Plus ça change, plus c'est la même chose?

Recent developments in EU competition policy and regional aid control

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Preface

This paper was originally drafted for EoRPA (European Regional Policy Research Consortium), which is a grouping of national government authorities from countries across Europe. The Consortium provides sponsorship for the EPRC to undertake regular monitoring and comparative analysis of the regional policies of European countries and the inter-relationships with EU Cohesion and Competition policies.

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The paper has been drafted by Fiona Wishlade. It draws on country-specific research contributed by the following research team

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ABSTRACT

State aid control is evolving rapidly to meet the challenges posed by the changing economic and geopolitical context resulting from the 2004 enlargement and the adoption of the Lisbon agenda. In parallel with the wholesale review of State aid policy, significant changes to EU Cohesion policy post-2006 are also under discussion. The Commission emphasis on policy 'coherence' between national regional and EU cohesion policies means that the review of regional aid control has had to straddle the reforms of both EU State aid and EU Cohesion policy.

The current regional aid guidelines expire at the end of 2006; since 2003, the Commission has been considering how to replace them. Following protracted negotiations, in July 2005 the Commission published Draft Guidelines on Regional Aid for further discussion. This paper traces the history of the Draft, assessing the impact of the various proposals on the Member States and the impact of the Member States on Commission policy. It argues that agreement can now relatively easily be reached on the Draft, but that some outstanding issues remain, in particular: whether revised GDP data will be used in determining final coverage and the impact of updated statistical information; how the challenges of operationalising area designation at the national level can be met; whether the Commission's ambition of 'coherent' national and EU Cohesion policy maps can be achieved; and how the relationship between horizontal State aids and the assisted areas will evolve.

Recent Developments in EU Competition Policy and Regional Aid Control

Table of Contents

Recent Developments in EU Competition Policy and Regional Aid Control

1. INTRODUCTION

Long regarded as the Cinderella of the EU competition provisions, State aid control is increasingly seen as a policy that has come of age. Policy is in the process of evolving rapidly to meet the challenges posed by the changing economic and geopolitical context resulting from the 2004 enlargement and the adoption of the Lisbon agenda. Since the late 1990s, successive European Councils have called for the reinforcement and reorientation of State aid control and a reduction in overall levels of aid. For its part, the Commission has stressed the contribution that State aid control can make to achieving the Lisbon objectives, while recognising the policy and administrative changes required by enlargement. This has been reflected in four key elements underpinning the changing approach to State aid control: the role of market failure as a justification for State aid approval; concerns with the efficiency and effectiveness of aid; the place of economic analysis in State aid control; and the simplification, modernisation and clarification of the State aid rules. These in turn have been embodied in the State Aid Action Plan, a roadmap for the reform of policy adopted by the Commission in Spring 2005.

In parallel with the wholesale review of State aid policy, significant changes to EU Cohesion policy post-2006 are also under discussion. The Commission emphasis on policy 'coherence' between national regional and EU cohesion policies means that the review of regional aid control has had to straddle the reforms of both EU State aid and EU Cohesion policy. In practice, DG Competition has been engaged in a review of its approach to controlling regional aid for the last three years or so. In Spring 2003 DG Competition issued an initial consultation with the Member States and the Candidate Countries. Early in 2004, the Third Cohesion Report was published as a precursor to the reform of EU Cohesion policy for 2007-13; it also indicated the main lines of Commission thinking on regional aid. By end 2004, DG Competition had issued two documents outlining its proposed approach to regional aid control post-2006: a Working Paper made available in May 2004, and a so-called 'Non-Paper' in December 2004, prepared for discussion at a State aid multilateral meeting on 1-2 February 2005. In July 2005, the Commission published Draft Guidelines on Regional Aid for discussion at a further multilateral meeting scheduled for 15-16 September 2005. Each document produced by the Commission has resulted in a wave of responses from the Member States that have varied widely both in their level of support for the Commission's proposals and in the detail of their criticisms or alternative proposals.

The main focus of this paper is on the July 2005 Draft Guidelines.[1] To set these in context, Section 2 outlines the evolution of the Commission's proposals, beginning with the current

[1] This paper draws on a number of national and European Commission documents concerned with the reform of the Regional Aid Guidelines, as well as the fieldwork undertaken by the EPRC team. The author is also grateful to Dr Junginger-Dittel, DG Competition for providing some insights into the reforms.

position and describing the main elements of the two proposals made in 2004. This section also describes the implications of these proposals and, of key importance for understanding the origins of the Draft Guidelines, the reactions of the Member States. Section 3 sets out the key elements of the Draft Guidelines. It attempts to replicate the calculations made by the Commission for determining regional aid coverage and to understand the implications of the proposals for the Member States. Section 4 outlines some of the initial reactions of the Member States to the new proposals. Section 5 takes a broader view of recent State aid policy changes, highlighting some developments of relevance to regional development policy. Section 6 identifies some initial discussion issues.

2. REGIONAL AID CONTROL POST-2006: 2004 PROPOSALS

2.1 Background and current policy approach

Regional policy was the first area in which the Commission developed guidelines for the discipline of State aids. These date back to the early 1970s when the Commission sought to 'coordinate' the use of investment aids for large firms in the more prosperous regions of the Community, mainly in response to concerns at competitive-outbidding for mobile investment. Over time the system of regulating regional aids has become progressively more elaborate, with the Commission becoming increasingly involved in determining the extent of the regional aid maps, the types of assistance that may be offered and the value of that assistance, such that large firms may now only receive investment aid in the designated problem regions.

In the late 1980s, the Commission began to make explicit use of the two derogations available for approving regional aid:[2] Article 87(3)(a), which concerns "regions where the standard of living is abnormally low or where there is serious underemployment" – essentially regions that are disadvantaged in relation to the EU average; and Article 87(3)(c), which concerns aid for the development of "certain areas" where it does not affect trade contrary to the common interest – in principle, areas that are disadvantaged in relation to the national average. Of particular importance, the definition of Article 87(3)(a) areas[3] has become entrenched in regional aid control policy and applied increasingly strictly. Moreover, as the Community has expanded, so too has the basis for determining eligibility – EU12, EU15 and, looking forward, EU25. For its part, the definition of Article 87(3)(c) areas has been much more fluid.

The increased formalisation of regional aid control in the late 1980s was partly prompted by the emergence of a bespoke Community regional policy, and this in turn raised important issues of policy coordination.[4] Indeed, since then, the Commission has promoted the control of regional aid as an aspect of Cohesion policy, viewing it as having the capacity both to contribute to cohesion and to undermine it: on the one hand, it has sought to rein-in the use of incentives to large firms in the more prosperous regions in order to maintain award rate differentials; on the other hand, it has recognised that incentives may play a role in attracting and maintaining investment in the least-favoured regions and has allowed aid on relatively generous terms.

The current approach to regional aid is set out in the 1998 Guidelines on National Regional Aid.[5] The essence of the approach was as follows. First, regional aid control was perceived in terms of the need to restrict assisted area coverage expressed as a percentage of the

[2] Commission communication on the method for the application of Article 92(3)(a) and (c) [*now renumbered to Article 87(3)(a) and (c)*] to regional aid, OJEC No C 212 of 12 August 1988.
[3] NUTS II regions where GDP(PPS) per head is less than 75 percent of the Community average for the last three years for which data are available.
[4] See F. G. Wishlade, 'The Relationship between EU Competition Policy and EU Regional Policy' in *Regional State Aid and Competition Law in the European Union,* Kluwer Law International, The Hague (2003).
[5] OJEC No 74 of 10 March 1998.

population: a ceiling of 42.7 percent of the EU15 population was set. Within this ceiling, the Article 87(3)(a) regions (around 21 percent of the EU population) were identified. Second, the remaining population (around 22 percent) was allocated among the Member States as 'quotas' for the designation of areas on the basis of Article 87(3)(c). For most countries, this resulted in significant cutbacks in assisted area coverage, although all of some Member States (Greece, Ireland and Portugal) remain eligible for national regional aid until December 2006 (for current coverage see Figure 3, last three columns). Third, although Member States were responsible for selecting the assisted areas within their respective Article 87(3)(c) quotas, the methodology was constrained by the guidelines and the outcome had to be approved by the Commission. Fourth, the validity of the maps approved by the Commission for national regional policy was timed to coincide with the Structural Fund planning period (2000-6), and a special derogation was introduced to encourage Member States to designate areas both for national regional aid and the Structural Funds Objective 2. Last, the Commission imposed lower award maxima across the board, although aid values are set to reflect the severity of the regional problem; typically, these range from 50 percent to 20 percent net grant-equivalent.[6]

For the new Member States, the *formal* position was slightly different.[7] The (then) ten Candidate Countries were obliged to implement a domestic State aid policy in accordance with the *acquis* on the basis of their respective Europe Agreements, with supervision being exercised by *national* State aid monitoring authorities rather than the Commission. Following the May 2004 enlargement, the Commission confirmed that it raised no objections to the maps that had been agreed prior to accession. (Again, for current coverage see Figure 3 below).

