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Wishlade, Fiona

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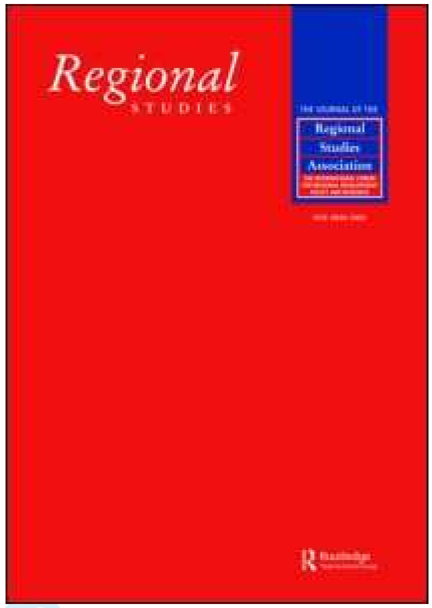

Competition and cohesion - coherence or conflict? EU regional state aid reform post-2006

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COMPETITION AND COHESION - COHERENCE OR CONFLICT? EU REGIONAL STATE AID REFORM POST-2006

Fiona G. Wishlade, European Policies Research Centre, University of Strathclyde, Glasgow G1 1QE

e-mail: fiona.wishlade@strath.ac.uk

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Abstract

In 2005 the European Commission adopted competition policy Guidelines regulating national regional aid. Mirroring EU Cohesion policy reforms, initially the Commission took a 'hard line' outlawing national regional aid, except in areas designated by the Commission, in order to improve cohesion, competition and the efficiency of aid spending. This was successfully resisted by the Member States in favour of a more flexible regime. This paper argues that Commission's approach to regional aid reform was flawed and raises wider questions about the relationship between national and EU regional policies and the way in which the EU promotes cohesion, competition and competitiveness.

Keywords:

EU competition policy

EU cohesion policy

State aid

Regional policy

Regional incentives

Assisted areas

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INTRODUCTION

Enlargement of the European Union in 2004 focused academic and policymaker attention on the implications for EU Cohesion policy reform. In contrast, the potential impact of enlargement on Member States *own* regional policies passed largely unremarked, at least by the academic community. Just after the Council agreed the Cohesion policy budget for 2007-13, the Commission quietly approved regional aid Guidelines for the same period, imposing significant new constraints on the design and implementation of regional state aid.

The review of the regional aid Guidelines took place against the backdrop of considerable upheaval in the wider policy context. As well as enlargement and the reform of EU Cohesion policy, the Commission was trying to remodel State aid control policy and take account of the so-called Lisbon Agenda. Mirroring the refocusing of EU Cohesion policy on the poorest regions, the Commission initially took a 'hard line' – the *concentration* scenario - in its proposed reforms. It attempted to outlaw national regional aid except in areas designated by the Commission, claiming that this approach best satisfied the considerations and constraints arising from the new policy environment. This was fiercely resisted by several Member States, which argued for a more flexible regime – the *continuity* scenario - with scope for Member States to designate their own assisted areas. The continuity scenario ultimately prevailed, so that the rules adopted for 2007-13 bear greater resemblance to those in place for 2000-6 than to the Commission's initial reform proposals.

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In considering these developments, this article is structured as follows. First, it places the reforms in context by setting out the background to regional state aid control policy. Second, it traces out the origins of the reforms for 2007-13 and analyses the implications of the concentration and continuity scenarios. Third, it questions the rigour of the debate about which scenario was best suited to the changing policy context. Last, it draws some conclusions about the implications of the new Guidelines for national regional policy and wider policy relations.

BACKGROUND

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

The use of state aids in economic development policy is controversial. Domestically, debates tend to centre on whether subsidies are efficient or effective ways of addressing market failure, market imperfections or permanent geographical handicaps and whether policy should seek instead to improve the general business environment and reduce corporate taxation. This debate is beyond the scope of this article which deals with the regulation of state aids at the European level; this is not fundamentally

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about efficiency and effectiveness (although the Commission has increasingly drawn on these arguments) but rather about the distortion of trade and competition in the EU.

