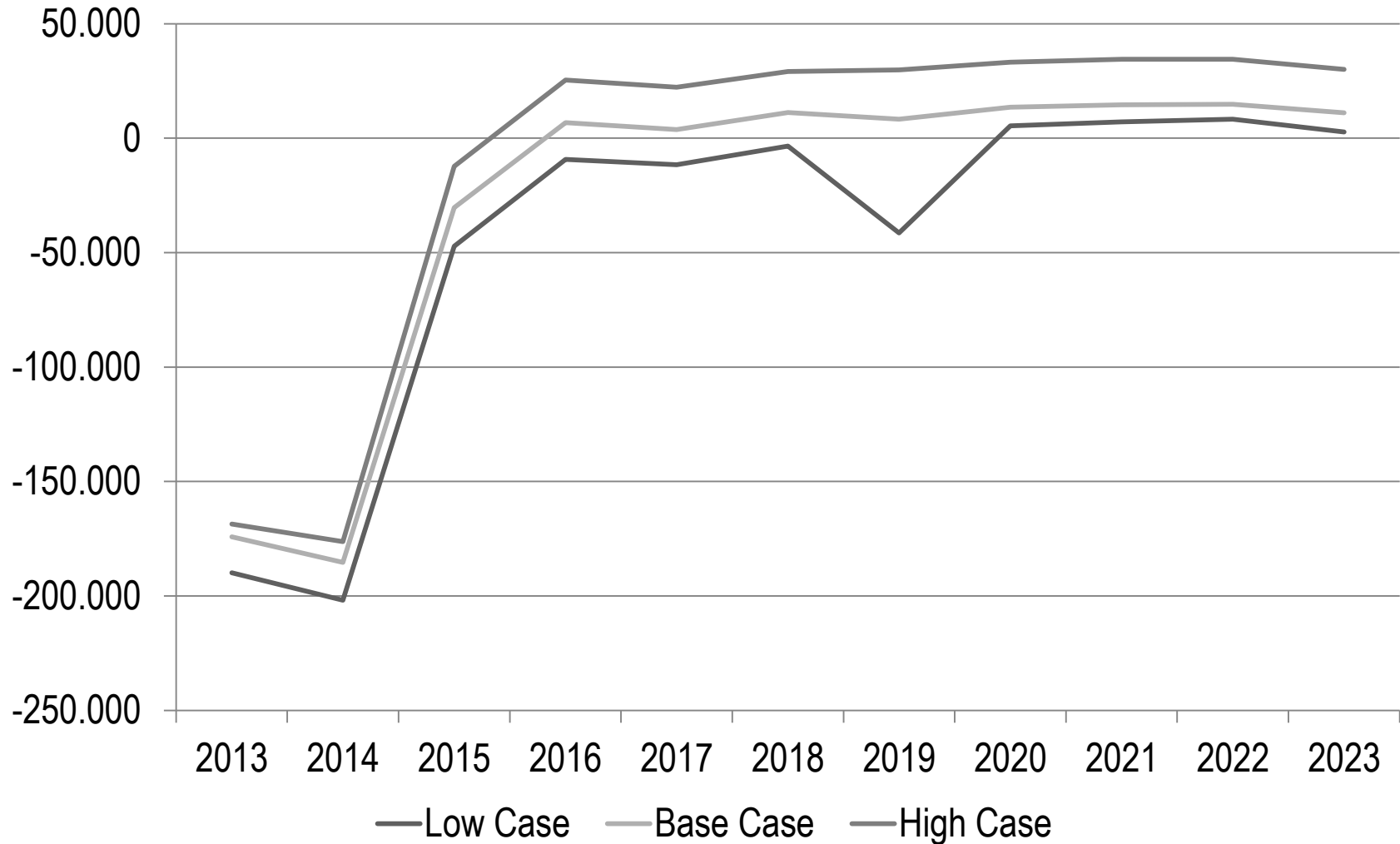
## Examples of entrepreneurial issues

### Examples for high uncertainty assumptions:

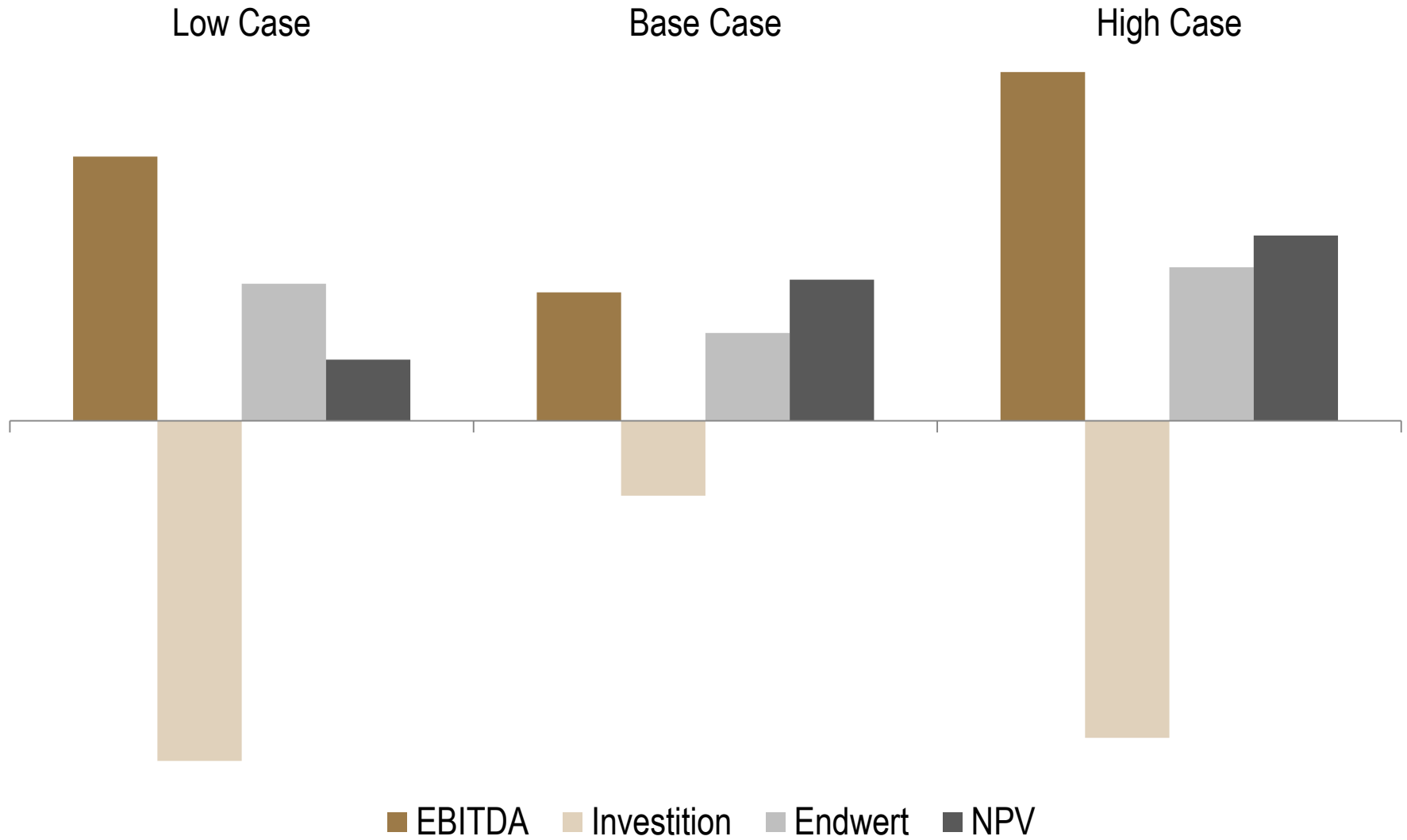
- **Development of regional demand**
  - Affects utilisation of plant
  - Affects relative profitability of locations
- **Quality and costs of regional input factors**
  - Affects location specific costs...
  - ...either through higher transport costs or through higher production costs (at given quality levels)
- **Market structure**
  - Capacity built by others (future State aid decisions)
- **Alternative use of money**