For a number of reasons – the impact of the 2004 enlargement on the methodology, the outcome of a German legal challenge to the Commission Decision on its regional aid map[8] and widespread resentment among some EU15 Member States at the impact of the 1998 Guidelines – the 1998 rules could not simply be rolled forward with minor adjustments for enlargement. Moreover, the reform of regional aid control could not be considered in isolation either from the future of EU Cohesion policy or from the changing context for State aid control.

[6] Net grant-equivalent (NGE) refers to the after-tax value of assistance and is used by the Commission for comparing the value of all forms of regional aid.
[7] In practice, the Commission was closely involved in determining map coverage and award values in the Candidate Countries.
[8] C-242/00 Federal Republic of Germany v Commission of the European Communities [2002] ECR I-05603

2.2 DG Competition 'Working Paper' on Regional Aid Guidelines[9]

The Working Paper on the review of the Regional Aid Guidelines[10] stated that it drew on the comments submitted by the Member States in response to its earlier consultation, as well as taking account of the literature on the economics and effectiveness of aid, including two preparatory studies commissioned for the review,[11] the conclusions of recent Council meetings and its own experience with the 1998 Guidelines. However, the proposed form of regional aid control was not specified: the paper indicated that the Commission did not propose to present a complete draft of the new Regional Aid Guidelines 'at this stage', although it mentioned the possibility of a regional aid block exemption regulation being adopted in the future.[12] The key features of the proposals were essentially threefold:

- that Article 87(3)(a) areas be defined on the basis of EU25 GDP(PPS) per head data, rather than EU15 averages;
- that Article 87(3)(c) coverage be limited to so-called 'earmarked' regions, rather than based on national population quotas as at present; and
- that aid ceilings across the board be reduced.

These features are reviewed briefly in turn.

2.2.1 Article 87(3)(a) criteria and coverage

The main change with respect to Article 87(3)(a) was the move to EU25, rather than EU15 averages, reflecting enlargement to include 10 new Member States: the Working Paper proposed that the threshold for Article 87(3)(a) be 75 percent of EU25 GDP(PPS) per head. As is well-known, the main effect of this is to lower the limit for Article 87(3)(a) status thereby excluding a number of regions in EU15 from eligibility. According to the Working Paper, Article 87(3)(a) would cover 27.11 percent of the EU25 population.

2.2.2 Article 87(3)(c) criteria and coverage

For Article 87(3)(c), DG Competition proposed to replace the current system of 'population quotas' with an approach based on so-called 'earmarked' regions. The Working Paper proposed four such categories of region.

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[9] A fuller discussion of the Working Paper is available in F. Wishlade, 'The Beginning of the End or Just Another New Chapter? Recent Developments in EU competition policy and the control of regional state aid' *European Policies Research Paper* no. 54, (EPRC, University of Strathclyde, 2004) available at: <http://www.eprc.strath.ac.uk/eprc/publications.htm>.

[10] *Review of the Regional Aid Guidelines – a first consultation paper for the experts in the Member States*, available at: <http://europa.eu.int/comm/competition/state_aid/regional/>

[11] Ibex consultants Ltd, Review of Community guidelines for national regional aid, final report to DG Competition, April 2003 and M. Parissaki, Methodology and Indicators Used by Member States to determine eligible regions for Regional State Aid for 2000-2006: An Inventory of Choices and Summary of Efficiency analyses, both reports available from DG Competition website at: <http://europa.eu.int/comm/competition/state_aid/regional/>

[12] Member States were asked to submit their comments to the Working Paper by 1 July 2004.

(i) 'Statistical effect' regions

This concerns areas that would have met the Article 87(3)(a) GDP per head threshold using EU15 data, but are excluded on the basis of EU25 averages. For the most part, these are areas which currently have Article 87(3)(a) status, mainly in Germany, Greece and Spain. However, some regions that are not currently within Article 87(3)(a) would meet the Article 87(3)(a) criteria were these based on EU15 averages.[13] The Working Paper acknowledged this situation – citing the example of Hainaut – and proposed to include such areas within the 'statistical effect' group. According to the Working Paper, the statistical effect regions would cover 4.18 percent of the EU25 population.

(ii) Economic growth regions

A further group of regions would have ceased to qualify for Article 87(3)(a), even without enlargement, owing to a relative increase in levels of GDP per head. According to the Working Paper, these economic growth regions account for 2.71 percent of the EU population.

(iii) Outermost regions

The Outermost regions (OMRs) were treated as a distinct category, reflecting the conclusions of the Third Cohesion Report and the provisions of Article 299 of the Treaty. In practice, most, perhaps all, would anyway fall within Article 87(3)(a). The OMRs may benefit from operating aid. According to the Working Paper, the OMRs covered by Article 87(3)(c) account for 0.43 percent of the population.

(iv) Low population density areas

The Working Paper proposed to continue to make special provision for regions of low population density, using the same definition as at present, this being NUTS III regions with a population density of less than 12.5 inhabitants per km^2. The Working Paper noted that "transportation aid can continue as before" and proposed that, for Arctic areas suffering from continued depopulation, the Commission may authorise "other types of operating aid where such aid is necessary to stop depopulation". According to the Working Paper, the low population density areas cover 0.41 percent of the EU population.

2.2.3 Award rates and ceilings

An important element of the Working Paper was the proposal to reduce rates of award across the board (except for SMEs, where the Commission planned to raise the ceilings). This was to be achieved through the combined effects of reductions in nominal award values and the setting of rates of award in gross rather than net terms. In addition, in the statistical effect regions, rates of award would fall over the 2007-13 period to reach the same level as in economic growth areas.

[13] The equivalent threshold to 75 percent of the EU15 average is 82.2 percent of the EU25 average, on the basis of GDP data for 2000-2. (Own calculations).

Figure 1: Rates of award by firm size post 2006? (gross grant equivalents)

	Large	Medium	Small
Article 87(3)(a) ≤ 50% GDP	50	60	70
Outermost Article 87(3)(a) ≤ 60% GDP	50	60	70
Article 87(3)(a) ≤ 60% GDP	40	50	60
Outermost Article 87(3)(a) < 75% GDP	40	50	60
Article 87(3)(a) < 75% GDP	30	40	50
Outermost Article 87(3)(c) statistical effect	40 → 30	50 → 40	60 → 50
Article 87(3)(c) statistical effect	30 → 20	40 → 30	50 → 40
Other Article 87(3)(c) (sparse pop; economic growth)	20	30	40
Non-assisted	0	10	20

Source: Regional Aid Working Paper.

2.2.4 Other proposals / issues

Several other issues were raised by the Working Paper. Regarding regional aid specifically, there was reference to the definition of eligible investment and especially the treatment of land and intangible investment. There was also a proposal to clarify the definition of initial investment.

More generally, the Working Paper suggested increasing rates of award for small and medium-sized enterprises (SMEs) in the non-assisted areas from 15 percent and 7.5 percent gross to 20 percent and 10 percent respectively (as illustrated in Figure 1).