Basic principles of state aid control

Under the Treaty of Rome (1957) the control of government subsidies was viewed as essential to the internal market: as quotas and tariffs were being outlawed, the temptation for governments to resort to other forms of protectionism was considered likely to increase. Initially Commission action was tentative, but the last two decades have seen state aid control rise up the agenda, culminating in the 2005-9 State Aid Action Plan – SAAP (EUROPEAN COMMISSION, 2005b) a 'roadmap' for reform. Moreover, as Commission confidence has increased, so has the scope of state aid control. Not only do the rules apply to all publicly-funded intervention, but they also impinge on activities as diverse as urban regeneration, broadband access, public private partnerships, credit unions and infrastructure provision; they are not limited to regulating aid for mobile projects or state-owned companies.

The underlying principle of the EC Treaty provisions is that state aids are prohibited (Article 87(1)). However, the ban is not absolute. There are some mandatory exceptions,[2] but more importantly, a number of discretionary exceptions are outlined in Article 87(3); their interpretation is the exclusive competence of the European Commission. Crucially, plans to offer state aid (whether *ad hoc* or as an aid scheme) must be notified to the Commission and approved by it before implementation;[3] unauthorised aid is illegal and may have to be repaid.

The regional aid derogations: 'a' regions and 'c' areas

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The core of Commission policy on regional aids is its interpretation of Article 87(3)(a) and (c), which enable regional aids to be exempted from the general ban. Article 87(3)(a) concerns "regions where the standard of living is abnormally low or where there is serious underemployment" (referred to as 'a' regions); Article 87(3)(c) covers "aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest" (referred to as 'c' areas).

The differences between the two provisions are important and have increasingly affected how the Commission authorises aid area maps, the types of aid allowed and the aid values permitted. This flows from a European Court of Justice ruling in the late 1980s that 'a' areas were disadvantaged in relation to the *Community as a whole*; in contrast, it held that 'c' areas were those disadvantaged *in relation to the national average.*[4]

Following this judgement, and partly as a consequence of the 1988 Structural Funds reform, the Commission began to make explicit reference to 'a' and 'c' areas in approving regional aid schemes and maps (EUROPEAN COMMISSION, 1988a); until then, the Commission had been lax in so doing, and its decision-making generally lacked transparency.

Since 1988 the definition of 'a' regions has become entrenched in regional aid control policy and applied increasingly strictly. The 'a' regions are those where GDP per head is less than 75 percent of the Community average.[5] For its part, the definition of 'c' 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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assisted area maps and aid ceilings, there were no constraints on the absolute amounts of aid, the capital intensity of the investment or the market power of the recipient.[8] In the 1990s, the Commission, and to some extent the Council, became concerned at this lacuna and various mechanisms were considered, culminating in the 1998 'Multisectoral Framework' (MSF). This required case-by-case recalculation and approval of awards to exceptionally large projects. However, the 1998 MSF failed to have an impact (WISHLADE, 2003, p 127) and was replaced by the more straightforward 2002 MSF (EUROPEAN COMMISSION, 2002b). This systematically reduced aid rates available to all projects involving eligible expenditure exceeding €50 million. Moreover, the Commission had to individually approve aid for investments of more than €100 million where the aid proposed exceeded a specified amount. In these individual cases aid would not be authorised if it reinforced a high market share or increased capacity in a stagnant sector; the onus was on the Member State to demonstrate that this was not so.

EVOLUTION OF THE REGIONAL AID GUIDELINES 2007-13

For several reasons the 2000-6 Guidelines could not simply be rolled forward for 2007-13. In particular, the impact of the 2004 enlargement on average EU GDP per head had implications for 'a' region eligibility and Member States lobbied intensively for special treatment of the affected regions; the Commission was sympathetic, but had to reconcile this with its desire to maintain overall discipline. In addition, a legal challenge to the Commission Decision on the German regional aid map had resulted in criticism of the 1998 Guidelines; the Commission could not ignore these observations. Also, there was widespread resentment among EU15 Member States at the impact of the 1998 Guidelines; privately some Commission officials admitted that

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a repeat of the 1999-2000 map negotiations could not be contemplated. More generally, the renewal of the Guidelines could not be isolated either from the future of EU Cohesion policy or from the changing context for state aid control – as reflected in the four considerations and constraints identified by DG Competition discussed below.

Genesis of a reform

Early signs that radical change might be countenanced were contained in a questionnaire circulated to the Member States in 2003.[9] This indicated that the Commission's position on 'a', former 'a', Outermost[10] and sparsely-populated regions was "relatively clear", but opened the debate about what might be acceptable elsewhere. In particular, the questionnaire asked whether "investment aid is a relic of an obsolete concept of regional aid" and mooted the possibility of prohibiting investment aid for large firms outside 'a' regions. This line of thinking was fleshed out by the Director-General of DG Competition who outlined two "provisional scenarios" (LOWE, 2003a), here termed the 'concentration' and 'continuity' scenarios.

