The economics of state aid economics essay

Economics

INTRODUCTION

State aid control is a unique and an important element of EU competition policy providing a necessary protection to defend effective competition and free trade in the single market. Less and better targeted aid has become the political mandate at both the national and European level.

THE ECONOMICS OF STATE AID

It has been emphasized that state support exists when there is a measure arranged by the state and through state resources. State aid can also take many forms such as lump sum grants, interest relief, tax relief, loan guarantees, government holdings, preferential borrowing requirements. From an economic perspective, state aid has two justifications: (1) Efficiency rationale and (2) Equity rationales. In the presence of market distortions, efficiency can be restored through subsidies as outlined by economic theory. However, it is also the case that subsidies can create distortions leading to welfare losses.

MARKET FAILURES

The economic description of market failure is closely linked with efficiency. Market failures are rooted in the nature of goods and embody two key issues – cost reflectivity and incentives. The argument is that with the right incentives, firms would respond by changing their behavior towards the need of society. Generally, in order for state aid to improve efficiency, the market failure needs to be significant. Analyzing the occurrence and scale of market failures is hence essential to make out the effect of State aids on efficiency. Even when an enterprise may not be able to embark on a project in the absence aid, this does not necessarily imply the existence of a market failure. On the contrary, it might represent the characteristics of a well functioning market. A market failure can be considered to exist only where market forces alone, in the absence of aid, would not be able to reach an efficient outcome. Those activities which have negative environmental impacts are examples of situations where market failures often arise. The reason is that property rights related with negative effects to the environment often do not exist or are not enforceable, and the activities of SMEs, which go through various market failures including those caused by capital market imperfections. Research and development is another classic example. The spillovers created by R&D efforts lead to positive externalities which are not captured by the enterprise undertaking the research. The above is in line with the general principle of competition policy. Market failures can appear in different forms, possess different origins and characteristics. The main ones are as follows: Externalities: From a societal point of view it is common for free markets to produce too much or too little of a good or service. This can happen when a firm individual cost of production do not take account of the wider costs or benefits to the general public. Pollution is a good example on the other hand, education would be underprovided if left to private markets. In order to try and address negative externalities, the instrument of regulation is used by Government to mandate remedial measures, persuasion, establishing property rights in the externality, and charging for pollution generating behavior. Market power: Firms that have market power may charge high prices that are excessive from society's point of view. In theory, the providing of state aid may reduce or create market power of firms when enterprises, which are not receiver of the measure, have to exit the market or where state aid is used to create entry barriers. Information asymmetries – In some markets, there is a gap between the information available to the supply-side and the information available to the demand-side. Firms seeking finance in the financial market is an important example as they are better informed about the state and prospects of the company than banks or investors. Where there is information asymmetry information disclosure alone may not be sufficient to change behaviour. As suggested by behavioural economics theory- individuals do not always make decisions in their best interests based on the information provided. Providing information in conjunction with other instruments may be necessary to overcome this market failure. Public goods are generally goods or services that are desirable in a social context but cannot be financed through the private sector. The reason for this is that a public good is a commodity or service whose benefits are not exhausted by an extra user and for which it is hard or impossible to exclude people from its benefits, even if they are unwilling to pay for them. Given these reasons, government intervention is thought necessary to subsidize training, take on part of the cost of research and other knowledge-based activities, offer inducement for investment in environmentally friendly machinery and production processes, control entry into the utilities sector and define the requirement of producers towards consumers." The " first-best" policy would be to address market failure directly, instead of granting state aid to compensate for it. Only when direct measures are not feasible should aid be considered, as a " second-best" option".[1]However, to determine the appropriate amount and method of aid may still be too difficult. Government may have to rely on incomplete information about the state of the economy and suffer from asymmetric information. The private sector looking to benefit from state aid holds information not directly available to the government, which thus runs the danger of being misled when designing and implementing its aid policy. Special interest groups may try and capture the aid-giving agency. The " politicization" of state aid is one of the main challenges facing aid-granting agencies. Hence, the cost of getting the policy incorrect may outweigh the gains of intervention to correct market failure. In conclusion, as a matter of economics, state aid should not be provided when there is no market failure because there can be no positive outcome on welfare from the aid and so the overall effect on welfare must be negative once the costs of raising the funds to finance the aid are considered. State intervention will not always be positive and in many cases will do more damage than good in the existence of a market failure.