2.3 DG Competition Non-Paper 'Review of the Regional Aid Guidelines'

In December 2004, DG Competition issued a Non-Paper summarising the main provisional conclusions that it had drawn from the consultation process to date. For the most part, the Non-Paper confirmed the approach adopted in the May 2004 Working Paper. The principal changes proposed in the Non-Paper (in relation to the Working Paper) were as follows.

- The automatic inclusion of OMRs in Article 87(3)(a) (previously, OMRs above the Article 87(3)(a) threshold were treated as earmarked Article 87(3)(c) regions).

- A lowering of the threshold for the poorest Article 87(3)(a) regions from 50 percent of EU average GDP per head to 45 percent (with implications for maximum award rates).

- A reduction in maximum award rates in relation to the Working Paper, notably for the poorer Article 87(3)(a) regions (GDP(PPS) per head less than 60 percent of the EU25 average) and the Article 87(3)(c) statistical effect and economic growth regions. The rates proposed in the Non-Paper are set out in Figure 2.

Figure 2: Rates of award by firm size post 2006? (gross grant equivalents)

	Large	Medium	Small
Article 87(3)(a) ≤ 45% GDP	40	50	60
Article 87(3)(a) ≤ 60% GDP	35	45	55
Article 87(3)(a) < 75% GDP	30	40	50
Article 87(3)(c) statistical effect	30 → 15	40 → 25	50 → 35
Article 87(3)(c) sparse pop	20	30	40
Article 87(3)(c) economic growth	15	25	35
Non-assisted	0	10	20

Note: In addition, OMRs receive higher rates of award.
Source: DG Competition Non-Paper.

- The introduction of provisions for least-populated regions to offer operating aid to counter depopulation. According to the Non-Paper, least-populated regions would be those with fewer than 8 persons per km^2; however, the geographical unit (NUTS II or III) was not specified. The earlier reference to 'Arctic' regions was dropped.

- The imposition of a maximum aid rate differential of 30 percent between regions in different Member States sharing a land border.

- The exclusion from eligible investment of transfer of plant and equipment within the same multinational group of firms

- The extension of eligible investment to include feasibility studies and advice.

In addition, in a number of areas, the Non-Paper sought further input from the Member States, notably on: mechanisms to address the issue of relocation or displacement investment; the scope of a possible block exemption on regional aid; and the future sectoral coverage of the Multisectoral Framework. For its part, DG Competition proposed to give further consideration to clarifying the distinction between initial and replacement investment and to the relationship between the horizontal aid guidelines and the assisted areas. The paper was discussed at the 1-2 February 2005 Multilateral Meeting, and Member States were asked to make any further submissions by 1 March 2005.

2.4 Implications for the Member States

The proposals contained in the May 2004 Working Paper and the subsequent Non-Paper represented a very significant shift in the rules governing regional aid. As Figure 3 shows, the implication of the proposals for the EU as a whole was a 17 percentage-point cutback in coverage from 52 percent of the population in 2000-6 to around 35 percent from 2007. These reductions were unevenly distributed: there would be no assisted area coverage at all in Cyprus, Denmark, mainland France, Luxembourg and the Netherlands; several countries (eg. Belgium, Ireland, Austria and the UK) would see cutbacks of more than 50 percent in relation to the current position; elsewhere (eg. Sweden and the Czech and Slovak Republics) there would be more modest reductions; and last, some countries would see no change in coverage (Estonia, Greece, Latvia, Lithuania, Hungary, Malta, Poland and

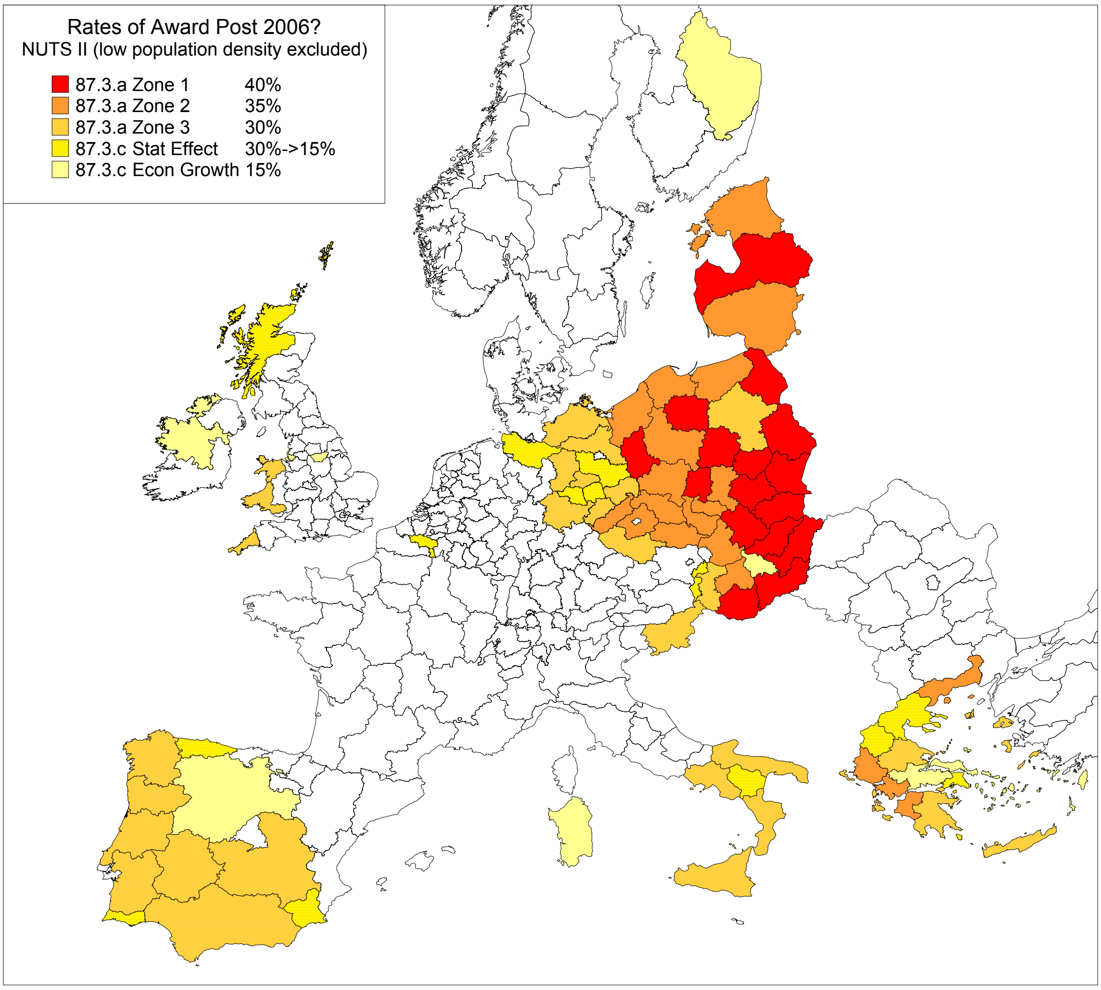
Slovenia) – although this might conceal changes is status (ie. 'downgrading' from Article 87(3)(a) to Article 87(3)(c)).

