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The Economics of State Aid Control: Some Remarks

Mathias Dewatripont

This short comment discusses the rationale for State aid control at the level of the European Community and then turns to the State Aid Action Plan and its application to aid to Research, Development, and Innovation. It discusses the merits of a refined economic approach for "better targeting" purposes and stresses the need for State aid control to focus on preventing an excessive reliance on an "innovation-based industrial policy."

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I. Introduction

In his paper,[1] Philip Lowe has offered an excellent discussion of the general objectives and challenges of EC State aid policy, as well as a detailed description of the "State Aid Action Plan" (the SAAP) and of its implementation so far. He has, however, essentially taken as given the existence of a State aid control, a subject of debate among economists, in particular since this policy is unique to the European Community. In this short comment, I will briefly address the rationale for a State aid control before turning to the new approach embodied in the SAAP, considered first in general, and second in the area of Research, Development, and Innovation (R&D&I).

II. Why State Aid Control?

The motto of the SAAP is: less and better targeted State aid. Of course, reducing State aid is not a new policy. And at one level, reducing State aid should not be controversial to economists: it merely reflects the idea of the primacy of competition policy over industrial policy, and experience has taught us how tough it is for public authorities to pick winners. Moreover, State aid controls can be seen as a straightforward consequence of the Single Market program.

On the other hand, State aid policy is not without its critics. Beyond the obviously embarrassing cases of tiny undertakings that have at times occupied European attention, and which should be avoided in the future thanks to more powerful de minimis provisions, there are at least two more substantive arguments to consider. The first one concerns the case where there is only one European firm in the market (e.g., Airbus): isn't Europe hurting its competitiveness, in a world where it is the only jurisdiction to have State aid control? It is true that such cases should ideally be dealt with in a forum like the World Trade Organization. It is clear that State aid control works best in the presence of competitors that act as watchdogs, which means that EC State aid control is most seriously enforced in markets with multiple European-based firms. Beyond this, one should keep in mind the general idea underlying the Single Market program, i.e., that vigorous competition at home does contribute overall to international competitiveness.

The second question concerns the question of European paternalism: should State aid control solely focus on distortions of competition or should it also protect European citizens from their national or regional governments? It is true that, without State aid control, there is a risk of having too much—and unwarranted—aid, because firms are typically better politically organized than taxpayers. And in fact, excessive public funding can even come as a by-product of polit-

1 Philip Lowe, *Some Reflections on the European Commission's State Aid Policy*, 2(2) COMPETITION POL'Y INT'L 57 (2006).

ical accountability: Dewatripont and Seabright show in a theoretical model how inefficient aid can arise as a result of electoral concerns in an environment where politicians have to demonstrate to voters that they are actively trying to attract investment—that can in the end turn out to be good or bad for the region or country as a whole.[2]

This being said, while one can argue that State aid control is a commitment device against such governmental abuse that has moreover been agreed on ex ante by Member States, one should stress that it leads to an image problem for EU institutions, which typically end up playing the role of scapegoat in national politics. While it is obviously beyond the scope of this short comment to discuss in detail the pros and cons of State aid control, it is safe to say that this policy is on more solid ground when it explicitly focuses on distortions of competition.[3] Improving its ability to function along this dimension is the main goal of the SAAP.

III. Better Targeted Aid

As an economist, I am, of course, biased on this question, but an economic approach is in fact a very natural way of streamlining the existing—often ad hoc—case-by-case approach, since economists have, for a very long time, developed analyses trading off market failures and distortions of competition. See for example the paper by Friederiszik, Roeller, and Verouden (2006) for a discussion of the roadmap that can emerge from such an approach.[4]

As stressed quite rightly by Philip Lowe, the challenge for the economic approach comes from the fact that one cannot focus on a simple consumer standard relied on in usual competition policy, because the direct effect of State aid is good for consumers, since, at least in the short run, it typically implies lower prices. This can easily be reversed when one takes into account the tax cost involved in State aid, but trading off this cost with the fall in prices it implies is no easy task.

