Examining the incentive effect of state aid

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This article examines how the incentive effect of state aid is defined and measured.

It also considers how the use of the incentive effect may impact on the behaviour of aid recipients. The availability of state aid would naturally induce them to undertake riskier projects that are not normally included in business plans which tend to be conservative.

Therefore, if business plans (looking into future) are the benchmark by which the incentive effect of state aid is established, then this benchmark may be a too easy test of the existence of the incentive effect.

The article also argues that the timing of the assessment of the need for state aid has a decisive impact on the determination of whether aid has an incentive effect or not. The timing of the assessment of the need for state aid is critical. Even projects that have already started may deserve to receive state aid if the aid can ensure that they are not abandoned.

This is highlighted by an analysis of the case of training aid to DHL. The Commission believes that training aid should not be used to induce companies to undertake regional investment. Commercial reality suggests that companies take into account the total amount of aid they expect to receive at different locations. The article examines this Commission Decision on the proposed training aid to DHL and suggests that that aid could have had an incentive effect, if it were offered to DHL before it made its decision to establish a logistics centre in Leipzig[1].

State aid must have an “ incentive effect”. But it may induce beneficiaries to undertake riskier projects and investment in riskier projects may not be in the interest of society at large.

The incentive effect of state aid means that undertakings are expected to do something extra with the aid. That “ extra” must go beyond their normal practices. This has recently been confirmed by the CFI in the Kronoply case: Case T-162/06, Kronoply GmbH & Co. KG v Commission of the European Communities (2009)[2].

The Commission has defined how the incentive effect is to be understood and measured in a number of recent policy documents, most notably the

Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General block exemption Regulation) – Recital 28, Article 8;

Framework on Research and Innovation (the R&D&I Framework): Community framework for state aid for research and development and innovation (OJ C 323, 30/12/2006, p. 0001 – 0026) – 1. 3. 4.;

Guidelines on Risk Capital: Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises (OJ C 194, 18/8/2006, p. 0002 – 0021) – 1. 3. 4.;

Guidelines on Environmental Protection: Community guidelines on state aid for environmental protection (OJ C 082, 01/04/2008, p. 0001 – 0033) – Recitals 27, 28;

Guidelines on the Assessment of Large Regional Projects: Commission Communication criteria for an in-depth assessment of regional aid to large investment projects, 24/6/2009 [not yet published in OJ],

http://europa. eu/rapid/pressReleasesAction. do? reference= MEMO/09/292&format= HTML&aged= 0〈uage= EN&guiLanguage= en.

The incentive effect is established at three levels of assessment that may be termed " standard", " additional" and " detailed" (note that all guidelines use these three levels):

at the " standard" level which applies to all cases, state aid lacks an incentive effect and it is therefore unnecessary when it is granted after a project or investment has been initiated. [see Art 8(2) of the block exemption Regulation, chapter 6 of the R&D&I Framework, chapter 3 of Environmental Guidelines, point 17 of the Guidelines on the Individual Assessment of Large Regional Projects];

at the " additional" level of assessment, undertakings [primarily large] which apply for aid before they start a project or investment, must also demonstrate that they do something extra by showing that they go beyond their normal practice as defined by their annual reports, or business plans OR other typical or benchmark behaviour for the industry in question in terms of output, expenditure, jobs, etc. [see chapter 6 of the R&D&I Framework, chapter 3 of Environmental Guidelines, point 19 of the Guidelines on the Individual Assessment of Large Regional Projects].

at the “ detailed” level of assessment [for aid amounts above certain thresholds], undertakings [primarily large] must further show that in the absence of aid they would not carry out the project or investment. They must also demonstrate that the project or investment itself is uneconomic or too risky. [see chapter 7 of the R&D&I Framework, chapter 5 of the Environmental Guidelines and point 23 of the Guidelines on the Individual Assessment of Large Regional Projects].

Phedon Nicolaides, Michael Kekelekis: An Economic Analysis of EC Guidelines on State Aid for the Rescue and Restructuring of Companies in Difficulty, Intereconomics, July/August 2004, 9p.

The Rescue and Restructuring State Aid Guidelines 1999 to expire on 9 October 2004.

This article mentions certain inconsistencies and proposes how to improve the next guidelines.

COM itself was aware of certain problems, namely:

What is the definition of “ firm in difficulties”?

