

E.CA Economics

# Theories of harm in EU State aid control

Brussels, 30 September 2016

## State Aid Control: Where Law and Economics Meet

Lexion Conference

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## Agenda

Introduction

Theories of harm in EU State aid control – a typology

Conclusion

## The "two faces" of State aid

- State aid may pursue sound public policy objectives of the Member States
  - State aid may distort competition and trade
    - negative spill-overs on other MS
    - undermine functioning of internal market
- general rationale of EU state aid control

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## A closer look at the negative effects of aid

- Assessment of effects of aid requires understanding of the **counterfactual**: what would the company do without aid?
- Close link to the question of the **incentive effect**
  - Incentive effect usually considered as part of assessing the necessity of aid, but equally relevant for assessing the negative effects

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## Nexus between incentive effect and distortions

Different distortions, depending on the scenario:

*Either*

- Aid is effective in achieving in the stated objective (e.g. fostering R&D, energy savings, ...): direct effect

*or*

- Aid is *not* effective: potential indirect effects
  - windfall profit to the firm: what impact?
  - aid is given to achieve "something else" (concealed support to preserve jobs, investment, ...)

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## Illustration – training aid to Ford Genk (2006)

- Aid for a training programme for production staff in Ford's production plant in Genk
- Cost: EUR 34 million
- Proposed subsidy: EUR 12 million
- Key question: incentive effect/counterfactual
- Background: strong competition between car plants (of the same company) for attracting new models

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## Ford Genk (cont'd)

- Commission's assessment: Ford would have carried out part of the training programme in any event
  - Linked with the launch of new car models
- Part of the aid (EUR 6 million – about half) was prohibited
  - Concern: the aid might influence Ford's location decision (i.e. aid is given to achieve "something else" than the nominal objective)

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## ... and an anecdote

- In 2012, Bekaert (large Belgian industrial firm active in steel wire transformation and coatings) announced that it would shed a large number of employees in response to worsening economic conditions.
- Questions were asked in the Flemish parliament as to whether previously given innovation aid (EUR 16 million) could be recovered from the firm. The leader of the opposition was quoted as saying:

*"Companies do not get these subsidies merely as a present. We expect these firms to make an effort as regards employment and [job] security"*

Source: De Standaard of 02.02.2012, *Peeters onderzoekt terugvordering steun aan Bekaert* (own translation)

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## Negative effects of state aid – a typology

### A. Loss of welfare (allocative inefficiencies)

1. Product market distortions
2. Input market distortions / locational inefficiencies
3. Distortive impact on other sectors
4. Shadow cost of taxation

### B. Shifts in welfare (distributional concerns)

1. Across EU Member States
2. Within Member States

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## A1. Product market distortions

### A. Interfering with the competitive entry and exit process

- Economic literature identifies the “churn process” (entry/exit process) within industries as a major driver of productivity growth

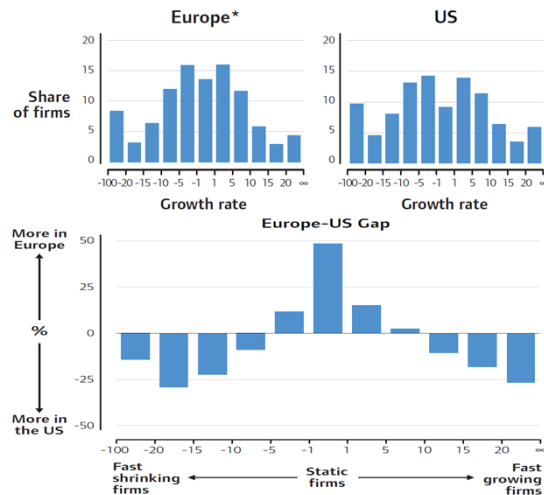
*E.g. Bailey, Hulten, and Campbell (Brookings, 1992); Foster, Haltiwanger & Krizan (2000, NBER; 2006 REStat) for the USA; Disney, Haskel & Heden (2003, Econ J) for the UK; Bartelsman, Haltiwanger & Scarpetta (2004); Aghion & Howitt (2006); EAGCP (2008); Bravo-Biosca (2011); Syverson (2011), ...*

- State aid may interfere with this process

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## Churn process (EU vs. US)

- Europe has a larger share of 'static' firms, the US has more fast growing and shrinking firms



Source: Bravo-Biosca (2011)

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## Churn process and state aid

- State aid may interfere with the (vital) churn process by maintaining market positions of less efficient, less innovative firms for longer than otherwise would be the case
  - important to well target the aid, e.g.
    - guard against too much recurrent aid
    - target the 'right' firms: focus eligibility on firm characteristics which correlate with a likely need for aid: e.g. target SME aid to younger firms
    - use types of aid that likely attract the 'right' firms: e.g. repayable advances in R&D
    - strict enforcement of R&R rules (of course)

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## Product market distortions (cont'd)

### B. Distorting dynamic incentives on the part of the recipient

- Kornai (1980): The 'Soft Budget Constraint': recurring aid, esp. given on an ex post basis, leads to all sorts of productive inefficiency
- Key concern in the context of aid to banks (TBTF): aid, or the prospect thereof, (i) reduces borrowing costs for the banks in question and (ii) may lead to more risk taking

*Weder di Mauro (2013) find that banks in major countries enjoyed an estimated funding cost advantage of 60 basis points in 2007 and 80 basis points in 2009. Survey results point to even greater reductions for some individual banks*

→ Important role of burden sharing

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## Product market distortions (cont'd)