The concentration scenario involved allowing regional aid only in 'a' regions and in 'c' areas selected by the Commission ('earmarked' areas). The continuity scenario was built on a simplification of the 2000-6 approach; in addition to the 'a' regions and earmarked 'c' areas, further 'c' areas could be designated by the Member States, subject to an overall ceiling of the EU25 population.

The Director General argued that the concentration scenario would be simpler and better satisfy the four considerations and constraints on DG Competition's agenda, namely: the objective of 'less and better aid'; the need to reconcile the reduction in

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state aid volumes with the objective of economic and social cohesion; the simplification and modernisation of state aid control and a focus on the most distortive aids; and experience with the 1998 Guidelines. The Third Cohesion Report (EUROPEAN COMMISSION, 2004, pp xxxiii-xxxiv) soon confirmed the Commission view that the concentration scenario should be the basis for future regional aid control.

Concentration scenario proposals – a hard line

By end 2004, DG Competition had issued proposals for regional aid control post-2006 embodying the concentration scenario (DG COMPETITION 2004a and 2004b). For 'a' regions, the main change proposed was that the threshold be 75 per cent of EU25 (rather than EU15) GDP per head.[11] The main impact of this (the 'statistical effect') was to lower the cut-off point for 'a' region status and exclude a number of EU15 regions from eligibility. For the 'c' areas DG Competition proposed to replace the population quotas with three categories of earmarked region:

- 'statistical effect' regions - those that would have met the 'a' region GDP per head threshold using EU15 data, but were excluded on the basis of EU25 averages. Most had 'a' status in 2000-6, but some that did not would also qualify e.g. Highlands & Islands (UK);[12]

- 'economic growth' regions - areas that would have outgrown 'a' region eligibility, even without enlargement, owing to a relative increase in levels of GDP per head e.g. Valencia (Spain);

- sparsely-populated areas - regions with fewer than 12.5 inhabitants per km^2 (mainly in Finland and Sweden).

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An important element of the proposals was the reduction of maximum rates of award (except for SMEs, for which ceilings would be higher). The lower ceilings were achieved by reducing nominal award values and setting award rates in gross rather than net terms. Moreover, in response to concerns of some Member States about cross-border issues, DG Competition proposed a maximum rate differential of 30 percentage points between neighbouring regions at a national border.

These proposals represented a very significant shift in the rules governing regional aid, effectively outlawing traditional regional aid in much of the EU15. The implication of the proposals for the EU25 was a 17 percentage-point cutback in coverage from 52 per cent of the population in 2000-6 to around 35 per cent from 2007 (Table 2). These reductions were unevenly distributed: there would be no aid area coverage in Cyprus, Denmark, mainland France, Luxembourg and the Netherlands; several countries, including the UK, would see cutbacks of more than 50 per cent; elsewhere there would be more modest reductions or coverage would be unchanged.

[Table 2 about here]

There were also significant implications for maximum award rates. Direct comparisons are difficult but, by way of example, a region where the maximum was 50 per cent *net* would probably have a new maximum of 30 per cent *gross* – less than half the previous value.

Finally, the proposals referred to possible new ‘significant impact test’ instruments, which would partially compensate for the loss of aid area status by offering greater flexibility for ‘non-significant’ aid in *all* areas. The proposed frameworks on lesser amounts of state aid (LASA) and aid with a limited effect on trade (LET) were an

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important part of the Commission's strategy to focus resources on cases raising the most serious competition concerns. However, they were dropped by DG Competition early in 2005.[13] They failed to gain widespread support among the Member States and it seems probable that the Commission legal services also had concerns.

A multilateral meeting took place in February 2005, after which Member States were invited to submit any further comments; the reactions were diverse. Most of the new Member States supported the principle of the approach with its focus on poorer regions. However, some (for example, the Netherlands) argued for an even stricter approach, with regional aid limited to the new Member States and the phasing-out of all regional aid in the EU15. In contrast, many EU15 countries (notably Austria, France, Germany, and the UK, which sent a joint letter to the Commissioner for Competition Policy) expressed concern at the loss of scope for *national* policy to target underperforming regions. (WISHLADE, 2004).