How to assess group of companies (allocation of costs within the group)?

Urgency issue: when the state aid is granted prior to COM approval.

One time, last time principle – rescue aid is a one-off operation

Different time limits in the current framework

What compensatory measures are sufficient?

There are 3 internal inconsistencies in the Guidelines:

99% of companies are SMEs, but state aids for SMEs are exempted from state aids notification if lower than 10 mil. EUR + if purpose of rescuing companies is to prevent their surviving competitors dominating the market, then SMEs would not need to be rescued;

why to ask firms facing bankruptcy to reduce their output?;

if every company that receives restructuring aid has more than a fair chance to become profitable (return to viability), why then do private investors need any state aid?

ECJ has repeatedly ruled (e. g. in case C-730/79 Phillip Morris v. COM, paras. 16-17): " State aid is allowed for the purposes of inducing firms to do something they would not otherwise do under free market conditions."

The article further analyses 3 hypothetical plans for restructuring (to reduce workforce from 300 to 200, 100 OR 50) and assesses how minimising social cost is taken and should be taken into account by the COM.

60 % of EU awards were for just 4 MS (Germany, France, Spain and Italy): Are the firms in other countries immune from financial problems OR are the governments of these countries less willing to bail out firms in financial difficulty?

It is not for the COM to tell MS how to spend their money wisely. However, there must be an upper limit to the amount of authorised aid -> the social costs of letting the company go bankrupt. On the other hand, there is cost

for owners (redundancy payments) which can be avoided, if they can save the company. It should be up to the beneficiary company to argue the case and provide convincing evidence.

The authors welcome simplified procedure proposed for the new guidelines for “ urgency aids”. Urgency aids (to be repaid in 6 months) replace “ rescue aids” (to be repaid in 12 months). But they are not happy, that no restructuring plan is required for SMEs. The money contributed by owners must be at least 25% for small enterprises, 40% for medium-sized enterprises and 50% for large enterprises.

The new guidelines also do not require MS to grant socially optimum amounts of aid. The aid per employee varies from 4, 000 EUR to 755, 000 EUR[3]. The market shares vary from 0. 8% to 61%. Number of employees varies from 20 to 64, 000.

Phedon Nicolaides: Re-introducing the Market in the “ Market Economy Investor” Principle, European State Aid Law Quarterly 2003, 5p.

COM invented this principle almost 20 years ago (1983) to deal with injections of public capital, which cannot be prohibited by virtue of Article 295 EC (Art. 345 TFEU) to determine whether public investments contain state aid.

The author considers 3 observations:

the term “ market economy investor” is a misnomer;

ex-post assessment may undermine the principle itself;

it is necessary to “ re-introduce” market.

Firstly, the COM compares the actions of the public authority with those of a “ typical” private investor in a similar situation (in terms of the size, risk and terms of investment) – see landmark cases C-234/84 Belgium v. COM, C-40/85 Belgium v. COM, C-305/89 Italy v. COM, C-278/92 Spain v. COM, T-228/99 WestLB v. COM). In some cases (recovery of debt, rescheduling of debt OR closure of factories) the ECJ invented term “ private creditor” (T-152/99, C-334/99 C-342/99, C-256/97). In these conditions there are no comparable market benchmarks (every case is different): Creativity and ingenuity are as important as toughness and persistence in negotiations. That is why successful corporate bankers command huge salaries. Since public authorities are not known for their foresight and investments skills, it is hard to believe that public officials can negotiate as well as private investors. It is not a case of comparing agreed rates with market rates.

Secondly, as the landmark WestLB judgement clarifies, a private investor will demand a return on his investment that reflects all the benefits obtained by the recipient of his funds and will take into account all foreseeable future contingencies. Private investor always looks forward: “ bygones are bygones”. The author criticizes the judgement T-98/00 Linde v. COM, because a reasonable investor would never obliged himself to provide the privatised company with certain (chemical) product for a period of ten years at market prices. The German authorities argued, that when the agreement was made it was hoped that a second user of that chemical would build a plant in the area (PN: how reasonable was that expectation?). But the CFI found further payments to prevent much larger cost justified. The author

agrees with the judgement C-334/99 Germany v. COM: “ public authorities may not create costs for themselves which can justify the granting of additional state aid later on”, because ECJ correctly observed that Germany has included in the cost of closure the repayment of state aid that had been granted earlier.