  - Interest rate used in NPV calculation
- **Duration**
  - End value in NPV calculation

... quantify them or not?

## Cashflow business plan w/o additional location costs

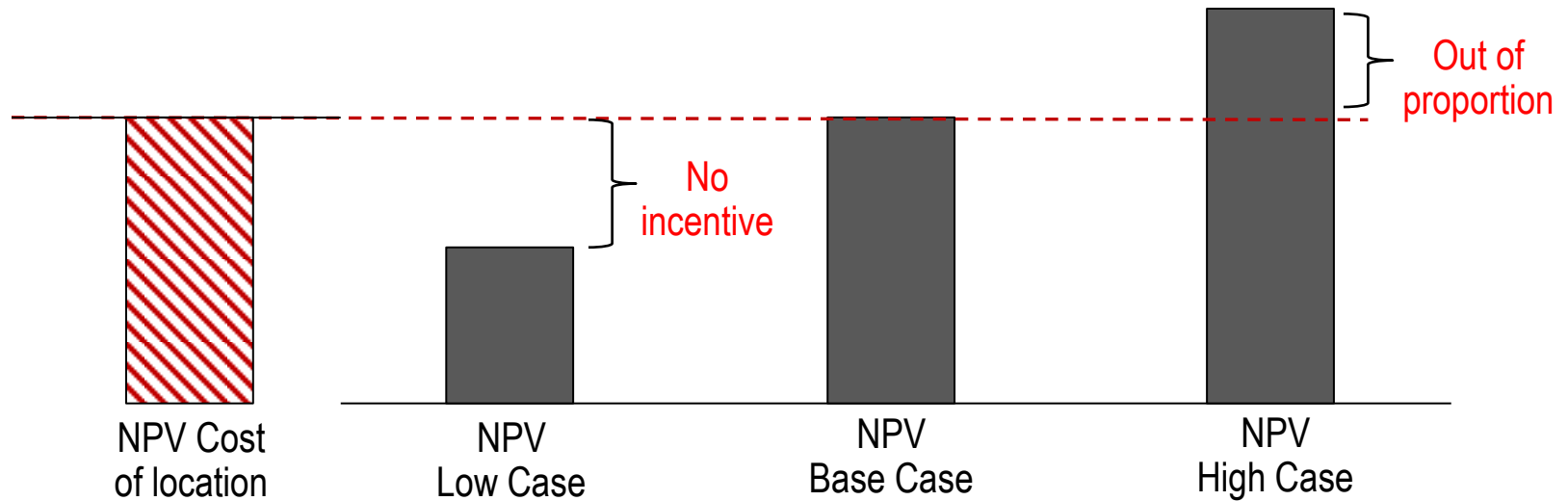


# Net present value without additional location costs





## Comparison of NPV costs of location and NPV project



"Practitioner's" view: Can we squeeze entrepreneurial decisions into the assessment framework?

## Conclusion on implementation

**Can we squeeze entrepreneurial decisions into the assessment framework?**

**Only to some extent**

**But the questions asked are right**