Continuity scenario proposals – a 'U-turn'

Against this background, in July 2005 the Commission reversed its position in a draft Communication (EUROPEAN COMMISSION, 2005c). There were further meetings with and submissions from the Member States; the European Parliament and the Committee of the Regions also reported, both criticising the 'hard line' on spatial coverage (EUROPEAN PARLIAMENT, 2005; COMMITTEE OF THE REGIONS, 2005). Last, immediately after the European Council agreed the EU budget, the Commission issued the final text of the new rules (EUROPEAN COMMISSION, 2006).

The 2006 Guidelines are a retreat from the 2004 proposals and a partial return to the approach embodied in the 1998 Guidelines. The most significant aspects of the U-turn

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concern the reintroduction of an overall population ceiling (43 per cent of the EU25 population) within which ‘c’ areas may be designated by the Member States (see Table 3 – non-earmarked ‘c’ areas). The outcome is a return to the situation where every Member State not entirely covered by ‘a’ status has a population quota for ‘c’ areas with eligibility determined by the national authorities. The national ‘c’ population quotas are, as in the 1998 Guidelines, based on internal disparities in GDP and unemployment adjusted to reflect the EU context, but a ‘safety net’ provision limits losses to 50 per cent of 2006 coverage and modest transitional arrangements apply.

[Table 3 about here]

As Table 3 shows, the addition of non-earmarked ‘c’ areas means there were no ‘losers’ from the continuity scenario, compared with the concentration scenario proposals. However, the gains for some countries were non-existent or very modest: Italy, Portugal, Spain and Sweden see small increases and coverage is unchanged for all the new Member States except Cyprus. By contrast, for Austria, Belgium, Cyprus, France, Germany, Ireland, Luxembourg and the UK aid area population coverage is increased by between 10 and 50 percentage points. In no case is coverage for 2007-13 higher than for 2000-6 (compare Tables 1 and 3).

SATISFYING THE CONSTRAINTS AND CONSIDERATIONS

The evolution of the 2006 Guidelines is the road from DG Competition’s (preferred) concentration scenario to the continuity scenario. Opinion is divided among national policymakers as to whether this was a deliberate negotiating strategy. It could be argued that presenting such a radical proposal at the start essentially ‘softened them

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up' to accept rules that were, by contrast, much less stringent, but nevertheless much more constraining than the 1998 Guidelines. An alternative view is that DG Competition was initially unable, from a technical perspective, to devise proposals for nationally-designated 'c' areas that disciplined coverage sufficiently; it therefore opted simply to eliminate 'c' areas, other than those earmarked using EU criteria.

Whether or not this policy U-turn was planned from the outset, DG Competition quite evidently had to square a range of policy objectives, address technical and legal challenges and reconcile differing viewpoints. Moreover, its preference for the concentration scenario reflected the view that it better satisfied the four key considerations identified earlier. This section questions the rigour of this claim.

Less and better aid

Of late, the 'less and better aid' mantra has become the *leitmotif* of Commission state aid policy (KROES 2005). This sentiment first appeared in the Commission's 'Strategy for Europe's Internal Market' (EUROPEAN COMMISSION 1999). It was endorsed by the 1999 Helsinki European Council and picked up at the Lisbon Summit in 2000, which noted the need to:

> "promote competition and reduce the general level of State aids, shifting the emphasis from supporting individual companies or sectors towards tackling horizontal objectives of Community interest, such as employment, regional development, environment and training or research." (EUROPEAN COUNCIL, 2000, p 6)

By the time of the Barcelona Summit, this objective had mutated somewhat and the European Council:

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> "renew[ed] its call to Member States to reduce the overall level of State aid as a percentage of GDP by 2003, and onwards, and to redirect such aid towards horizontal objectives of common interest, including economic and social cohesion, and target it to identified market failures. Less and better-targeted State aid is a key part of effective competition." (EUROPEAN COUNCIL, 2002, p 7)

The notion of 'better' aid is not defined. Nevertheless, a number of elements have emerged in recent policy debates, notably: the targeting of aid at clearly identified market failures (COUNCIL, 2002); the efficiency and effectiveness of aid (EUROPEAN COMMISSION 2002a); and the redirection of aid towards 'horizontal' objectives and away from rescue, restructuring and sectoral objectives (EUROPEAN COUNCIL, 2002).