Figure 3: Assisted Area Coverage Post-2006? (% of population)

	Coverage post 2006?						**Coverage 2000/2004-2006**		
	Article 87(3)(a)	Statistical Effect	Economic Growth	Sparsely-populated	**Article 87(3)(c)**	**TOTAL**	Article 87(3)(a)	Article 87(3)(c)	**Total**
EU25	**27.7**	3.6	3.6	0.41	**7.6**	**35.3**	34.3	18.0	**52.3**
EU15	**15.0**	4.3	3.5	0.49	**8.2**	**23.3**	21.9	21.1	**43.0**
NMS10	**92.9**		3.8		**3.9**	**96.7**	97.6	2.4	**100.0**
Belgium		12.4			**12.4**	**12.4**		30.9	**30.9**
Czech Rep	**88.6**					**88.6**	88.6	11.4	**100.0**
Denmark						**0.0**		17.1	**17.1**
Germany	**12.5**	6.1			**6.1**	**18.6**	17.2	17.7	**34.9**
Estonia	**100.0**					**100.0**	100.0		**100.0**
Greece	**36.6**	55.5	7.8		**63.4**	**100.0**	100.0		**100.0**
Spain	**36.0**	5.9	16.3	0.34	**22.5**	**58.6**	58.4	20.8	**79.2**
France	**2.7**					**2.7**	2.8	33.9	**36.7**
Ireland			26.5		**26.5**	**26.5**	26.6	73.4	**100.0**
Italy	**29.2**	1.0	2.9		**3.9**	**33.1**	33.6	10.0	**43.6**
Cyprus						**0.0**		100.0	**100.0**
Latvia	**100.0**					**100.0**	100.0		**100.0**
Lithuania	**100.0**					**100.0**	100.0		**100.0**
Luxembourg						**0.0**		32.0	**32.0**
Hungary	**72.2**		27.8		**27.8**	**100.0**	100.0		**100.0**
Malta	**100.0**					**100.0**	100.0		**100.0**
Netherlands						**0.0**		15.0	**15.0**
Austria		3.4			**3.4**	**3.4**	3.5	24.1	**27.6**
Poland	**100.0**					**100.0**	100.0		**100.0**
Portugal	**70.1**	3.8			**3.8**	**74.0**	66.6	33.4	**100.0**
Slovenia	**100.0**					**100.0**	100.0		**100.0**
Slovakia	**88.9**					**88.9**	88.9	11.1	**100.0**
Finland			13.0	10.71	**23.7**	**23.7**	13.4	28.9	**42.3**
Sweden				13.04	**13.0**	**13.0**		15.9	**15.9**
UK	**4.0**	0.6	4.4		**5.1**	**9.1**	8.6	22.1	**30.7**

Note: The sparsely populated coverage only includes population not covered by another criterion.
Source: Own calculations using Eurostat data (April 2005 update), information in DG Competition Working Paper and on DG Competition website at : <http://europa.eu.int/comm/competition/state_aid/regional/2004/>; and F. G. Wishlade, *Regional State Aid and Competition Law in the European Union,* Kluwer Law International, The Hague (2003), Figure 34 at p 205.

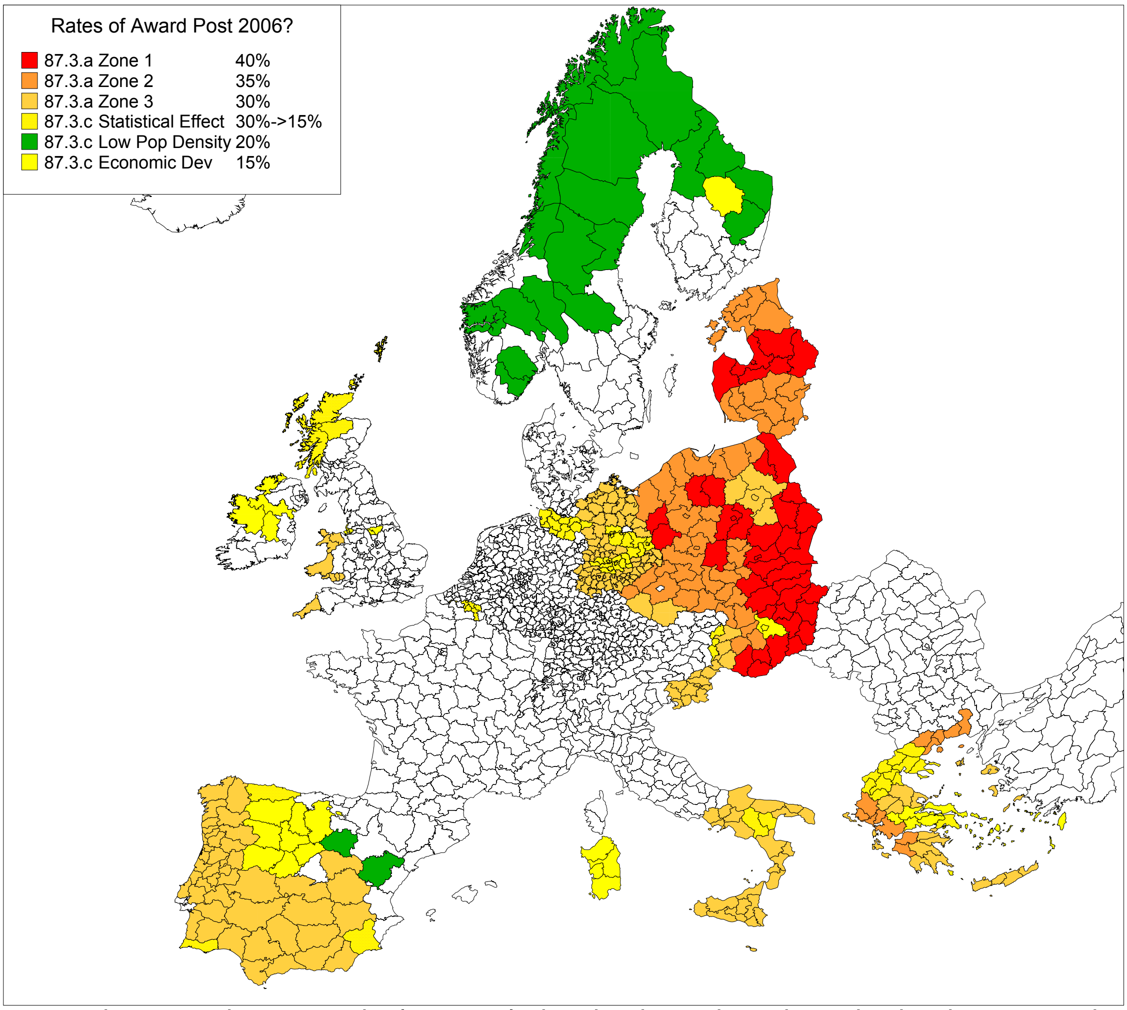
Figure 4: Proposed rates of award in Article 87(3)(a) and former Article 87(3)(a) areas



Source: Own calculations based on Eurostat data (April 2005) using the Non-Paper proposal.

There were also significant implications for maximum award rates; the rates proposed under the Non-Paper are illustrated in Figure 4 and Figure 5. Direct comparisons are difficult because of the proposed shift from net grant equivalent to gross values and the use of EU25 rather than EU15 GDP averages. By way of example, whereas the current standard rate for large firms in Article 87(3)(a) regions with GDP(PPS) per head of less than 60 percent of the EU 15 average is 50 percent NGE, under the December 2004 proposals the maximum would be just 35 percent gross (40 percent for regions with GDP(PPS) per head of less than 45 percent of the EU25 average). In fact, this reduction is more dramatic than it appears in nominal terms: the use of gross maxima means that *actual* values would be even less after tax; and the use of EU25 averages would mean that the qualifying threshold for higher values is at a lower level. As a result, a region where the maximum currently applicable might be 50 percent NGE would probably have a maximum of 30 percent gross under the 2004 proposals.

Figure 5: Proposed award maxima - all eligible areas



Note: Where a region meets the low population density and another criterion (eg. economic development) the higher rate has been applied.
Source: Own calculations based on Eurostat data (April 2005) using the Non-Paper proposal.

2.5 Member State positions on the reforms

As mentioned earlier, DG Competition has sought the views of the Member States at various stages in preparing regional aid rules for the post-2006 period. The following section aims to synthesise the views of the Member States, as expressed in their responses to DG Competition,[14] in relation to assisted areas, award values and the relationship between regional aid and other policies.

