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Competition and cohesion - coherence or conflict? EU regional state aid reform post-2006

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3 **COMPETITION AND COHESION - COHERENCE OR CONFLICT? EU**
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5 **REGIONAL STATE AID REFORM POST-2006**
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17
18 **Abstract**
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21 In 2005 the European Commission adopted competition policy Guidelines regulating
22 national regional aid. Mirroring EU Cohesion policy reforms, initially the
23 Commission took a 'hard line' outlawing national regional aid, except in areas
24 designated by the Commission, in order to improve cohesion, competition and the
25 efficiency of aid spending. This was successfully resisted by the Member States in
26 favour of a more flexible regime. This paper argues that Commission's approach to
27 regional aid reform was flawed and raises wider questions about the relationship
28 between national and EU regional policies and the way in which the EU promotes
29 cohesion, competition and competitiveness.
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44 **Keywords:**
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47 EU competition policy
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50 EU cohesion policy
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53 State aid
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56 Regional policy
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59 Regional incentives
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3 Assisted areas
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7 **JEL classification:** R58, F13, L50
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10 INTRODUCTION

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13 Enlargement of the European Union in 2004 focused academic and policymaker
14 attention on the implications for EU Cohesion policy reform. In contrast, the potential
15 impact of enlargement on Member States *own* regional policies passed largely
16 unremarked, at least by the academic community. Just after the Council agreed the
17 Cohesion policy budget for 2007-13, the Commission quietly approved regional aid
18 Guidelines for the same period, imposing significant new constraints on the design
19 and implementation of regional state aid.
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31 The review of the regional aid Guidelines took place against the backdrop of
32 considerable upheaval in the wider policy context. As well as enlargement and the
33 reform of EU Cohesion policy, the Commission was trying to remodel State aid
34 control policy and take account of the so-called Lisbon Agenda. Mirroring the
35 refocusing of EU Cohesion policy on the poorest regions, the Commission initially
36 took a 'hard line' – the *concentration* scenario - in its proposed reforms. It attempted
37 to outlaw national regional aid except in areas designated by the Commission,
38 claiming that this approach best satisfied the considerations and constraints arising
39 from the new policy environment. This was fiercely resisted by several Member
40 States, which argued for a more flexible regime – the *continuity* scenario - with scope
41 for Member States to designate their own assisted areas. The continuity scenario
42 ultimately prevailed, so that the rules adopted for 2007-13 bear greater resemblance to
43 those in place for 2000-6 than to the Commission's initial reform proposals.
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3 In considering these developments, this article is structured as follows. First, it places
4 the reforms in context by setting out the background to regional state aid control
5 policy. Second, it traces out the origins of the reforms for 2007-13 and analyses the
6 implications of the concentration and continuity scenarios. Third, it questions the
7 rigour of the debate about which scenario was best suited to the changing policy
8 context. Last, it draws some conclusions about the implications of the new Guidelines
9 for national regional policy and wider policy relations.

20 21 **BACKGROUND**

22
23
24 State aids have long been a staple instrument of government policy across a number
25 of sectors. Commission figures suggest EU25 expenditure of around €40 billion in
26 2004 for manufacturing and services.¹ Across the EU25 around €800 million of this is
27 regional aid (EUROPEAN COMMISSION, 2005a). However, this figure significantly
28 underplays true levels of regional aid expenditure because it excludes Structural Fund
29 cofinancing of national expenditures and because regional aid for small and medium-
30 sized enterprises (SMEs) is classed as SME aid, rather than regional aid. Nevertheless,
31 it is clear that regional aid remains a significant category of expenditure for many
32 countries. Importantly, Structural Funds spending is also subject to the state aid rules.

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35 The use of state aids in economic development policy is controversial. Domestically,
36 debates tend to centre on whether subsidies are efficient or effective ways of
37 addressing market failure, market imperfections or permanent geographical handicaps
38 and whether policy should seek instead to improve the general business environment
39 and reduce corporate taxation. This debate is beyond the scope of this article which
40 deals with the regulation of state aids at the European level; this is not fundamentally
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3 about efficiency and effectiveness (although the Commission has increasingly drawn
4 on these arguments) but rather about the distortion of trade and competition in the EU.
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8 9 ***Basic principles of state aid control***

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11 Under the Treaty of Rome (1957) the control of government subsidies was viewed as
12 essential to the internal market: as quotas and tariffs were being outlawed, the
13 temptation for governments to resort to other forms of protectionism was considered
14 likely to increase. Initially Commission action was tentative, but the last two decades
15 have seen state aid control rise up the agenda, culminating in the 2005-9 State Aid
16 Action Plan – SAAP (EUROPEAN COMMISSION, 2005b) a ‘roadmap’ for reform.
17 Moreover, as Commission confidence has increased, so has the scope of state aid
18 control. Not only do the rules apply to all publicly-funded intervention, but they also
19 impinge on activities as diverse as urban regeneration, broadband access, public
20 private partnerships, credit unions and infrastructure provision; they are not limited to
21 regulating aid for mobile projects or state-owned companies.
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39 The underlying principle of the EC Treaty provisions is that state aids are prohibited
40 (Article 87(1)). However, the ban is not absolute. There are some mandatory
41 exceptions,² but more importantly, a number of discretionary exceptions are outlined
42 in Article 87(3); their interpretation is the exclusive competence of the European
43 Commission. Crucially, plans to offer state aid (whether *ad hoc* or as an aid scheme)
44 must be notified to the Commission and approved by it before implementation;³
45 unauthorised aid is illegal and may have to be repaid.
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57 ***The regional aid derogations: ‘a’ regions and ‘c’ areas***