Would the concentration scenario for regional aid reform have delivered better on the objective of 'less and better' aid than the continuity scenario? It is plausible to argue that reducing aid areas from 52.3 per cent to 35.5 per cent of the EU25 population would result in lower state aid expenditure. But would eliminating regional aid in most 'c' areas make for 'better' aid? Neither scenario provided for a clear identification of market failures nor for any mechanisms for determining the efficiency or effectiveness of policy. The nub of the 'better aid' question therefore lies in the interpretation of 'horizontal objectives'.

As quoted, the 2000 Lisbon summit conclusions cite "regional development" as an example of a horizontal objective; by the 2002 Barcelona Council, this focus had shifted to "economic and social cohesion". For the *Commission*, this has become synonymous with targeting 'a' regions: "Greater cohesion will only be achieved…

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…if aid is concentrated on the least developed regions….the so-called 'a' regions" (EUROPEAN COMMISSION, 2003, p 6). Taking this narrow interpretation, it is clear that the concentration scenario fulfils the 'less but better' objective more closely. However, under Article 158 of the EC Treaty, the notion of 'cohesion' is less restricted: "the Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas." Article 159 requires the Member States to conduct and coordinate their economic policies "in such a way as, in addition, to attain the objectives set out in Article 158."

In short, the concentration scenario only delivers 'less and better aid' to the extent that cohesion policy is synonymous with targeting 'a' regions. This narrow interpretation which has emerged in recent policy statements is questionable; it limits the scope for *Member States* to tackle "disparities between the levels of development of the various regions" as required by the Treaty.

Reconciling lower state aid volumes with cohesion in an enlarged EU

The 'less and better' objective is closely related to the aim of reconciling lower state aid spending with cohesion. The Director General of DG Competition argued that the concentration scenario would deliver better on this because the elimination of almost all 'c' areas would itself reduce state aid spending. Moreover, within the 'a' regions, aid would not only be more effective but rates of award could be lowered (further reducing spending) because of the absence of rate competition from 'c' areas (LOWE 2003a).

[*Table 4 about here*]

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Table 4 illustrates the erosion of rate differentials in the evolution of the 2006 Guidelines. In the continuity scenario proposals (DG COMPETITION, 2004b), the threshold for the poorest grouping was lowered from 50 per cent to 45 per cent of EU GDP, excluding around 12 million (Polish and Slovak) inhabitants from this category. In addition, the scope for 'c' areas to be designated by the Member States was introduced, with maximum award rates of 10 to 15 per cent of investment. Last, special provisions were introduced to limit the aid rate differentials between regions in neighbouring countries.

The adoption of the continuity scenario will certainly result in higher spending in 'c' areas, although data constraints and the 'unknown' of future policy designs make it impossible to estimate the scale of such spending. Moreover, the maintenance of more extensive 'c' areas clearly erodes the rate differential between 'a' regions and other parts of the EU. However, this does not mean that the continuity scenario fails to reconcile cohesion objectives with reduced spending. In practice, this depends, as noted earlier, on the interpretation of 'cohesion' – is the consideration of cohesion from a Commission or Member State perspective? In addition, favouring the concentration scenario presupposes an understanding of the impact of award rate differentials and an ability to calibrate these to reflect policy objectives. There is no evidence of this. Historically, the Commission has rather arbitrarily set award ceilings broadly in line with its perception of the regional problem, mainly using GDP per head. The resulting pattern of rates and rate differentials bears no direct relationship to that which would influence location decisions (which in turn would be likely to vary between project types and sectors). More generally, the focus on aid differentials is only reasonable if it is assumed that regional policy is solely a means of *diverting* jobs and investment between regions (ARMSTRONG, 1984).

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Simplification, modernisation and emphasis on the most distortive forms of aid

Simplification and modernisation are key themes of the reform agenda in the SAAP (EUROPEAN COMMISSION, 2005b). They have primarily been concerned with procedural issues and the governance of state aid control. In parallel, the Commission has been sensitive to criticism of its formalistic approach and concerned at the disproportionate resources involved in scrutinising measures with limited competition effects. The DG Competition Director General has observed that "there is the impression that we are simply applying rules which aim to curtail state aid as such rather than concentrating on controlling aid which really distorts the European single market" (LOWE, 2003b, p 1). These concerns led to (unsuccessful) attempts to devise a 'light touch' approach to measures with insignificant competition implications – the LASA and LET proposals mentioned earlier.