### C. Creation or maintenance of market power

- Not a very frequent concern
- Probably mostly relevant to cases where the recipient already has a dominant position and is given support to expand

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## A2. Input market distortions

- Impact of certain types of aid is (partly or mainly) to be found in input markets
- Examples:
  - aid for energy efficiency
  - aid to compensate large industrial users for high electricity costs
  - regional aid (think of location as a bundle of inputs)
- Such aid may benefit the beneficiary and other firms in the input market who see demand for their products/services grow, but may also
  - harm the suppliers of other, competing inputs
  - indirectly affect other sectors using the same inputs
    - E.g. ETS compensation for some firms and sectors, but not for others

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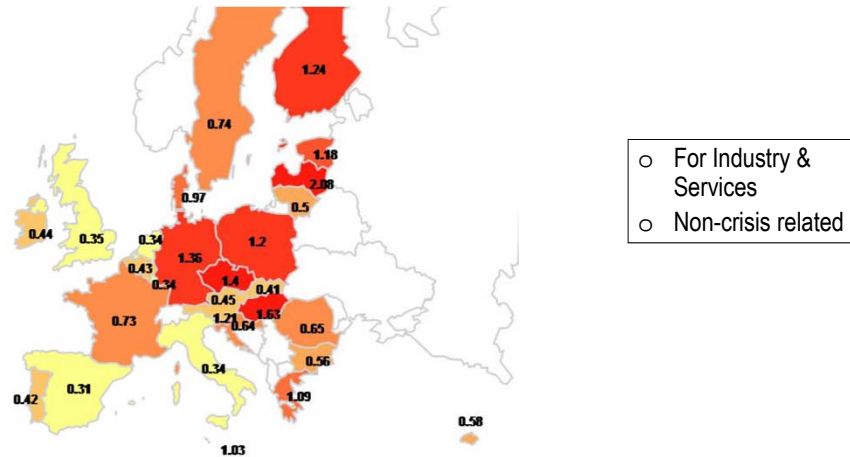
## Location as a bundle of inputs

- Prime example of aid affecting input markets: regional aid
  - One can view 'location' as a bundle of inputs (local labour force, natural resources, suppliers, capital markets)
- Regional aid may lead to negative effects on the efficient allocation of economic activity (e.g. when it goes against 'comparative advantage')
- But this is by no means a certainty. Indeed, subsidy races can be *efficient*
  - Cf. Besley/Seabright (1999):
    - "bidding contest" between regions would allow the region with the highest external regional benefits to obtain the investment → efficient outcome
    - However, the efficient outcome may not be achieved when some countries (e.g. poorer countries) are resource constrained

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## Propensity to give aid - differences across Member States



Source: State aid Scoreboard (2016)

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### A3. Distortive impact on other sectors

- Systematic support to certain sectors may harm other sectors
- Example: large scale operating aid to ailing sectors in the past (coal, steel, textiles, shipbuilding, ...) may have gone at the expense of investment in other sectors: R&D support to more promising sectors, public education, infrastructure, ...
- More recent example: compensation for direct and indirect ETS costs given to large industrial users in certain sectors. If not well designed, aid may take away incentive to reduce emissions/electricity consumption. Imposes burden on other sectors
- Side remark: application of selectivity criterion in Art. 107(1) TFEU (aid is selective when it differentiates across sectors)

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## A4. Shadow cost of taxation

- It costs money to raise money
- Empirical estimates of the shadow cost of taxation range from to country (partially reflecting differences in existing tax levels)
- Conservative estimates: 1.15 – 1.3.
  - This means that, for every euro of subsidy, it would cost an additional 15 to 30 cents to raise the funds through taxation
- Particularly relevant concern where state aid driven by subsidy races

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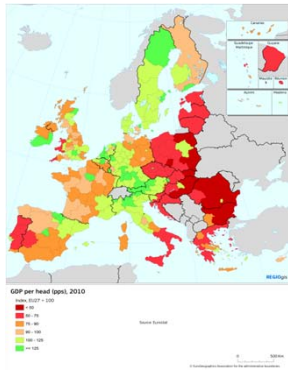
## Negative effects – distributional concerns

- Welfare shifts across EU Member States
- Welfare shifts within Member States

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## B1. Distributional concerns – shifts across Member States

### EU: more than a common market



- Article 3 TFEU:

*"The Union shall promote economic, social and territorial cohesion, and solidarity among Member States."*

- Article 174 TFEU

*"In order to promote its overall harmonious development, the Union shall develop and pursue actions leading to a strengthening of economic, social and territorial cohesion."*

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## Shifts across Member States (cont'd)

- Insofar as aid leads to effects on competition, it will affect (to a greater or lesser extent) trade among Member States
  - aid affects location of economic activity
- Agglomeration effects can reinforce this process
- Specific example: regional investment aid.
  - State Aid Modernisation (SAM): greater scrutiny of regional aid which will likely lead to shifts in location choice in the 'wrong' direction (attracting investment away from even more disadvantaged regions)
    - Approach already visible in IDAC Communication (2009) and application in cases in automotive sector

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## B2. Distributional concerns within Member States

- Shifts in welfare within Member States: from tax payer to owner or beneficiary
- Mainly a concern when the transfer is the result of a subsidy race (cross border dimension)
- Rent seeking

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## Questions

- Is the typology complete?
- Does it provide the right emphasis?
- What is the practical need? Does it 'merely' raise awareness, or can it achieve more?

(my claim: it has achieved more, cf. SAM)

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## Conclusion

- Analysis of incentive effect (counterfactual) essential element to assess theories of harm
- Typology of theories of harm possible and useful

## Thank you!

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