2.5.1 Assisted areas

As discussed, the main thrust of DG Competition's 2004 proposals was to shift the criteria for Article 87(3)(a) onto an EU25 basis, thereby excluding most current Article 87(3)(a)

[14] Copies of national position papers have kindly been provided by many policymakers for the purposes of this paper. They concern Austria, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Latvia, Lithuania, the Netherlands, Norway, Poland, Slovak Republic, Sweden, and the UK. In addition, insights have been gained from these and other countries through fieldwork. However, not all of the papers received relate to the same phase of the consultation process.

areas in the EU15 from eligibility, and to limit the application of Article 87(3)(c) to certain 'earmarked' regions. The spectrum of responses from the Member States was wide. As might be expected, most of the new Member States supported the principle of this approach, but the *Netherlands* argued for an even tougher approach, suggesting that investment aid should only be allowed in the new Member States, with transitional arrangements for currently eligible regions in EU15. In contrast, as will be seen, many countries (*Austria, France, Germany, Ireland* and the *United Kingdom*) expressed concern at the loss of scope for *national* policy to target underperforming regions, with Ireland and the United Kingdom questioning the appropriateness of NUTS II as the effective building block for area designation. The remainder of this section discusses the various area designation issues raised in the national responses.

(i) Article 87(3)(a)

The change in criteria for Article 87(3)(a) designation passed largely unremarked by the national authorities. This doubtless partly reflected the widely-held expectation that the thresholds for Article 87(3)(a) would be adjusted post-enlargement, which had also been confirmed in the Third Cohesion Report and paralleled the approach taken to the new Convergence Objective. Instead, the focus for many policymakers had been on the status of regions losing Article 87(3)(a) eligibility and/or the future of Article 87(3)(c) regions.

While Member States supported the retention of the Article 87(3)(a) criteria, the *United Kingdom,* in its initial response to DG Competition, expressed concern at the use of NUTS level II, arguing that this would "prevent aid being targeted at some of the least-favoured areas of the EU, while other more relatively prosperous areas would benefit." Instead, the UK proposed that Article 87(3)(a) be designated at NUTS III, this being the only alternative that would ensure a consistent approach across the EU. Later input to the consultation acknowledged that the Commission position was unlikely to shift, not least given the use of NUTS II for Cohesion policy purposes. For its part, the *Slovak Republic* called for a review of the criteria for determining Article 87(3)(a) eligibility, arguing that GDP per head did not reflect standards of living and noting the distortions in the measurement of regional GDP per head induced by the 'commuter effect'.

(ii) Article 87(3)(c) statistical effect

A major concern in the initial consultation had been the treatment of regions losing Article 87(3)(a) status owing to the statistical effect of enlargement. This concern largely appeared to have been addressed in the DG Competition proposals, although several countries commented on the issue of award values (see below). However, there were some other specific observations: the *Czech Republic* and *Denmark* opposed the notion of a statistical effect category in principle; *Germany* suggested that the status of regions should be monitored on an ongoing basis so that phase-out provisions would cease to apply and rate reductions be reversed in the event that the situation of a region worsened; *Hungary* proposed that the statistical effect and economic growth regions be treated the same.

More specifically, *Slovenia* argued that statistical effect regions should not be immediately downgraded from Article 87(3)(a) to (c) but rather should benefit from a more transitional regime. Both the European Parliament[15] and the Committee of the Regions[16] shared the view that statistical effect regions should have Article 87(3)(a) status in order to remain in line with Cohesion policy proposals.

(iii) Article 87(3)(c) low population density

DG Competition's Working Paper contained a number of proposals in relation to sparsely-populated regions, notably: that such areas be 'earmarked' under Article 87(3)(c); that transport aid continue as before; and that other types of operating aid be authorised in so-called 'Arctic areas'. The position papers of *Finland, Sweden* and *Norway* all seized the opportunity to argue that Arctic areas should coincide with the areas listed in Protocol 6 to the Accession Agreement as eligible for Objective 6.[17] In addition, Norway argued that sparsely-populated regions need to be defined flexibly owing to the heterogeneous nature of the areas when defined at NUTS III. All three countries also proposed that the sparsely-populated regions should receive the same treatment as the OMRs in terms of award values.

(iv) Border regions

DG Competition's Working Paper made no provision for special treatment of non-assisted areas bordering designated regions, whether or not across national frontiers. This issue was raised by *Austria, Germany, Ireland* and *Italy*, which all proposed that special provisions be introduced to counter negative cross-border effects. The extent of non-assisted areas adjacent to assisted areas across a national frontier, whether designated under Article 87(3)(a) or earmarked under Article 87(3)(c), is illustrated in Figure 6.

Figure 6: Non-assisted areas bordering assisted areas across national frontiers

Non-assisted areas in:	Neighbouring assisted areas in:	% of population
EU25		1.3
EU15		1.6
France	Belgium	4.7
Germany	Czech Republic	1.0
Austria	Czech Republic, Slovakia, Slovenia	17.9
Italy	Slovenia	1.6

Note: Population is measured at NUTS III.
Source: Own calculations from Eurostat data.

Figure 6 reveals the cross-border question to be a major issue for Austria; moreover, the population concerned would be higher still were it not for the 'buffer' provided by the Article 87(3)(c) status of Burgenland against assisted areas in Hungary. The *Austrian* position paper proposed that border regions at NUTS III and adjacent areas be included in

[15] European Parliament, 'Draft Report on the role of direct State aid as a tool of regional development' Committee on Regional Development, 2 June 2005.
[16] Opinion of the Committee of the Regions of 7 July 2005 on the Revision of the guidelines for regional State aids, COTER-037, Brussels.
[17] OJEC No C 241 of 29 August 1994.

Article 87(3)(c) in order to avoid increasing the aid rate differential with the new Member States. Within the old Member States, however, it is noteworthy that relatively disadvantaged parts of France (Nord and Ardennes) would border parts of Belgium with Article 87(3)(c) status. Perhaps surprisingly, this issue is not raised in the French position paper. By contrast, the issue is raised by ***Ireland***, presumably in anticipation of special provisions for Northern Ireland.

The question of border effects was clearly taken on board by the Commission in its December 2004 Non-Paper. This proposed that aid rate differentials across national frontiers should not exceed 30 percent. In its March 2005 submission, the *UK* suggested that this differential could be reduced to 20 percent, a proposal also made by ***Italy***. At the February 2005 Multilateral Meeting, there was evidently a suggestion that NUTS III regions in the old Member States bordering new ones should be allowed to offer a 10 percent rate. This proposal was vigorously contested by several of the new Member States. The *Czech Republic*'s opposition to this suggestion was founded on the principle of equal treatment and the wider aims of EU Cohesion policy, a view broadly shared by *Poland* and *Slovenia*, which doubted the need for any special treatment of border areas.

(v) Islands

A number of position papers - *Finland, France, Ireland, Italy* and *Norway* – argued for the special treatment of islands, a claim which has some backing from the Treaty of Amsterdam and in the Constitutional Treaty (Article III-116) which identifies island regions as among those to which particular attention shall be paid.

Under the 2004 proposals, Corsica and the Balearics would lose assisted area status while Sardinia would be eligible under Article 87(3)(c) as an economic growth region. The Finnish Åland islands would also lose their partial Article 87(3)(c) status, as would the Irish and Norwegian regions not meeting the economic growth or population density criteria respectively. The position papers cited put forward a range of proposals – addressing particular national situations – to mitigate the impact of the Working Paper on islands. The Norwegian position argued that island municipalities should be eligible for transport aid, even if the population density criteria were not met; the Finnish position suggested that island regions should have Article 87(3)(c) status; and the French and Italian papers argued for special treatment of Corsica and Sardinia respectively.

