A very brief introduction to EU policy

Before discussing Dr Thomas' paper, I should like to outline very briefly what I consider to be the salient points of EU state aid policy as far as investment incentives are concerned. The policy lies at the intersection of two major objectives: on one hand, minimising distortions of competition and, on the other hand, reducing the disparities between the prosperous regions of the EU and the disadvantaged regions (the so-called cohesion objective). The EC Treaty requires that any public authority's proposals to grant aid to commercial enterprises must receive the prior approval of the European Commission. The Commission only gives such approval if it deems that the aid serves some recognised purpose of EU policy, such as the cohesion objective, and that the resulting distortion of competition is not excessive.

Over the years the Commission has developed quite a formidably complex set of rules to put these principles into effect. As far as investment incentives are concerned, the main rules can be summarised as follows:

- Aid can only be given to large enterprises in designated assisted regions.
- The aid must be linked to an investment.
- The aid must not exceed an "aid ceiling" expressed as percentage of the investment cost.
- The aid ceiling, which varies between 10% and 65%, is prescribed by the Commission for each region according to the degree of economic disadvantage.
- The ceilings are lowered for very large projects.

The sources of tax and subsidy competition

In my view, Dr Thomas has correctly identified the two main sources of tax and subsidy competition, at least as far as attracting investment from outside is concerned. However, the history of state aid policy in the EU is also a history of a long struggle against a mindset that sees the government's task as promoting national champions. Some aspects of state aid policy are therefore strongly marked by the suspicion that Member States will use state aid as a means of protecting already established firms from incursions into their markets or promoting their expansion into other markets.

About the need for governments to attract investment, I need to add nothing to what is already said in Dr Thomas' paper. About capital mobility, I think that perhaps we should be careful not to over-dramatise. Of course, capital mobility has increased significantly in the last two or three decades. However, the real options open to firms when choosing an investment location are, in many cases, still quite limited. Proximity to markets or sources of raw materials, the availability of a pool of skilled labour, different languages and legal systems and a host of other factors all tend to limit these options. A couple of studies carried out in Belgium over the last ten years illustrate this point. In general it seems that, because of sunk costs, already

1 There are some exceptions to the rules. For example, the Commission is prepared to tolerate some temporary aid for operating costs, not linked to investment, in the most disadvantaged regions. In addition, small and
established companies move very rarely, although they may outsource some parts of their activities. When they do move, they usually do not go very far. In Belgium's case, for example, they often go to Northern France.

Asymmetric information

Of course, it is in the interest of company when applying for aid to give the impression that it can choose between numerous feasible locations and that the choice of your region could only be justified if a substantial subsidy were granted. Here we come to the crux of the problem, so clearly identified by Dr Thomas: asymmetric information. In an ideal world, a public authority would know exactly what benefits its region would reap from a given investment and exactly what incentive is needed to attract that investment. When the benefits exceed the required incentive, the government would offer the subsidy. In the real world, the public authority is often not able to estimate either of these variables with any accuracy. This is particularly true when the public authority is a small municipality. Often, the decision-makers appear to be seduced by the prestige of a project, so that they do not examine too closely its real benefits to the local community. Dr Thomas' discussion of the use of powers of eminent domain and citizen participation can in some ways be viewed as aspects of the problem of evaluating the net benefit of a project. To be complete, any such evaluation has to take account of the value that people place on their homes and their amenities. It also has to take account of any environmental harm that the project may cause. This may be difficult to assess, since the aid-seeking company will naturally be concerned to downplay any negative aspects.

Concerning the bargaining process, Dr Thomas cites some examples from Missouri that seem to indicate that city authorities are often not good judges of whether or not it is necessary to offer an incentive. From EU experience, I can offer some anecdotal evidence of the difficulty of estimating the size of the incentive needed to attract an investment. For a number of years, the European Commission applied special rules to regional aid in the motor vehicle industry. These rules required that the beneficiary should be able to show that there was a feasible alternative site for the investment. If the company could do this, aid was allowed, subject to the lower of two limits: the normal aid ceiling for the region or the difference in net present value between the proposed location and the alternative. The company therefore had to produce a comparative cost-benefit analysis of the two sites. On several occasions, the automobile company produced analyses which showed a net disadvantage for the assisted region significantly in excess of the amount of subsidy being offered. And yet the company was proposing to take the subsidy and invest in the assisted region. Similarly, beneficiaries have gone ahead with investments even when the application of the EU's regional aid ceiling meant that the amount of the state aid had to be less than the alleged cost penalty of locating in the assisted region. In both types of case, the Commission examined the beneficiary's cost-benefit analyses very thoroughly with the aid of industry experts and could find no major errors or misrepresentations. Thus, either the companies were withholding quantifiable evidence or the location decision was strongly influenced by non-quantifiable factors not known to the Commission or, presumably, the national and regional authorities. Whatever the explanation, this experience illustrates quite clearly the problem of asymmetric information.
Efficiency

Some economists have asked, "What does it matter if a government pays more than the amount needed to attract an investment, provided that the subsidy does not exceed the benefits to the local community? Surely the outcome will still be increased welfare."²

Firstly, of course, it matters because the public purse is not bottomless. The budgets of public authorities are subject to a number of constraints – balanced budget laws, the Stability and Growth Pact in the EU, the sheer unwillingness of voters to accept higher taxes. This means that any expenditure on investment expenditure has a high opportunity cost. Furthermore, the extra taxation needed to finance the incentives creates inefficiencies or "deadweight loss", as well as having inevitable distributional consequences. Finally, from the point of view of EU competition policy, there is always a danger that the windfall gain arising from over-generous incentives may be used by the recipient to strengthen its market position at the expense of competitors³. Such an outcome, resulting from government intervention rather than the competitive merits of the company, distorts competition and is detrimental to economic efficiency.

Conclusions

It will come as no surprise that I am sympathetic to Dr Thomas' conclusions and recommendations. I am in no position to comment on the feasibility of his proposal. Clearly, since state aid control is not written into your constitution as it is in our Treaty, the task confronting those who want to impose some limitations is a formidable one. Even with our advantages, it took the European Commission about thirty years to develop a really effective set of rules and these rules are still evolving.

The proposal to enact a nation-wide ban on relocation subsidies has the merit of simplicity, although the notions of "relocation" and "subsidy" will have to be carefully defined and I suspect that they will never be entirely litigation-proof. I can see the attraction of this proposal, even though the EU has no such absolute ban. Our policy allows governments to give financial support for relocation from prosperous regions to disadvantaged regions. However, the EU can probably afford to adopt a more complex and flexible policy because it possesses a supranational authority with full powers to enforce the policy and because, after many years, we have a consensus about a generally objective (albeit crude) way of defining regional disadvantages.

One final word on "retention incentives". Happily, the EU rules already excluded the possibility of such subsidies even before the concept was borne. This is because all aid has to be linked to a limited number of categories of eligible expenditure, usually investment, and may not exceed a certain proportion of that expenditure. If the demand for retention incentives becomes widespread, I can foresee a need for some sort of legally binding rule, either at state or at federal level, that enables public authorities to credibly commit to refuse such demands.

³ In EU state aid law it is generally assumed that windfall gains will be used to bolster the recipient's market