Regional Aid - observations on welfare and entrepreneurs

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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
• 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
Capturing effects: How does regional aid affect welfare?

Relevant effects on welfare

- State
  - Shadow cost of funds, transaction costs, lobbying

- Recipient
  - Distortion of incentives
  - Regional development
  - Crowding out
  - More supply at lower prices

- Staff and suppliers
- Rivals
- Consumers

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?
Comments on assessment principles

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
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

Low Case  Base Case  High Case

EBITDA  Investition  Endwert  NPV
Comparison of NPV costs of location and NPV project

NPV Cost of location

NPV Low Case

NPV Base Case

NPV High Case

Out of proportion

No incentive
“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