(vi) Other assisted areas

Beyond the calls for special treatment of particular types of region outlined above, a number of countries were vociferous in their opposition to the withdrawal of Article 87(3)(c) areas designated on the basis of national criteria. The *Austrian* paper described the “complete abolition” of Article 87(3)(c) as a “severe interference with the policy of reducing regional disparities” and proposed transitional arrangements for areas losing Article 87(3)(c) status. The *German* position argued that the ability to support weak regions under Article 87(3)(c) is a core function of national independence and that there must be room for national policy, based on national socio-economic criteria, within the new EU framework. In its response following the February 2005 Multilateral Meeting, the German authorities argued that, within an overall ceiling of 50 percent of the EU27 population,

there was scope for around 17.7 percent of the EU25 population not covered by Article 87(3)(a) or earmarked Article 87(3)(c) regions to be designated on the basis of Article 87(3)(c). It proposed that Member States should be free to designate their assisted areas within this ceiling.[18]

The *Irish* and *UK* papers both expressed concern at the use of NUTS II, the risk that disparities are concealed at this level and that Member States are not able to target assistance at the worst-off areas. In response, they proposed a 'safety net' approach where cutbacks would be limited to a proportion of existing Article 87(3)(c) coverage with the actual areas selected by the Member State concerned.[19] In a detailed illustration, the UK proposed overall coverage of 42 percent of the EU25 population and a safety net such that Member States would retain at least 56 percent of existing coverage.

The *French* position described the abolition of government support for significant projects in Article 87(3)(c) areas as unacceptable, but noted that the Commission was not proposing to abolish Article 87(3)(c) areas as such, but rather to limit them to former Article 87(3)(a) areas, sparsely-populated regions and outermost regions. As an alternative, it proposed the abolition of Article 87(3)(c) regional aid maps *per se* and their replacement with a thematic approach echoing that envisaged under EU Cohesion policy. This would, according to the French proposal, provide scope to target aid at industrial closure and rural areas, emerging clusters and areas where economic change was imminent (eg. where major job losses are expected).

2.5.2 Award values

The overall thrust of the 2004 DG Competition proposals in relation to award values was to lower rates of award both by reducing aid values and by expressing those values in gross rather than net terms. In addition, comments were sought on more technical aspects of regional aid control, notably the proposal to express award values in gross grant-equivalents (GGE) rather than net grant-equivalents (NGE) and the need to clarify some issues related to eligible expenditure.

(i) Rates of award

The majority of EU15 national position papers responding to the Working Paper expressed the view that proposed rates of award, and specifically rate differentials between Article 87(3)(a) areas and the rest, were too high. This largely reflected the intended abolition of Article 87(3)(c) areas based on national criteria, leaving EU15 Member States with no scope to offer aid to large firms in regions of their choosing, but with the prospect of rates of 50 percent in parts of the new Member States.

This was clearly taken into account in the December 2004 Non-Paper which proposed lower maximum rates for most eligible region categories and adjusted the award rate banding for

[18] Each Member States would have Article 87(3)(c) coverage equal to 17.7 percent of the population *not* covered by Article 87(3)(a) or Article 87(3)(c) earmarked regions.
[19] In addition, the UK called for special treatment of Northern Ireland, which is alluded to by the Working Paper, but not explored in detail.

Article 87(3)(a) areas (contrast Figure 1 and Figure 2). This revised proposal was opposed by several of the new Member States. *Latvia* observed that it was iniquitous to impose such rate reductions on the new Member States when many EU15 countries had benefited from very high ceilings over a long period. *Lithuania* also opposed the reductions and pointed out that the administrative costs of lower rates of award are relatively higher, reducing the incentive effect of aid to firms; it also argued that rates should not distinguish between small firms and medium-sized firms. *Slovakia* suggested that rates of award should be adjusted to take account of very high unemployment; for its part, *Poland* argued that DG Competition's initial proposal should be retained.

(ii) Net or gross grant equivalents

A number of countries express support for the proposal to express rates in gross rather than net terms[20] – *Estonia*, *Finland, Germany, Hungary, Latvia, Lithuania, Poland, Sweden,* the *UK* (although it was noted that this view was not shared by all UK stakeholders) and *Norway*. On the other hand, *France***,** *Italy***,** *Slovakia* and *Slovenia* favour the retention of net grant-equivalents. The position of *Austria* and *Ireland* is more nuanced: Austria argues that the relevant levels of taxation need to be established if calculations are to be in gross terms and that further mechanisms would be needed to prevent competition between different tax relief regimes; for its part, Ireland proposes that, if GGE is used, then the discounting of aid to calculate present values should be allowed – this is especially relevant where investment is staggered over long periods or where interest rate subsidies or accelerated depreciation allowances are used.

(iii) Eligible expenditure, relocation and displacement investment

DG Competition's Working Paper did not put forward detailed changes on the definition of eligible expenditure, but highlighted some issues raised by Member States in relation to relocation, the definition of initial investment and intangible investment. These were further explored in the Non-Paper where DG Competition confirmed its intention to clarify the distinction between initial and replacement investment and stated that it would exclude from eligibility the transfer of plant and equipment within the same multinational group.

A number of countries expressed concern that the aid differentials proposed by DG Competition could create an incentive for relocation within the EU, and specifically a drift of investments from west to east. Against this background, *France* argued for a clear strategy to combat relocation (*délocalisations*) comprising a monitoring capability and eligibility restriction on transferred activities. In similar vein, *Austria* proposed that relocation should not be eligible - only increases in capacity should be aided.

The *Irish* perspective was more concerned with *global* competitiveness for mobile investment and suggested more flexible rules for non-EU direct investment where only one Member State is under consideration. The Irish paper also proposed that a 10 percent rate be allowed everywhere and that there be scope to support large firms throughout the

[20] In line with the approach taken in other aid policy areas, such as support for SMEs.

Community, which, through genuine innovation, create a new product market. *France* also pointed to the need to consider the impact of aid reductions on global competitiveness. *Latvia* and *Hungary* expressed similar concerns, noting actual or potential relocations to Russia, Belarus, Ukraine and China. In contrast, *Italy* argued that incentives cannot compensate for low labour costs in, for example, south-east Asia, even if award rates are high.

As far as the definition of eligible investment is concerned, there were few concrete proposals from the Member States, although *Hungary* suggested that the definition rely on existing accounting standards. However, there was general support for greater clarity. *Estonia, Germany* and *Italy* opposed the exclusion of modernisation from eligible investment and favoured continuing support for intangible investment: Germany argued that this be defined as widely as possible and Italy that the proportion of intangible investment eligible be raised from 25 percent to 35 percent. *Ireland* and the *UK* expressed concern at the possible exclusion of land from eligible costs, even if brownfield sites were to remain eligible, but the proposal to exclude land was supported by *Lithuania* and *Slovakia*. *Italy* argued that land should be excluded for large firms, except for contaminated sites.

A further, and somewhat distinct strand to the *UK* position was the suggestion that the Regional Aid Guidelines be used to ensure that regional aid is used in as effective a way as possible to raise regions' economic performance by requiring Member States to make assessments against criteria that seek to ensure value for money and avoid direct job displacement.

2.5.3 Relationship with other policies

An important dimension to DG Competition's 2004 Working Paper was the relationship with the wider reform agenda and the scope for horizontal policies to address regional disparities. The Working Paper made explicit reference to the possibility of the proposed LASA (lesser amounts of State aid) and LET (limited effect on trade) frameworks being used for regionally-differentiated aid, without the need for an aid map.[21] In addition, the paper held up the prospect of the revision of many of the horizontal aid rules which, coupled with the significant impact test approach, would provide Member States "with a large margin for manoeuvre to tackle such problems and to differentiate between regions where this is considered to be necessary". Last, the paper pointed to the compatibility of regional aid proposals with the conclusions of the Third Cohesion Report and, specifically, the consistency between the 'thematic' approach proposed under the Regional Competitiveness and Employment Objective (formerly Objectives 2 and 3, in broad terms) and the revision of the horizontal aid guidelines against the backdrop of the Lisbon agenda.

[21] For detailed discussion of the LASA and LET proposals and their relationship with regional aid see Wishlade, F. 'The Beginning of the End, or Just Another New Chapter? Recent developments in EU competition policy control of regional state aid' *European Policy Research Paper* No. 54 (European Policies Research Centre, University of Strathclyde, Glasgow, November 2004).