Would the concentration scenario have contributed more effectively to the simplification and modernisation agenda and targeted the most distortive forms of aid better? At a superficial level, a policy which allows regional aid only in 'a' regions and earmarked areas is clearly 'simpler' than one with wider criteria, but it seems doubtful that it could be deemed more 'modern'. More relevant is the issue of competition distortion. In practice, both scenarios focus on aid area coverage and, specifically whether Member States should have the scope to designate 'c' areas beyond those earmarked. It can be argued that the spatial extent of policy is of limited relevance to targeting the most distortive forms of aid; instead, competition effects are more likely to be driven by sectoral considerations like the extent of international exposure or market power.

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The view that the concentration scenario would better fulfil this criterion implicitly assumes that aid is more distortive if offered in a more prosperous region. Historically this derives from the interpretation of the Article 87(3)(c) derogation for 'aid to facilitate the development of… …certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.' BESLEY and SEABRIGHT (1998) have pointed out that there are few agreed criteria for determining when an aid distorts competition. Moreover, evidence to establish what is in the 'common interest' remain elusive, so that, in practice, an analysis of the potential trade impacts has been supplanted by an assessment of whether regional aid is justified by social and economic conditions. Even the Chief Economist of DG Competition acknowledges that balancing the common interest against distortions of competition is not explicitly undertaken in Commission assessments (ROLLER, 2005).

Experience with the 1998 regional aid Guidelines

The last consideration concerns practical constraints. There was considerable frustration and resentment among national policymakers at the detailed involvement of Commission officials in the selection of aid areas in 1999-2000 (WISHLADE, 2003); and many acknowledged that they would not wish to repeat the process. In addition, the 1998 Guidelines were criticised in litigation brought by Germany against a Commission Decision on the German aid map.[14] This action was not successful, but the Advocate General questioned the methodology for allocating 'c' area population quotas between countries and concluded that it breached the principle of equal treatment.[15]

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Clearly the concentration scenario would have eliminated these issues from the reform agenda: restricting ‘c’ areas to those earmarked by the Commission would have obviated the need to calculate ‘c’ population quotas and negotiate the aid maps. Undoubtedly, the concentration scenario would have responded more simply to the issues raised by the 1998 Guidelines, but it is important not to confuse simplicity with even-handedness. As the adoption of the continuity scenario has shown, the criticisms made by the Advocate General were not insurmountable and the more straightforward area designation framework under the 2006 Guidelines suggests that there were ways to avoid excessively detailed map negotiations.

WIDER POLICY ISSUES

This paper has argued that the case for the concentration scenario was self-fulfilling: the concentration scenario only delivers better on DG Competition’s constraints and considerations to the extent that a restrictive interpretation of ‘cohesion’ is adopted. Moreover, the choice presented was false: because both scenarios focused on spatial coverage, neither had the capacity, in itself, to address the key issues of ‘better aid’ or competition distortion.

The debate surrounding the reform of the regional aid Guidelines was contrived as a choice between options for spatial coverage, based on a narrow view of ‘cohesion’ – targeting the ‘a’ regions. The limited focus of the reform options meant that wider questions about the relationship between national and EU regional policies and the ways in which cohesion, competition and competitiveness are promoted were not really addressed in the debate. The discussion that follows seeks to open up some of

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these issues by situating the new Guidelines in a broader context and considering some of their wider policy implications.

A missed opportunity to decouple national and EU regional policies?

The new Guidelines are a U-turn in the Commission's original position, but the spatial coverage of *national* regional policies will still be driven by EU Cohesion policy objectives; areas holding less than 8 per cent of the EU25 population are designated on the basis of national priorities. The preoccupation with spatial coverage, combined with the use of EU cohesion criteria, has implications for subsidiarity and the capacity of Member States to design and conduct spatially-differentiated policies.

There have long been direct links between the control of Member State regional policies and the emergence of a bespoke Community regional policy. Early observers stressed the importance of Community-level controls over national regional aid as a partial substitute for a common regional policy (DEACON, 1982) and from the late 1980s it became standard Commission rhetoric to promote regional aid control as an aspect of cohesion policy (EUROPEAN COMMISSION, 1988b). As the two policies became more closely intertwined, issues of policy coherence, primarily expressed in terms of the extent to which the national and the EU assisted areas maps coincide, gained prominence (WISHLADE, 2003). BESLEY and SEABRIGHT (1999), among others, argued that there was no justification for seeking to ensure map coincidence; while VANHOVE (2000) has taken the opposite view.