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3 The core of Commission policy on regional aids is its interpretation of Article
4 87(3)(a) and (c), which enable regional aids to be exempted from the general ban.
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6 Article 87(3)(a) concerns “regions where the standard of living is abnormally low or
7
8 where there is serious underemployment” (referred to as ‘a’ regions); Article 87(3)(c)
9
10 covers “aid to facilitate the development of certain economic activities or of certain
11
12 economic areas, where such aid does not adversely affect trading conditions to an
13
14 extent contrary to the common interest” (referred to as ‘c’ areas).
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21 The differences between the two provisions are important and have increasingly
22
23 affected how the Commission authorises aid area maps, the types of aid allowed and
24
25 the aid values permitted. This flows from a European Court of Justice ruling in the
26
27 late 1980s that ‘a’ areas were disadvantaged in relation to the *Community as a whole*;
28
29 in contrast, it held that ‘c’ areas were those disadvantaged *in relation to the national*
30
31 *average*.⁴
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36 Following this judgement, and partly as a consequence of the 1988 Structural Funds
37
38 reform, the Commission began to make explicit reference to ‘a’ and ‘c’ areas in
39
40 approving regional aid schemes and maps (EUROPEAN COMMISSION, 1988a);
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42 until then, the Commission had been lax in so doing, and its decision-making
43
44 generally lacked transparency.
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49 Since 1988 the definition of ‘a’ regions has become entrenched in regional aid control
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51 policy and applied increasingly strictly. The ‘a’ regions are those where GDP per head
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53 is less than 75 percent of the Community average.⁵ For its part, the definition of ‘c’
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55 areas has been much more fluid and, partly as a result, much more controversial.
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Regional aid Guidelines 2000-6

The 1998 Guidelines (EUROPEAN COMMISSION, 1998) covered the period 2000-6. Central to the approach was the perceived need to restrict aid area coverage: a ceiling of 42.7 per cent of the EU15 population was set.⁶ Within this, the 'a' regions contained around 21 per cent of the EU population. The remainder (around 22 per cent) was allocated between countries as 'c' area population 'quotas'. For most, this resulted in significant aid area cutbacks (compared with the position until 1999), although all of Greece, Ireland and Portugal remained eligible for national regional aid until December 2006 (see Table 1).

[Table 1 about here]

The selection of the 'c' areas within the population quotas was a national responsibility, but the area designation methodology was severely constrained by the Guidelines. Moreover, map proposals were closely scrutinised by the Commission and, following protracted negotiations, many had to be amended before the Commission would approve them.

The 1998 guidelines also imposed lower aid ceilings. As before, aid maxima reflected the severity of the regional problem; typically, these ranged from 20 per cent to 50 per cent of eligible investment, compared with up to 30 per cent and 75 per cent before 2000.⁷

Historically, regional aid control has used guidelines within which aid *schemes* can be authorised, obviating the need for case-by-case analysis of awards to firms. From a competition distortion perspective, the downside of this approach was that it sheltered thousands of awards from scrutiny of their competition and trade effects. Within the

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2
3 assisted area maps and aid ceilings, there were no constraints on the absolute amounts
4 of aid, the capital intensity of the investment or the market power of the recipient.⁸ In
5
6 the 1990s, the Commission, and to some extent the Council, became concerned at this
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8 lacuna and various mechanisms were considered, culminating in the 1998
9
10 'Multisectoral Framework' (MSF). This required case-by-case recalculation and
11
12 approval of awards to exceptionally large projects. However, the 1998 MSF failed to
13
14 have an impact (WISHLADE, 2003, p 127) and was replaced by the more
15
16 straightforward 2002 MSF (EUROPEAN COMMISSION, 2002b). This
17
18 systematically reduced aid rates available to all projects involving eligible expenditure
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20 exceeding €50 million. Moreover, the Commission had to individually approve aid for
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22 investments of more than €100 million where the aid proposed exceeded a specified
23
24 amount. In these individual cases aid would not be authorised if it reinforced a high
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26 market share or increased capacity in a stagnant sector; the onus was on the Member
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28 State to demonstrate that this was not so.
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39 **EVOLUTION OF THE REGIONAL AID GUIDELINES 2007-13**

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41 For several reasons the 2000-6 Guidelines could not simply be rolled forward for
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43 2007-13. In particular, the impact of the 2004 enlargement on average EU GDP per
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45 head had implications for 'a' region eligibility and Member States lobbied intensively
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47 for special treatment of the affected regions; the Commission was sympathetic, but
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49 had to reconcile this with its desire to maintain overall discipline. In addition, a legal
50
51 challenge to the Commission Decision on the German regional aid map had resulted
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53 in criticism of the 1998 Guidelines; the Commission could not ignore these
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55 observations. Also, there was widespread resentment among EU15 Member States at
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57 the impact of the 1998 Guidelines; privately some Commission officials admitted that
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3 a repeat of the 1999-2000 map negotiations could not be contemplated. More
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5 generally, the renewal of the Guidelines could not be isolated either from the future of
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7 EU Cohesion policy or from the changing context for state aid control – as reflected in
8
9 the four considerations and constraints identified by DG Competition discussed
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11 below.
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14 15 16 *Genesis of a reform* 17

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19 Early signs that radical change might be countenanced were contained in a
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21 questionnaire circulated to the Member States in 2003.⁹ This indicated that the
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23 Commission's position on 'a', former 'a', Outermost¹⁰ and sparsely-populated regions
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25 was "relatively clear", but opened the debate about what might be acceptable
26
27 elsewhere. In particular, the questionnaire asked whether "investment aid is a relic of
28
29 an obsolete concept of regional aid" and mooted the possibility of prohibiting
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31 investment aid for large firms outside 'a' regions. This line of thinking was fleshed
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33 out by the Director-General of DG Competition who outlined two "provisional
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35 scenarios" (LOWE, 2003a), here termed the 'concentration' and 'continuity'
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37 scenarios.
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44 The concentration scenario involved allowing regional aid only in 'a' regions and in
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46 'c' areas selected by the Commission ('earmarked' areas). The continuity scenario
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48 was built on a simplification of the 2000-6 approach; in addition to the 'a' regions and
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50 earmarked 'c' areas, further 'c' areas could be designated by the Member States,
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52 subject to an overall ceiling of the EU25 population.
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57 The Director General argued that the concentration scenario would be simpler and
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59 better satisfy the four considerations and constraints on DG Competition's agenda,
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namely: the objective of 'less and better aid'; the need to reconcile the reduction in