(i) LASA and LET

A major development since the appointment of the new Commissioner was the decision to abandon the proposals for LASA and LET; this was confirmed to the Member States at the 1-2 February 2005 multilateral meeting. LASA and LET had received a mixed reception both in specific, earlier, consultations and in the responses on the Regional Aid Guidelines. LASA was implicitly or explicitly supported, at least in principle, by *France, Ireland, Italy* and the *United Kingdom*. Other countries (for example, *Germany, Lithuania, the Netherlands, Poland* and *Sweden*) were more sceptical about the role of LASA and LET, expressing a range of concerns, ranging from doubts about whether they would offer the flexibility desired to the view that they would erode the relative value of regional aid.

(ii) Other horizontal policies

Several countries – notably *France, Italy* and the *United Kingdom* - explored the issue of the relationship between regional aid and horizontal policy frameworks in their responses. The *French* paper proposed the *complete* abolition of Article 87(3)(c) regional aid maps and their replacement with a thematic approach, echoing that envisaged under EU Cohesion policy, which would allow aids that met specific horizontal priorities; it also insisted on the need for the existing horizontal frameworks to be reviewed at the same time as the Regional Aid Guidelines and argued that to segment the discussion would be to deprive the Member States of a broader appraisal of the policy instruments aimed at achieving the Lisbon objectives.

The *Italian* paper proposed the integration of horizontal objectives into the award matrix. The policies cited were R&D and innovation, environmental protection and human capital. As well as adjusting the rates of award in relation to those proposed by DG Competition, the Italian paper also proposed that these revised ceilings should only be attainable where projects integrated the specified horizontal objectives.

The *UK* position suggested that there might be scope for the horizontal guidelines to address issues outside the assisted areas, for example, by allowing a ‘top-up’ of horizontal aid rates in order tackle local market failures or underperformance. The examples cited are aid for SMEs, aid for risk capital and aid for employment and training (especially for SMEs). Under such a mechanism, it is suggested that each Member State could be allocated a population quota to define areas within which ‘top-ups’ would be allowed. A further strand to the UK position was the proposal to be able to target pockets of deprivation with support for SMEs.

Aside from the existing horizontal frameworks, *Ireland, the Netherlands* and the *United Kingdom* all drew attention to urban problems. The UK has long lobbied for a separate framework to allow aid for the physical regeneration of land and property; the Irish paper noted that regeneration is not addressed in DG Competition’s paper; and the Dutch response noted the increase of urban problems and raised the question of whether and how these can be addressed under the regional aid framework.

(iii) EU Cohesion policy

Many of the national position papers (eg. *Austria, France*), along with the European Parliament Regional Development Committee and the Committee of the Regions, drew attention to the need to coordinate the reform of regional aid control with changes to EU Cohesion policy. The *German* paper went so far as to argue that regional aid control should not be agreed until the Council has decided on the new Structural Funds regime. The *Italian* paper made some explicit proposals regarding the relationship between the two, suggesting that, outside the assisted areas, maximum rates of award should be achievable under horizontal aid regimes only if measures were cofinanced by the Structural Funds. As already discussed, *Finland, Sweden* and *Norway* all argued for the definition of 'Arctic' areas to be based on the Objective 6 definition contained in the Act of Accession in the interests of coherence between the national and the EU assisted areas. *Slovenia* suggested that the transitional arrangements for regional aid control should mirror those for EU Cohesion policy: the statistical effect (Phasing-Out) regions under the Structural Funds proposals are part of the Convergence Objective, whereas under the 2004 Working Paper the plan was for an immediate downgrading of statistical effect regions from Article 87(3)(a) to (c).

The *UK* position was somewhat distinct; its submissions reiterated the long-held view that coincidence of the national and EU assisted area maps is unnecessary and, in line with the 2003 White Paper on regional policy,[22] argued that only the poorest Member States should receive the Structural Funds while the State aid rules should enable Member States to tackle underperformance wherever it occurs.

[22] HM Treasury, Department of Trade and Industry and Office of the Deputy Prime Minister, *A Modern Regional Policy for the United Kingdom,* DTI URN 03/649, The Stationery Office, London, March 2003 (available online at: <www.dti.gov/europe/consultation.pdf>).

3. REGIONAL AID CONTROL POST-2006: 2005 DRAFT COMMUNICATION

In July 2005 the Commission issued a draft Communication[23] in anticipation of a further multilateral meeting on regional aid control scheduled for 15 and 16 September 2005. In a number of important respects, the draft Communication represents a retreat by the Commission from the position set out in the 2004 papers and, to some extent, a return to the current approach, as embodied in the 1998 Guidelines. This is said to reflect the comments made by Member States, the European Parliament, the Committee of the Regions and other stakeholders.[24] The most significant change in relation to the 2004 proposals is the extension of Article 87(3)(c) coverage beyond the 'earmarked' regions to include areas selected by the Member States.

The Draft Guidelines also propose:

- increasing coverage from 35 percent to around 43 percent of the EU25 population with a safety net provision to limit losses in coverage to 50 percent of current coverage
- giving the statistical effect regions Article 87(3)(a) status rather than earmarked Article 87(3)(c) status
- transitional provisions for areas losing Article 87(3)(a) status
- specific rules for border areas in order to reduce the risk of local relocation
- higher rates of award in the poorest regions and the outermost regions
- more flexibility in the definition of low population density areas
- the scope for micro-targeting of assistance for SMEs under Article 87(3)(c)
- new provisions, termed 'aid for enterprise', for business start-ups in the assisted areas
- the incorporation of the rules on regional aid to large projects in the Regional Aid Guidelines
- the adoption of a block exemption regulation to obviate the need for prior approval of regional aid schemes.

[23] Available at: <http://europa.eu.int/comm/competition/state_aid/regional/>
[24] DG Competition Press release 'Commission Staff working document on Regional aid is published for further discussion with Member States' experts', available at: <http://europa.eu.int/comm/competition/state_aid/regional/>

3.1 Overall coverage

The starting point for the Commission proposals in the 2005 draft Communication is the principle that assisted area coverage should be "substantially less than that of the unassisted regions."[25] On this basis, the draft sets the initial population coverage at 42 percent of the EU25 population; however, the provisions made for the application of a 'safety net' to ensure that no Member States loses more than 50 percent of the population covered compared with 2000-6 means that overall coverage would rise to 43.1 percent.[26]

3.2 Article 87(3)(a)

The 2005 draft Communication retains the now well-entrenched definition of Article 87(3)(a) areas as NUTS II regions where GDP(PPS) per head for the last three years for which data are available is less than 75 percent of the EU average. The Commission makes clear that the same data will be used for Article 87(3)(a) as for the Structural Funds in order to maximise the coincidence of the assisted area maps.[27]

In addition, and as under the December 2004 Non-Paper, the seven outermost regions (OMR)[28] are included in Article 87(3)(a), irrespective of whether they meet the GDP per head threshold.

Last, and a new development, the 'statistical effect' regions are included in Article 87(3)(a) on a transitional basis at least until end 2009.[29] Before 2009, the data will be reviewed and regions where GDP(PPS) per head has fallen below 75 percent of the EU25 average will retain Article 87(3)(a) status but the remainder will become eligible for Article 87(3)(c) from 2010 to 2013; the 2004 proposals had included the statistical effect regions in Article 87(3)(c) from 2007.

3.3 Article 87(3)(c)

Under Article 87(3)(c), the 2005 draft proposes that each Member State (except those entirely covered by Article 87(3)(a)) should be allocated a population for Article 87(3)(c) designation. This would comprise two elements: first, an allocation equivalent to the population of what were previously referred to as 'earmarked' regions; and second, a quota based on regional disparities in GDP and unemployment within Member States.[30] In addition, a safety net would be applied to ensure that in no Member State is coverage reduced by more than 50 percent.[31]

[25] Paragraph 9.
[26] Paragraph 11; the draft also notes that enlargement to include Bulgaria and Romania would result in coverage of 46.4 percent of the EU27 population.
[27] Paragraph 13.
[28] Azores, Madeira, Canarias, Guadeloupe, Martinique, Réunion and Guyane.
[29] Paragraph 16.
[30] Paragraph 24.
[31] Paragraph 25.