The reform of cohesion policy against the backdrop of enlargement created an opportunity for a fundamental reappraisal of the targeting and coordination of EU and Member States' regional policies. In spite of some prompts (e.g. the SAPIR report (2003) and the UK regional policy White Paper (HM TREASURY *et al.*, 2003)) the

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emphasis was on how to adapt *existing* policy rather than on radical reform. A discussion of the refocusing of EU Cohesion policy is outside the scope of this paper; however, it can be argued that, whilst it is justifiable for enlargement to affect the targeting of EU resources, this does not hold for *national* resources. Enlargement has altered the *relative* prosperity of the EU15 regions, but not their *absolute* situations; it is difficult to justify tighter constraints on *national* regional policy simply because the EU now includes even poorer regions. The chance to reconsider the appropriate articulation of EU, national and subnational policies appears to have been missed.

A blunt instrument for addressing competition distortion

An important strand of the state aid reform agenda is the focus on the most distortive aids. This has partly been driven by the administrative implications of enlargement and concerns at the disproportionate resources involved in the scrutiny of measures raising few competition concerns.

Neither of the scenarios proposed addresses the issue of distortion head-on; in line with long-standing trends, the emphasis of the proposals was on the spatial coverage of policy rather than on the competitive effects of aid. As long as 20 years ago, the Commission itself acknowledged that: "area and population coverage provide a better indication of Member States' regional policy than of the impact of schemes on competition" (EUROPEAN COMMISSION, 1986, point 229).

The main scope for competition distortion to be addressed directly lies in the Multisectoral Framework, now brought within the regional aid Guidelines. For most projects, the MSF rules are substantially unchanged. However, because maximum award values are reduced under the Guidelines, the aid rates available to investments exceeding €50 million also fall, as does the aid threshold beyond which projects must

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be notified individually to the Commission.[16] For these projects, if the beneficiary accounts for more than 25 per cent of product sales or if the capacity created by the project is more than five per cent of the market:

> "the Commission will approve regional investment aid only after detailed verification... …that the aid is necessary to provide an incentive effect and that the benefits of the aid measure outweigh the resulting distorting of competition and effect on trade between Member States" (para 68)

It is not yet clear quite how this will be operationalised: the criteria to be taken into account in making this assessment will be the subject of further guidance (footnote 63). Nevertheless, the abandonment of LASA and LET and, for now, of a sectoral component to the MSF (CAVALLO and JUNGINGER-DITTEL, 2004), which would have outlawed aid to certain industries, means that the Commission has scarcely sharpened its focus on the most distortive aids. There are reasons to believe that the distortion of competition could have been targeted more accurately in two ways: first, by pursuing the 'significant impact' approach proposed under LASA and LET to eliminate minor aid from scrutiny; and second, by exploiting data on aid awards in order to better understand their competition effects.[17] Instead, regional aid control remains a rather blunt instrument essentially regulating geographical coverage and aid values. Radical reductions in spatial coverage have seriously constrained aid area maps, often prohibiting measures that would have been quite innocuous; at the same time, significant reductions in award values may, perversely, *reduce* the effectiveness of aid if rates fall to levels where they cease to influence investment decisions and 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.

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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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regions, the scope may be limited: for instance, in the new Guidelines on aid to regional airports (EUROPEAN COMMISSION, 2005d) disadvantaged areas are restricted to areas that are clearly defined at EU level and/or are specifically recognised in the Treaty, not those identified by Member States.

More generally, the combined effects of the Lisbon agenda and enlargement are shaping EU Cohesion policy and state aid control policy in ways that have significant implications for the problem regions of Member States without designated area status. On the one hand, the competitiveness agenda promotes horizontal policies (most obviously for R&D) that favour the development of *all* regions, but using policy instruments where the impact and uptake is likely to be higher in the more prosperous regions, especially under demand-led national schemes; on the other hand, EU Cohesion and regional aid control policies target assistance at the least-prosperous regions. Unless regional policymakers can influence their horizontal policy counterparts, the net effect of this may be to create a policy vacuum for those regions that are neither well-placed to benefit from policies focused on innovation or other horizontal priorities, nor sufficiently disadvantaged to qualify for regional aid, either 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.

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Table 2: Coverage under the first Commission proposals for 2007-13concentration 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.

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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.

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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 ≤ 45% GDP [b]	50	40	50
'a' areas ≤ 60% GDP	40	35	40
'a' areas ≤ 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 Canaries.

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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.

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