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3 state aid volumes with the objective of economic and social cohesion; the
4
5 simplification and modernisation of state aid control and a focus on the most
6
7 distortive aids; and experience with the 1998 Guidelines. The Third Cohesion Report
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9 (EUROPEAN COMMISSION, 2004, pp xxxiii-xxxiv) soon confirmed the
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11 Commission view that the concentration scenario should be the basis for future
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13 regional aid control.
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16 17 18 *Concentration scenario proposals – a hard line* 19

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22 By end 2004, DG Competition had issued proposals for regional aid control post-2006
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24 embodying the concentration scenario (DG COMPETITION 2004a and 2004b). For
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26 ‘a’ regions, the main change proposed was that the threshold be 75 per cent of EU25
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28 (rather than EU15) GDP per head.¹¹ The main impact of this (the ‘statistical effect’)
29
30 was to lower the cut-off point for ‘a’ region status and exclude a number of EU15
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32 regions from eligibility. For the ‘c’ areas DG Competition proposed to replace the
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34 population quotas with three categories of earmarked region:
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38 • ‘statistical effect’ regions - those that would have met the ‘a’ region GDP per
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40 head threshold using EU15 data, but were excluded on the basis of EU25
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42 averages. Most had ‘a’ status in 2000-6, but some that did not would also
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44 qualify e.g. Highlands & Islands (UK);¹²
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48 • ‘economic growth’ regions - areas that would have outgrown ‘a’ region
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50 eligibility, even without enlargement, owing to a relative increase in levels of
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52 GDP per head e.g. Valencia (Spain);
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56 • sparsely-populated areas - regions with fewer than 12.5 inhabitants per km²
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58 (mainly in Finland and Sweden).
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4 An important element of the proposals was the reduction of maximum rates of award
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6 (except for SMEs, for which ceilings would be higher). The lower ceilings were
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8 achieved by reducing nominal award values and setting award rates in gross rather
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10 than net terms. Moreover, in response to concerns of some Member States about
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12 cross-border issues, DG Competition proposed a maximum rate differential of 30
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14 percentage points between neighbouring regions at a national border.
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18 These proposals represented a very significant shift in the rules governing regional
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20 aid, effectively outlawing traditional regional aid in much of the EU15. The
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22 implication of the proposals for the EU25 was a 17 percentage-point cutback in
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24 coverage from 52 per cent of the population in 2000-6 to around 35 per cent from
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26 2007 (Table 2). These reductions were unevenly distributed: there would be no aid
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28 area coverage in Cyprus, Denmark, mainland France, Luxembourg and the
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30 Netherlands; several countries, including the UK, would see cutbacks of more than 50
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32 per cent; elsewhere there would be more modest reductions or coverage would be
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34 unchanged.
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41 *[Table 2 about here]*
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44 There were also significant implications for maximum award rates. Direct
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46 comparisons are difficult but, by way of example, a region where the maximum was
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48 50 per cent *net* would probably have a new maximum of 30 per cent *gross* – less than
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50 half the previous value.
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54 Finally, the proposals referred to possible new ‘significant impact test’ instruments,
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56 which would partially compensate for the loss of aid area status by offering greater
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58 flexibility for ‘non-significant’ aid in *all* areas. The proposed frameworks on lesser
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60 amounts of state aid (LASA) and aid with a limited effect on trade (LET) were an

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3 important part of the Commission's strategy to focus resources on cases raising the
4 most serious competition concerns. However, they were dropped by DG Competition
5 early in 2005.¹³ They failed to gain widespread support among the Member States and
6 it seems probable that the Commission legal services also had concerns.
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14 A multilateral meeting took place in February 2005, after which Member States were
15 invited to submit any further comments; the reactions were diverse. Most of the new
16 Member States supported the principle of the approach with its focus on poorer
17 regions. However, some (for example, the Netherlands) argued for an even stricter
18 approach, with regional aid limited to the new Member States and the phasing-out of
19 all regional aid in the EU15. In contrast, many EU15 countries (notably Austria,
20 France, Germany, and the UK, which sent a joint letter to the Commissioner for
21 Competition Policy) expressed concern at the loss of scope for *national* policy to
22 target underperforming regions. (WISHLADE, 2004).
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34 35 36 ***Continuity scenario proposals – a 'U-turn'*** 37

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39 Against this background, in July 2005 the Commission reversed its position in a draft
40 Communication (EUROPEAN COMMISSION, 2005c). There were further meetings
41 with and submissions from the Member States; the European Parliament and the
42 Committee of the Regions also reported, both criticising the 'hard line' on spatial
43 coverage (EUROPEAN PARLIAMENT, 2005; COMMITTEE OF THE REGIONS,
44 2005). Last, immediately after the European Council agreed the EU budget, the
45 Commission issued the final text of the new rules (EUROPEAN COMMISSION,
46 2006).
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59 The 2006 Guidelines are a retreat from the 2004 proposals and a partial return to the
60 approach embodied in the 1998 Guidelines. The most significant aspects of the U-turn