Thirdly, private money is not the same as public money. Private investor is willing to tolerate less. There are 3 solutions:

the MS should have independent investor advisor to assess the deal;

the MS should use private intermediary for negotiations;

to adjust upwards the rate of return demanded for public funding (in comparison to private investor).

The proposed measures are not discriminatory (Art. 345 TFEU), because public investment is not the same as private investment. The officials are not dealing with their own money, so the due diligence is not the same.

The “ market economy investor” principle has been narrowed to only “ private investor” principle. Once the “ market” drops out, it is difficult to identify any hidden state aid.

R. Meiklejohn (ed.): State aid and the single market, 1999, European Commission, 206 p.[4](in the syllabus from the first semester only Synopsis and Chapter 1: The Economics of State Aid were present: p. 7-32)

http://www. tu-dresden. de/wwbwleeg/publications/hirschhausen_roeller_european_economy_state_aids_0399en. pdf

This publication contains 7 studies by several authors on several issues. Because the documents is quite old, I will summarize only briefly the synopsis:

Economics of State Aid (Meiklejohn)

State aid should prevent market failures. Perfect competition is based on radical assumptions (perfect information and foresight, perfect factor mobility, no economies of scale, no externalities). In real world government intervention may increase total welfare.

We consider 8 market failures: public goods; merit goods; increasing returns to scale; externalities (positive and negative); imperfect or asymmetric information (SMEs and innovative firms looking for capital on capital markets); institutional rigidities (e. g. labour market); imperfect factor mobility; subsidisation of foreign competitors. Income redistribution constitutes an additional reason for government intervention.

Intervention must be carefully considered to minimise distortions of competition, evasion, abuse OR the creation of perverse incentives.

Government expenditure has to be financed, which is likely to lead to some loss of efficiency in other parts of the economy.

The instrument can be chosen from wide panoply including: regulation; direct government provision of certain goods or services; taxation OR state aids. (effectiveness)

Trends and Patterns

Recent developments

Market definition (Fingleton, Ruane, Ryan)

The Treaties expressly demand geographical extent of the market (“ trade between MS”). In antitrust we analyse: demand side substitutability, supply side substitutability, temporal aspects (product market definition) AND geographic boundaries (geographic market definition). The narrower the market definition the more likely it is that a firm will be found to be dominant. We can compare characteristics of different products, own-price elasticity of demand, cross-price elasticities, ability of firms to switch production (time necessary to do that and sunk costs).

For geographic market definition transport cost and trade barriers are taken into account. Elzinga-Hogarty test and study of correlations of prices and price movements in different areas have both important drawbacks.

According to the authors it is necessary to distinguish between inputs and final products. The situation differs according to whether output market and input market are national or international (4 combinations). Therefore it is

necessary to define the geographic relevant market also for upstream market (where it buys its inputs) and neighbouring markets.

Taxonomy of aids: activity-specific; firm-specific; industry-specific; region/area-specific.

In state aids methodology, greater weight should be given to potential competition. The recipient of aid can also change its geographic market strategy. If a recipient can easily switch its production, spill-over into other markets is possible (even for activity-specific aids). Input and output markets must be defined, even if the recipient is vertically integrated. The potential of widening the geographic market (cf. internal market) must be taken into account. Also we must assess how costs and benefits are distributed = the degree of price competition can be a guide to the distribution between producer surplus and consumer surplus.

Restructuring and Privatisation

The case of new German Länder

The international context

Further documents to look at:

State Aid Action Plan 2005-2009 (SAAP) – quoted in the presentation

http://eur-lex. europa. eu/LexUriServ/LexUriServ. do? uri= COM: 2005: 0107: FIN: EN: PDF

Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of

Articles 87 and 88 of the Treaty (General block exemption Regulation) (Text with EEA relevance)

http://eur-lex. europa. eu/LexUriServ/LexUriServ. do? uri= CELEX: 32008R0800: EN: NOT

http://ec. europa. eu/competition/state_aid/legislation/block. html

State Aid Reform

http://ec. europa. eu/competition/state_aid/reform/reform. html

State Aid Scoreboard, Reports + Studies

http://ec. europa. eu/competition/state_aid/studies_reports/studies_reports. html