It makes sense, therefore, to base the approach on the pragmatic idea of compatibility with the single market and thus on the notion of distortion of competition, which means in particular focusing on equal access to aid, for example through tendering processes.

2 Mathias Dewatripont and Paul Seabright, *"Wasteful" Public Spending and State Aid Control*, 4 J. EUR. ECON. ASS'N 513-522 (2006).

3 To justify State aid control, note, however, that one must moreover argue that it adds value to the other competition law provisions in guaranteeing a proper functioning of the market.

4 Hans Friederiszick, Lars-Hendrik Röller and Vincent Verouden, *European State Aids Control: An Economic Framework*, *in* ADVANCES IN THE ECONOMICS OF COMPETITION LAW (P. Buccirossi ed., 2006).

In any case, I think that attempting to systematically trade off market failures and distortions of competition will not imply a revolution in State aid policy, but rather a (welcome) streamlining: for example, it will still favor Services of General Economic Interest, Small and Medium-Sized Enterprises (SME), innovation, training, poor regions, and environmental measures.

The big questions ahead are: Where will one draw the line? Will better targeted aid necessarily lead to less aid overall? My feeling is that, while economics can help give guidance concerning the determination of desirable relative aid levels, defining the tolerated overall level of State aid will remain pretty much pragmatic, or ad hoc, since economics does not offer any easy rational way to address this issue. Let us, for example, discuss this question in the context of aid to R&D&I.

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IV. Aid to Research, Development, and Innovation

This is an area where economics has given particular attention to the tradeoff between market failures and distortions of competition. Going for an economic approach is, therefore, very natural here as a way to streamline the rules for granting aid.

Beyond this, aid to R&D&I is of course one area where there is a potential tension between the SAAP principle of less aid and the Lisbon strategy, which makes the case for giving preferential treatment to innovation. This case can easily be made, see for example the *Sapir Report*.[5] Better targeting, therefore, can resolve the tension by interpreting it to mean less aid overall but more aid to innovation.

However, it is important, in this Lisbon context, to be careful about the risk of the (re)emergence of an industrial policy captured by big incumbent firms. One way to avoid this is to focus aid to R&D&I on SMEs, which makes sense given that they are more subject to market failures (e.g., in credit markets) and that there is a lower risk of distortions. Moreover, when thinking about promoting European growth, one should keep in mind the key role of new firms in U.S. growth (which has crucially benefited from the ability of successful young firms to grow very fast). On the other hand, it is fair to acknowledge that European innovation may be less entrepreneurial than U.S. innovation. For example, the

5 André Sapir, Philippe Aghion, Giuseppe Bertola, Martin Hellwig, Jean Pisani-Ferry, Dariusz Rosati, José Vinals, and Helen Wallace, AN AGENDA FOR A GROWING EUROPE—THE SAPIR REPORT (2004).

Nokia of today did not start in a garage like Apple, but emerged from a (drastically restructured) large, diversified company. In this sense, ruling out State aid to large companies is not optimal. But it is then crucial to insist on good practices for aid provisions: accessibility to new entrants, limited duration provisions, investment in complementary inputs (like human capital). Current guidelines go in this direction, but doing it even more systematically would not hurt given the potentially excessive enthusiasm for innovation policies in our Lisbon era.[6]

V. Concluding Remarks

The need to streamline the existing case-by-case approach to State aid control was clear to most observers. Economics is a good way to attempt to do it, and trading off market failures with distortions of competition is the natural way to go. This can make policy choices more transparent (for example, by explicitly focusing on questions like: How much aid in total? How much aid for innovation?), and help focus attention to the consistency between policy initiatives, like the Lisbon strategy and the SAAP. Of course, there is a fair number of details still to fill in to make this economic approach operational. But, as Philip Lowe details in his article, progress is already being made.

6 For a discussion of these issues, *see* the Commentary of the State Aid Group of the Economic Advisory Group for Competition Policy (EAGCP), on the Draft Community Framework for State Aid R&D&I, *available at* http://ec.europa.eu/comm/dgs/competition/eagcp.pdf.