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3 concern the reintroduction of an overall population ceiling (43 per cent of the EU25
4 population) within which ‘c’ areas may be designated by the Member States (see
5
6 Table 3 – non-earmarked ‘c’ areas). The outcome is a return to the situation where
7
8 every Member State not entirely covered by ‘a’ status has a population quota for ‘c’
9
10 areas with eligibility determined by the national authorities. The national ‘c’
11
12 population quotas are, as in the 1998 Guidelines, based on internal disparities in GDP
13
14 and unemployment adjusted to reflect the EU context, but a ‘safety net’ provision
15
16 limits losses to 50 per cent of 2006 coverage and modest transitional arrangements
17
18 apply.
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26 *[Table 3 about here]*
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29 As Table 3 shows, the addition of non-earmarked ‘c’ areas means there were no
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31 ‘losers’ from the continuity scenario, compared with the concentration scenario
32
33 proposals. However, the gains for some countries were non-existent or very modest:
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35 Italy, Portugal, Spain and Sweden see small increases and coverage is unchanged for
36
37 all the new Member States except Cyprus. By contrast, for Austria, Belgium, Cyprus,
38
39 France, Germany, Ireland, Luxembourg and the UK aid area population coverage is
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41 increased by between 10 and 50 percentage points. In no case is coverage for 2007-13
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43 higher than for 2000-6 (compare Tables 1 and 3).
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50 **SATISFYING THE CONSTRAINTS AND CONSIDERATIONS**

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53 The evolution of the 2006 Guidelines is the road from DG Competition’s (preferred)
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55 concentration scenario to the continuity scenario. Opinion is divided among national
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57 policymakers as to whether this was a deliberate negotiating strategy. It could be
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59 argued that presenting such a radical proposal at the start essentially ‘softened them
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3 up' to accept rules that were, by contrast, much less stringent, but nevertheless much
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5 more constraining than the 1998 Guidelines. An alternative view is that DG
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7 Competition was initially unable, from a technical perspective, to devise proposals for
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9 nationally-designated 'c' areas that disciplined coverage sufficiently; it therefore
10
11 opted simply to eliminate 'c' areas, other than those earmarked using EU criteria.
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16 Whether or not this policy U-turn was planned from the outset, DG Competition quite
17
18 evidently had to square a range of policy objectives, address technical and legal
19
20 challenges and reconcile differing viewpoints. Moreover, its preference for the
21
22 concentration scenario reflected the view that it better satisfied the four key
23
24 considerations identified earlier. This section questions the rigour of this claim.
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28 29 *Less and better aid*

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31
32 Of late, the 'less and better aid' mantra has become the *leitmotif* of Commission state
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34 aid policy (KROES 2005). This sentiment first appeared in the Commission's
35
36 'Strategy for Europe's Internal Market' (EUROPEAN COMMISSION 1999). It was
37
38 endorsed by the 1999 Helsinki European Council and picked up at the Lisbon Summit
39
40 in 2000, which noted the need to:
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45 "promote competition and reduce the general level of State aids, shifting the
46
47 emphasis from supporting individual companies or sectors towards tackling
48
49 horizontal objectives of Community interest, such as employment, regional
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51 development, environment and training or research." (EUROPEAN
52
53 COUNCIL, 2000, p 6)
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58 By the time of the Barcelona Summit, this objective had mutated somewhat and the
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60 European Council:

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3 “renew[ed] its call to Member States to reduce the overall level of State aid as
4 a percentage of GDP by 2003, and onwards, and to redirect such aid towards
5 horizontal objectives of common interest, including economic and social
6 cohesion, and target it to identified market failures. Less and better-targeted
7 State aid is a key part of effective competition.” (EUROPEAN COUNCIL,
8 2002, p 7)
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18 The notion of ‘better’ aid is not defined. Nevertheless, a number of elements have
19 emerged in recent policy debates, notably: the targeting of aid at clearly identified
20 market failures (COUNCIL, 2002); the efficiency and effectiveness of aid
21 (EUROPEAN COMMISSION 2002a); and the redirection of aid towards ‘horizontal’
22 objectives and away from rescue, restructuring and sectoral objectives (EUROPEAN
23 COUNCIL, 2002).
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34 Would the concentration scenario for regional aid reform have delivered better on the
35 objective of ‘less and better’ aid than the continuity scenario? It is plausible to argue
36 that reducing aid areas from 52.3 per cent to 35.5 per cent of the EU25 population
37 would result in lower state aid expenditure. But would eliminating regional aid in
38 most ‘c’ areas make for ‘better’ aid? Neither scenario provided for a clear
39 identification of market failures nor for any mechanisms for determining the
40 efficiency or effectiveness of policy. The nub of the ‘better aid’ question therefore lies
41 in the interpretation of ‘horizontal objectives’.
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53 As quoted, the 2000 Lisbon summit conclusions cite “regional development” as an
54 example of a horizontal objective; by the 2002 Barcelona Council, this focus had
55 shifted to “economic and social cohesion”. For the *Commission*, this has become
56 synonymous with targeting ‘a’ regions: “Greater cohesion will only be achieved...
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3 ...if aid is concentrated on the least developed regions....the so-called ‘a’ regions”
4
5 (EUROPEAN COMMISSION, 2003, p 6). Taking this narrow interpretation, it is
6
7 clear that the concentration scenario fulfils the ‘less but better’ objective more closely.
8
9 However, under Article 158 of the EC Treaty, the notion of ‘cohesion’ is less
10
11 restricted: “the Community shall aim at reducing disparities between the levels of
12
13 development of the various regions and the backwardness of the least favoured
14
15 regions or islands, including rural areas.” Article 159 requires the Member States to
16
17 conduct and coordinate their economic policies “in such a way as, in addition, to
18
19 attain the objectives set out in Article 158.”
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24
25 In short, the concentration scenario only delivers ‘less and better aid’ to the extent that
26
27 cohesion policy is synonymous with targeting ‘a’ regions. This narrow interpretation
28
29 which has emerged in recent policy statements is questionable; it limits the scope for
30
31 *Member States* to tackle “disparities between the levels of development of the various
32
33 regions” as required by the Treaty.
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38 ***Reconciling lower state aid volumes with cohesion in an enlarged EU***