EFFECTIVENESS OF STATE AID TO CORRECT MARKET FAILURE

State aid as a candidate solution, whether and how it can represent an optimal solution where a significant market failure has been identified will depend on a number of factors: Alternative remedies availableState aid is not necessarily the most favorable way to lessen or eliminate the market failure even in cases where the benefits of giving aid outweigh the costs. Amount/intensity of aidThe amount of aid required to correct a market failure depends on the significance of the market failure. Aid instrumentHowever, some instruments are better suited than others for correcting specific market failures. The right response targets the source of the market failure rather than the symptoms. Conditions of aidThe nature of the conditions may have direct impact on whether the aid will have a positive or negative impact on welfare. The more directly the conditions target the aid on the market failure in question, the more likely it will be that the aid is effective in addressing that market failure.

THE MARKET ECONOMY INVESTOR PRINCIPLE (MEIP)

In state aid cases MEIP has been used as one of the entry points for economic analysis by the European Commission. Its objective is to establish the extent to which an aid measure awards an economic advantage on the receiver of the aid. The main issue surrounding the MEIP is how to assess whether the terms of the alleged state aid measure are in line with terms acceptable to the private investor." The MEIP tests whether a transfer of state resources can be considered state aid. It is best thought of as an initial filter for assessing government assistance: if a measure passes the test, further analysis is not required. The principle assesses whether a particular financial deal struck by the state or a state owned firm would have also been acceptable to a private investor by analyzing the deal’s profitability. If the expected future profitability of the investment is equal or greater than the level that would be required by private investors in the markets, the MEIP test is passed and the measure is not classed as state aid."[2]The MEIP is a test of economic advantage rather than a test of economic rationality. There are four important points to consider when conducting an MEIP analysis: Expected profitability of the investment: Conduct a forward looking analysis: Conduct an incremental analysis: Profit measures and discount rate." The best possible evidence for the MEIP to be met is generally that the terms of the investment not only would be acceptable to a market economy investor, but that there is actually such an investor making the same investment on the same terms"[3]The most common argument for MEIP test application is: Possibility of internalized benefits to the contract by private investors. MEIP assessment periodAllocation of joint costs. Starting versus terminal asset values. In essence such a ‘ market economy agent’ test should endeavor to determine whether the public authority has clearly identified the public good or the need in the public interest to be satisfied or covered, has taken due consideration of the economic effects of the measure has conducted a cost-benefit analysis in agreement with economically sound and generally accepted methodology and based on reasonable estimates and credible assumptions, and has not incurred extreme risks or made extreme financial commitments that would render the decision so economically unbalanced as to make it irrational or exclusively defensible on political grounds completely detached from economic considerations and basic principles of proper public management.

CONCLUSION

The economic justification for state aid is the correction of market failure. However, a number of qualifications have to be made in this respect. First, market failure is a necessary, but not sufficient condition. Second, the costs of government intervention to correct market failure may outweigh any benefits. These costs include the cost of distortion to competition, the cost of taxation for raising subsidies, and the cost of administering the disbursement of subsidies. Third, the aid-granting authorities are always at a disadvantage in relation to aid recipients because they do not know the real costs of the latter and above all cannot know what the recipients would have done in the absence of aid." Market failure is a necessary but not sufficient condition for government subsidies to be welfare enhancing. This means that even where a market failure exists, state intervention will not always be beneficial and in many cases will do more harm than good. However, where no significant market failure exists, state aid can only have a negative effect overall."[4]The MEIP is a useful and necessary tool in state aid control. The purpose of the MEIP test is to ascertain if there has been a transfer of state resources. The fact that the state has provided funds, it is insufficient to conclude that a transfer of state resources has occurred; the state may have received resources in return. It examines if the return the state receives for its input would also have been acceptable to a private investor by analyzing its profitability. The MEIP is also particularly helpful for aid quantification in cases where the state intervenes with measures that are directly comparable to private investment decisions.

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