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41 The ‘less and better’ objective is closely related to the aim of reconciling lower state
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43 aid spending with cohesion. The Director General of DG Competition argued that the
44
45 concentration scenario would deliver better on this because the elimination of almost
46
47 all ‘c’ areas would itself reduce state aid spending. Moreover, within the ‘a’ regions,
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49 aid would not only be more effective but rates of award could be lowered (further
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51 reducing spending) because of the absence of rate competition from ‘c’ areas (LOWE
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56 2003a).
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59 ***[Table 4 about here]***
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3 Table 4 illustrates the erosion of rate differentials in the evolution of the 2006
4 Guidelines. In the continuity scenario proposals (DG COMPETITION, 2004b), the
5 threshold for the poorest grouping was lowered from 50 per cent to 45 per cent of EU
6 GDP, excluding around 12 million (Polish and Slovak) inhabitants from this category.
7
8 In addition, the scope for 'c' areas to be designated by the Member States was
9 introduced, with maximum award rates of 10 to 15 per cent of investment. Last,
10 special provisions were introduced to limit the aid rate differentials between regions
11 in neighbouring countries.
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23 The adoption of the continuity scenario will certainly result in higher spending in 'c'
24 areas, although data constraints and the 'unknown' of future policy designs make it
25 impossible to estimate the scale of such spending. Moreover, the maintenance of more
26 extensive 'c' areas clearly erodes the rate differential between 'a' regions and other
27 parts of the EU. However, this does not mean that the continuity scenario fails to
28 reconcile cohesion objectives with reduced spending. In practice, this depends, as
29 noted earlier, on the interpretation of 'cohesion' – is the consideration of cohesion
30 from a Commission or Member State perspective? In addition, favouring the
31 concentration scenario presupposes an understanding of the impact of award rate
32 differentials and an ability to calibrate these to reflect policy objectives. There is no
33 evidence of this. Historically, the Commission has rather arbitrarily set award ceilings
34 broadly in line with its perception of the regional problem, mainly using GDP per
35 head. The resulting pattern of rates and rate differentials bears no direct relationship to
36 that which would influence location decisions (which in turn would be likely to vary
37 between project types and sectors). More generally, the focus on aid differentials is
38 only reasonable if it is assumed that regional policy is solely a means of *diverting* jobs
39 and investment between regions (ARMSTRONG, 1984).
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3 *Simplification, modernisation and emphasis on the most distortive forms of aid*
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7 Simplification and modernisation are key themes of the reform agenda in the SAAP
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9 (EUROPEAN COMMISSION, 2005b). They have primarily been concerned with
10
11 procedural issues and the governance of state aid control. In parallel, the Commission
12
13 has been sensitive to criticism of its formalistic approach and concerned at the
14
15 disproportionate resources involved in scrutinising measures with limited competition
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17 effects. The DG Competition Director General has observed that “there is the
18
19 impression that we are simply applying rules which aim to curtail state aid as such
20
21 rather than concentrating on controlling aid which really distorts the European single
22
23 market” (LOWE, 2003b, p 1). These concerns led to (unsuccessful) attempts to devise
24
25 a ‘light touch’ approach to measures with insignificant competition implications – the
26
27 LASA and LET proposals mentioned earlier.
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34 Would the concentration scenario have contributed more effectively to the
35
36 simplification and modernisation agenda and targeted the most distortive forms of aid
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38 better? At a superficial level, a policy which allows regional aid only in ‘a’ regions
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40 and earmarked areas is clearly ‘simpler’ than one with wider criteria, but it seems
41
42 doubtful that it could be deemed more ‘modern’. More relevant is the issue of
43
44 competition distortion. In practice, both scenarios focus on aid area coverage and,
45
46 specifically whether Member States should have the scope to designate ‘c’ areas
47
48 beyond those earmarked. It can be argued that the spatial extent of policy is of limited
49
50 relevance to targeting the most distortive forms of aid; instead, competition effects are
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52 more likely to be driven by sectoral considerations like the extent of international
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54 exposure or market power.
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3 The view that the concentration scenario would better fulfil this criterion implicitly
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5 assumes that aid is more distortive if offered in a more prosperous region. Historically
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7 this derives from the interpretation of the Article 87(3)(c) derogation for ‘aid to
8
9 facilitate the development of... ..certain economic areas, where such aid does not
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11 adversely affect trading conditions to an extent contrary to the common interest.’
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15 BESLEY and SEABRIGHT (1998) have pointed out that there are few agreed criteria
16
17 for determining when an aid distorts competition. Moreover, evidence to establish
18
19 what is in the ‘common interest’ remain elusive, so that, in practice, an analysis of the
20
21 potential trade impacts has been supplanted by an assessment of whether regional aid
22
23 is justified by social and economic conditions. Even the Chief Economist of DG
24
25 Competition acknowledges that balancing the common interest against distortions of
26
27 competition is not explicitly undertaken in Commission assessments (ROLLER,
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32 2005).

33 34 35 *Experience with the 1998 regional aid Guidelines*

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38 The last consideration concerns practical constraints. There was considerable
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40 frustration and resentment among national policymakers at the detailed involvement
41
42 of Commission officials in the selection of aid areas in 1999-2000 (WISHLADE,
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44 2003); and many acknowledged that they would not wish to repeat the process. In
45
46 addition, the 1998 Guidelines were criticised in litigation brought by Germany against
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48 a Commission Decision on the German aid map.¹⁴ This action was not successful, but
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50 the Advocate General questioned the methodology for allocating ‘c’ area population
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52 quotas between countries and concluded that it breached the principle of equal
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57 treatment.¹⁵
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3 Clearly the concentration scenario would have eliminated these issues from the reform
4 agenda: restricting 'c' areas to those earmarked by the Commission would have
5 obviated the need to calculate 'c' population quotas and negotiate the aid maps.
6
7 Undoubtedly, the concentration scenario would have responded more simply to the
8 issues raised by the 1998 Guidelines, but it is important not to confuse simplicity with
9 even-handedness. As the adoption of the continuity scenario has shown, the criticisms
10 made by the Advocate General were not insurmountable and the more straightforward
11 area designation framework under the 2006 Guidelines suggests that there were ways
12 to avoid excessively detailed map negotiations.
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29 **WIDER POLICY ISSUES**

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32 This paper has argued that the case for the concentration scenario was self-fulfilling:
33 the concentration scenario only delivers better on DG Competition's constraints and
34 considerations to the extent that a restrictive interpretation of 'cohesion' is adopted.
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36 Moreover, the choice presented was false: because both scenarios focused on spatial
37 coverage, neither had the capacity, in itself, to address the key issues of 'better aid' or
38 competition distortion.
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48 The debate surrounding the reform of the regional aid Guidelines was contrived as a
49 choice between options for spatial coverage, based on a narrow view of 'cohesion' –
50 targeting the 'a' regions. The limited focus of the reform options meant that wider
51 questions about the relationship between national and EU regional policies and the
52 ways in which cohesion, competition and competitiveness are promoted were not
53 really addressed in the debate. The discussion that follows seeks to open up some of
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3 these issues by situating the new Guidelines in a broader context and considering
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5 some of their wider policy implications.
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9 *A missed opportunity to decouple national and EU regional policies?*
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12 The new Guidelines are a U-turn in the Commission's original position, but the spatial
13 coverage of *national* regional policies will still be driven by EU Cohesion policy
14 objectives; areas holding less than 8 per cent of the EU25 population are designated
15 on the basis of national priorities. The preoccupation with spatial coverage, combined
16 with the use of EU cohesion criteria, has implications for subsidiarity and the capacity
17 of Member States to design and conduct spatially-differentiated policies.
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28 There have long been direct links between the control of Member State regional
29 policies and the emergence of a bespoke Community regional policy. Early observers
30 stressed the importance of Community-level controls over national regional aid as a
31 partial substitute for a common regional policy (DEACON, 1982) and from the late
32 1980s it became standard Commission rhetoric to promote regional aid control as an
33 aspect of cohesion policy (EUROPEAN COMMISSION, 1988b). As the two policies
34 became more closely intertwined, issues of policy coherence, primarily expressed in
35 terms of the extent to which the national and the EU assisted areas maps coincide,
36 gained prominence (WISHLADE, 2003). BESLEY and SEABRIGHT (1999), among
37 others, argued that there was no justification for seeking to ensure map coincidence;
38 while VANHOVE (2000) has taken the opposite view.
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54 The reform of cohesion policy against the backdrop of enlargement created an
55 opportunity for a fundamental reappraisal of the targeting and coordination of EU and
56 Member States' regional policies. In spite of some prompts (e.g. the SAPIR report
57 (2003) and the UK regional policy White Paper (HM TREASURY *et al.*, 2003)) the
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3 emphasis was on how to adapt *existing* policy rather than on radical reform. A
4
5 discussion of the refocusing of EU Cohesion policy is outside the scope of this paper;
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8 however, it can be argued that, whilst it is justifiable for enlargement to affect the
9
10 targeting of EU resources, this does not hold for *national* resources. Enlargement has
11
12 altered the *relative* prosperity of the EU15 regions, but not their *absolute* situations; it
13
14 is difficult to justify tighter constraints on *national* regional policy simply because the
15
16 EU now includes even poorer regions. The chance to reconsider the appropriate
17
18 articulation of EU, national and subnational policies appears to have been missed.
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22 23 ***A blunt instrument for addressing competition distortion*** 24

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26 An important strand of the state aid reform agenda is the focus on the most distortive
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28 aids. This has partly been driven by the administrative implications of enlargement
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30 and concerns at the disproportionate resources involved in the scrutiny of measures
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32 raising few competition concerns.
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36 Neither of the scenarios proposed addresses the issue of distortion head-on; in line
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38 with long-standing trends, the emphasis of the proposals was on the spatial coverage
39
40 of policy rather than on the competitive effects of aid. As long as 20 years ago, the
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42 Commission itself acknowledged that: “area and population coverage provide a better
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44 indication of Member States’ regional policy than of the impact of schemes on
45
46 competition” (EUROPEAN COMMISSION, 1986, point 229).
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52 The main scope for competition distortion to be addressed directly lies in the
53
54 Multisectoral Framework, now brought within the regional aid Guidelines. For most
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56 projects, the MSF rules are substantially unchanged. However, because maximum
57
58 award values are reduced under the Guidelines, the aid rates available to investments
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60 exceeding €50 million also fall, as does the aid threshold beyond which projects must

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3 be notified individually to the Commission.¹⁶ For these projects, if the beneficiary
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6 accounts for more than 25 per cent of product sales or if the capacity created by the
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8 project is more than five per cent of the market:
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11 “the Commission will approve regional investment aid only after detailed
12
13 verification... ..that the aid is necessary to provide an incentive effect and that the
14
15 benefits of the aid measure outweigh the resulting distorting of competition and
16
17 effect on trade between Member States” (para 68)
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22 It is not yet clear quite how this will be operationalised: the criteria to be taken into
23
24 account in making this assessment will be the subject of further guidance (footnote
25
26 63). Nevertheless, the abandonment of LASA and LET and, for now, of a sectoral
27
28 component to the MSF (CAVALLO and JUNGINGER-DITTEL, 2004), which would
29
30 have outlawed aid to certain industries, means that the Commission has scarcely
31
32 sharpened its focus on the most distortive aids. There are reasons to believe that the
33
34 distortion of competition could have been targeted more accurately in two ways: first,
35
36 by pursuing the ‘significant impact’ approach proposed under LASA and LET to
37
38 eliminate minor aid from scrutiny; and second, by exploiting data on aid awards in
39
40 order to better understand their competition effects.¹⁷ Instead, regional aid control
41
42 remains a rather blunt instrument essentially regulating geographical coverage and aid
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44 values. Radical reductions in spatial coverage have seriously constrained aid area
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46 maps, often prohibiting measures that would have been quite innocuous; at the same
47
48 time, significant reductions in award values may, perversely, *reduce* the effectiveness
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50 of aid if rates fall to levels where they cease to influence investment decisions and
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52 lead to more windfall gains.
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Implications for international competitiveness

Much of the concern at the reforms, as expressed by EU15 Member States, centred on relocation within the EU and the border effects of high aid differentials. A more general issue is whether the reductions in aid area coverage and rates might affect the EU's global competitiveness for mobile investment – will award ceilings and aid areas become so limited as to be of no interest to mobile investment? Some are sceptical about the capacity of incentives to offset locational disadvantages and rightly point to the importance of the general business environment in improving competitiveness. However, all EU Member States retain the scope to aid large mobile projects and the effectiveness and efficiency of such measures is a domestic consideration; the Commission's remit should be limited to preventing distortions of competition that are not in the common interest. Moreover, it is worth noting that the EU system of state aid discipline is unique; alternative locations do not display similar self-restraint and may offer tax and other advantages that prove irresistible to mobile investors. This possibility has been noted by national policymakers; the Spring 2006 European Council concluded that:

“taking into account the external aspects of competitiveness, it considers that the review of state aid should encourage a high level of investment in Europe and make Europe attractive for future investment.” (EUROPEAN COUNCIL, 2006)

It remains to be seen how the Commission will address this issue, but for now there is no mechanism to deal a situation in which a single EU location is competing with non-EU alternatives.

The challenge of area designation

Behind the tortuous evolution of the new Guidelines, and the relief for many that some scope for national regional aid remains, policymakers have faced a considerable challenge in designating areas for 2007-13. In many ways the criteria are more flexible than before, but it was uncertain how the Commission would apply the rules in practice and the population coverage that Member States were free to designate was often extremely limited (just one per cent of the population in Italy and Spain) or significantly reduced compared with the 2000-6 position. The role of the subnational level in regional economic policy and the tradition of consultation in many countries, makes map revision politically difficult and administratively costly. Crucially, restricted coverage may compromise policy objectives, especially where the targeting of rural, urban and restructuring areas has to be shoe-horned into a single regional aid map. ARMSTRONG (2001) has in the past warned that lower spatial coverage increases the risk of inappropriate 'policy bending'. This tension is arguably even more acute in the context of devolved responsibilities where views may differ about economic development needs and the targeting of resources.

An emerging policy vacuum?

A key feature of a number of the existing horizontal aid frameworks is that projects in designated problem regions may benefit from higher rates of award or more flexible conditions. The loss of 'a' or 'c' area status therefore involves the loss of these benefits under the existing horizontal frameworks. The SAAP confirms that many of these horizontal frameworks will be revised and consultations have raised the issue of whether special treatment of disadvantaged areas under horizontal frameworks is justified. Moreover, even where more generous terms *are* available in the problem

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3 regions, the scope may be limited: for instance, in the new Guidelines on aid to
4 regional airports (EUROPEAN COMMISSION, 2005d) disadvantaged areas are
5 restricted to areas that are clearly defined at EU level and/or are specifically
6 recognised in the Treaty, not those identified by Member States.
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14 More generally, the combined effects of the Lisbon agenda and enlargement are
15 shaping EU Cohesion policy and state aid control policy in ways that have significant
16 implications for the problem regions of Member States without designated area status.
17
18 On the one hand, the competitiveness agenda promotes horizontal policies (most
19 obviously for R&D) that favour the development of *all* regions, but using policy
20 instruments where the impact and uptake is likely to be higher in the more prosperous
21 regions, especially under demand-led national schemes; on the other hand, EU
22 Cohesion and regional aid control policies target assistance at the least-prosperous
23 regions. Unless regional policymakers can influence their horizontal policy
24 counterparts, the net effect of this may be to create a policy vacuum for those regions
25 that are neither well-placed to benefit from policies focused on innovation or other
26 horizontal priorities, nor sufficiently disadvantaged to qualify for regional aid, either
27 at the national or Community levels.
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Table 1: Aid area coverage 2000/4-06 (% of population)

	'a' areas	'c' areas	TOTAL
Austria	3.5	24.1	27.6
Belgium		30.9	30.9
Cyprus		100.0	100.0
Czech Rep	88.6	11.4	100.0
Denmark		17.1	17.1
Estonia	100.0		100.0
Finland	13.4	28.9	42.3
France	2.8	33.9	36.7
Germany	17.2	17.7	34.9
Greece	100.0		100.0
Hungary	100.0		100.0
Ireland	26.6	73.4	100.0
Italy	33.6	10.0	43.6
Latvia	100.0		100.0
Lithuania	100.0		100.0
Luxembourg		32.0	32.0
Malta	100.0		100.0
Netherlands		15.0	15.0
Poland	100.0		100.0
Portugal	66.6	33.4	100.0
Slovenia	100.0		100.0
Slovakia	100.0		100.0
Spain	58.4	20.8	79.2
Sweden		15.9	15.9
UK	8.6	22.1	30.7
EU25	34.3	18.0	52.3
EU15	21.9	21.1	43.0
NMS10	97.6	2.4	100.0

Note: New Member States' (NMS10) maps were approved by the European Commission from 2004.

Source: Wishlade (2003) Figure 34 at p 205; DG Competition website at:

http://europa.eu.int/comm/competition/state_aid/regional/ (accessed March 2006); and

author's calculations.

Table 2: Coverage under the first Commission proposals for 2007-13 concentration scenario (% of population)

	'a' areas	'c' areas - statistical effect	'c' areas - economic growth	'c' areas - sparsely- populated	'c' areas total	TOTAL
Austria		3.4			3.4	3.4
Belgium		12.4			12.4	12.4
Cyprus						0.0
Czech Rep	88.6					88.6
Denmark						0.0
Estonia	100.0					100.0
Finland			13.0	10.7	23.7	23.7
France	2.7					2.7
Germany	12.5	6.1			6.1	18.6
Greece	36.6	55.5	7.8		63.4	100.0
Hungary	72.2		27.8		27.8	100.0
Ireland			26.5		26.5	26.5
Italy	29.2	1.0	2.9		3.9	33.1
Latvia	100.0					100.0
Lithuania	100.0					100.0
Luxembourg						0.0
Malta	100.0					100.0
Netherlands						0.0
Poland	100.0					100.0
Portugal	70.1	3.8			3.8	74.0
Slovakia	88.9					88.9
Slovenia	100.0					100.0
Spain	36	5.9	16.3	0.3	22.5	58.6
Sweden				13.0	13.0	13.0
UK	4.0	0.6	4.4		5.1	9.1
EU25	27.7	3.6	3.6	0.4	7.6	35.3
EU15	15.0	4.3	3.5	0.5	8.2	23.3
NMS10	92.9	0.0	3.8	0.0	3.9	96.7

Source: Author's calculations based on Eurostat data.

Table 3: Aid area coverage 2007-2013 (under the 2006 guidelines (% of population))

	'a' areas	'a' areas - statistical effect	Earmarked 'c' areas	TOTAL	Non- earmarked 'c' areas	Transitional 'c' areas
Austria		3.4	19.1	22.5	19.1	
Belgium		12.4	13.5	25.9	13.5	
Cyprus			50.0	50.0	50.0	16.0
Czech Rep	88.6			88.6		7.7
Denmark			8.6	8.6	8.6	2.7
Estonia	100.0			100.0		
Finland			33.0	33.0	9.3	
France	2.9		15.5	18.4	15.5	6.9
Germany	12.5	6.1	11.0	29.6	11.0	
Greece	36.6	55.5	7.9	100.0		
Hungary	72.2		27.8	100.0		
Ireland			50.0	50.0	23.5	25.0
Italy	29.2	1.0	3.9	34.1	1.0	5.6
Latvia	100.0			100.0		
Lithuania	100.0			100.0		
Luxembourg			16.0	16.0	16.0	5.1
Malta	100.0			100.0		
Netherlands			7.5	7.5	7.5	2.4
Poland	100.0			100.0		
Portugal	70.1	3.8	2.8	76.7	2.8	19.2
Slovakia	88.9			88.9		7.5
Slovenia	100.0			100.0		
Spain	36.2	5.8	17.7	59.6	1.1	12.4
Sweden			15.3	15.3	2.3	
UK	4.0	0.6	19.3	23.9	14.9	
EU25	27.7	3.6	11.8	43.1	7.8	3.8
EU15	15.0	4.3	13.2	32.5	9.2	4.2
NMS10	92.9	0.0	4.3	97.1	0.5	1.8

Notes: After 2010 some statistical effect regions may be 'downgraded' from 'a' to 'c'. Non-earmarked 'c' areas are those not classified as economic growth or sparsely-populated areas; these are included in the total. Transitional 'c' areas will lose aid area status at end 2008; these are not included in the total.

Source: EUROPEAN COMMISSION (2006) and author's calculations.

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Table 4: Maximum rates of award for large firms (% of eligible investment)

	Concentration scenario		Continuity scenario
	Working paper	Non-paper	2006 guidelines ^a
'a' areas \leq 45% GDP	50	40	50
^b			
'a' areas \leq 60% GDP	40	35	40
'a' areas \leq 75% GDP	30	30	30
Statistical effect	30->20	30->15	30->20
Sparsely populated	20	20	15
Economic growth	20	15	15/10
Other 'c' areas	~	~	15/10
Maximum rate differential	0	30	20

Notes: Maximum rates are raised by 10 percentage points for medium-sized firms and 20 percentage points for small firms. a) Rates remained unchanged between the draft and final guidelines; b) Threshold set at 50 per cent of EU25 GDP in Working Paper.

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¹ That is, excluding agriculture, fisheries, coal and transport.

² Essentially social aid and aid to compensate for natural disasters (Article 87(2)).

³ Except measure that conform to one of the block exemption regulations see:
http://ec.europa.eu/comm/competition/state_aid/legislation/block.html (Accessed
March 2006).

⁴ Case 248/84 *Federal Republic of Germany v Commission of the European
Communities* [1987] ECR 4013.

⁵ Measured in purchasing power standards (PPS) over the last three years at NUTS II;
the same definition as Objective 1 under the Structural Funds.

⁶ Compared with previous coverage of 46.7 per cent.

⁷ Expressed in net grant-equivalent (NGE). This refers to the after-tax value of
assistance and until 2006 was used by the Commission for comparing the value of all
forms of regional aid.

⁸ For a small number of industries special aid rules applied, notably: coal and steel,
shipbuilding, synthetic fibres and motor vehicles.

⁹ This has never been published but was kindly provided to the author by several
national regional policymakers.

¹⁰ Guyane, Martinique, Guadeloupe, Réunion, Madeira, Azores and Canarias.

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¹¹ Reflecting the provisions of the Constitutional Treaty, the Outermost regions were also included in the 'a' areas.

¹² The equivalent threshold to 75 per cent of the EU15 average is 82.2 per cent of the EU25 average, on the basis of GDP data for 2000-2.

¹³ The draft LASA and LET frameworks were available on DG Competition's website, but were withdrawn in 2005; for an overview of the proposals see WISHLADE 2004.

¹⁴ C-242/00 *Germany v European Commission* [2002] ECR I-05603.

¹⁵ The Advocate General prepares an Opinion to assist the European Court of Justice. This is not binding, but in this case it was followed.

¹⁶ This being the amount of aid that a €100 million project could receive in the area concerned, so that the threshold is in effect raised in higher rate regions. For a €500 million project the rate at which aid is notifiable is 2.25 per cent of eligible expenditure in a 15 per cent rate region and 4.5 per cent in a 30 per cent rate region.

¹⁷ Member States have long been obliged to provide annual reports detailing the major aid beneficiaries.