3.3.1 Earmarked regions

There are essentially two groups of earmarked region. First, 'economic development' areas. These are regions eligible for Article 87(3)(a) in 2000-6, but above the Article 87(3)(a) GDP threshold for 2007-13, even when measured on an EU15 basis (and therefore not qualifying as statistical effect regions). In addition, Northern Ireland is included in this group, even though it has Article 87(3)(c) status for 2000-6, reflecting its special situation and the fact that maximum rates applicable in the province were comparable with those in some Article 87(3)(a) areas. The second group of earmarked region concerns low population density areas. These are defined as NUTS III areas with fewer than 12.5 persons per square kilometre.[32] Member States automatically receive an Article 87(3)(c) population allocation equal to that of the earmarked regions (with double-counting excluded).

3.3.2 National population quotas

In addition to the population derived from the earmarked regions, Member States also receive an Article 87(3)(c) quota based on internal disparities in GDP per head and unemployment rates. According to the working paper, the Article 87(3)(a) regions, together with the economic development and low population density areas amount to 35.3 percent of the EU25 population, leaving 6.7 percent of the population to be distributed on the basis of internal disparities while remaining within the overall ceiling of 42 percent.[33]

The method for distributing this quota is set out in Annex IV to the draft Communication. The distribution key is based on each Member State's share of the population in NUTS III regions with GDP(PPS) per head below 85 percent of the national average or unemployment 15 percent higher than the national average. The national averages are themselves adjusted to take account of EU disparities in GDP per head and unemployment rates. This process is described in more detail in Section 3.3.3 below.

The outcomes of the methodology are set out in Annex V to the Draft Guidelines and in the Summary of the Draft Guidelines, which provides the results in a slightly more disaggregated format; this is set out in Figure 7.

The proposal to extend Article 87(3)(c) coverage beyond the earmarked regions responds to pressures from various Member States, notably Austria, France, Germany and the UK. The German and UK position papers had each put forward detailed proposals for allocating an Article 87(3)(c) quota among the Member States. The working assumption in the German case was that, allowing for enlargement to include Bulgaria and Romania, some 17.7

[32] These areas are mainly in Finland and Sweden; however, there are several qualifying regions in other countries, specifically Greece, Spain and the UK. Of these, only Teruel in Spain is not covered by either Article 87(3)(a) or earmarked as an economic development region under Article 87(3)(c). For the purposes of this paper it has been assumed that Article 87(3)(a) status 'overrides' low population density; however, sparsely-populated economic development areas have been counted as low population density regions, on the basis that this will be their longer-term designation and that he latter designation is somewhat more advantageous. It is not entirely clear which line has been taken by DG Competition in its calculations.

[33] In practice, this appears not to include Northern Ireland, which would raise the total to 35.7 percent and reduce the amount to be distributed to 6.3 percent.

percent of the EU population would be available for nationally-determined Article 87(3)(c) areas, within an EU25 assisted area population ceiling of 50 percent; under the German proposal, each Member State would receive a quota equal to 17.7 percent of the national population *not* designated under other criteria. The UK proposal worked on the basis of a ceiling of 42 percent of the EU25 population and proposed that, after the Article 87(3)(a) and earmarked regions, the remaining Article 87(3)(c) population could be distributed through a safety net provision, such that no Member State would lose more than a set proportion (in its example, 56 percent) of its existing coverage.

Figure 7: Regional Aid Coverage 2007-2013 (DG Competition figures)

	Article 87(3)(a)	**Statistical effect**	**Econ dev & Low pop density**	**Other Article 87(3)(c)**	**TOTAL**
EU25	27.7	3.6	4.0	7.5	42.8[a]
EU15	15.0	4.3	4.0	9.0	32.2
Belgium		12.4		13.2	25.6
Czech Rep	88.6				88.6
Denmark				8.6	8.6
Germany	12.5	6.1		11.2	29.9
Estonia	100.0				100.0
Greece	36.6	55.5	7.9		100.0
Spain	36.2	5.8	16.3	1.1	59.6
France	2.9			15.5	18.4
Ireland			26.5	23.5	50.0
Italy	29.2	1.0	2.9	1.0	34.1
Cyprus				50.0	50.0
Latvia	100.0				100.0
Lithuania	100.0				100.0
Luxembourg				16.0	16.0
Hungary	72.2		27.8		100.0
Malta	100.0				100.0
Netherlands				7.5	7.5
Austria		3.4		19.5	22.9
Poland	100.0				100.0
Portugal	70.1	3.8		2.8	76.7
Slovenia	100.0				100.0
Slovakia	88.9				88.9
Finland			23.7	11.1	34.8
Sweden			13.0	2.4	15.4
UK	4.0	0.6	4.4	12.5	21.6[b]

Note: a) The Draft Guidelines give a figure of 43.1 percent for the EU25 total; **b)** The Draft Guidelines give a figure of 23.5 for the UK. The reason for these discrepancies is unclear.
Source: Summary of the draft guidelines on national regional aid.

3.3.3 Calculating national Article 87(3)(c) population quotas

The DG Competition methodology for allocating Article 87(3)(c) population quotas described in the Draft Guidelines has been replicated for the purposes of this paper. In the course of this, a number of anomalies emerged. These include:

- The apparent exclusion of Northern Ireland from economic development status for calculating the population to distribute in the form of Article 87(3)(c) quotas.

- Gaps and/or discontinuities in the underlying statistical data available from Eurostat.
- Difficulties in reconciling the description of the method with the outcome, and with the statement that the method used is the same as that in the 1998 Guidelines.[34]

The remainder of this section describes the different stages in the process of determining the Article 87(3)(c) quotas.

(i) National GDP and unemployment thresholds

The first stage of the methodology involves setting national thresholds for GDP and unemployment rates. These are GDP of less than 85 percent of the national average or unemployment of more that 115 percent of the national average. However, these thresholds are adjusted to reflect the *national* prosperity or unemployment situation according to the following formulae:

Adjusted GDP threshold = 85*(1+(100/RMS)/2)

Adjusted unemployment threshold = 115 *(1+(100/RMS)/2),

where RMS is the relative position of the Member State to the EU25 average in percentage terms.

The thresholds are calculated on the basis of the last three years data available, currently 2000-2 for GDP(PPS) per head and 2001-3 for unemployment rates. The outcome of this process is that regions in richer Member States or those with low unemployment must show a greater degree of disparity from the national average in order to qualify for aid. However, in order that the unemployment criterion not be too constraining, the threshold is capped at 150 percent.

This process produces the outcomes set out in Figure 8 and appears to be confirmed by the examples given in Annex IV for the Netherlands and Greece. Annex IV states that "regions in poorer Member States can have higher GDP than 85 and regions in Member States with high unemployment can prove sufficient disparity with an unemployment level below 115." However, this (and the examples given in Annex IV) appears to be at odds with earlier use of the thresholds and to produce contradictory results. More specifically, it is clear from past practice that the national threshold could not be higher than the basic thresholds – ie. 85 for GDP and 115 for unemployment.[35] Allowing the GDP threshold to rise above 85 percent of the national average may result in the inclusion of regions in the population quota where GDP is in excess of the national average; it is well established in case law that Article 87(3)(c) is concerned with "aid intended to further the economic development of

[34] See Footnote 22 of the draft Guidelines.
[35] The previous threshold was 10 percent above the unemployment average - see Commission communication on the method for the application of Article 92(3)(c) of the EC Treaty to national regional aid, OJEC No C 198 of 28 June 1997.

areas of a Member State that are *disadvantaged in relation to the national average*" [emphasis added].[36]

Figure 8: Adjusted GDP and Unemployment Rate Thresholds

	GDP(PPS) per head (2000-2) EU25=100	Adjusted GDP threshold (% of national av)	Unemp rate (2001-3) EU25=100	Adjusted unemployment threshold (% of national av)
EU25	100.0		100.0	
Belgium	116.9	**78.9**	82.6	**127.1**
Czech	66.2	**106.7**	86.3	**124.1**
Denmark	125.1	**76.5**	54.1	**150.0**
Germany	110.1	**81.1**	97.0	**116.8**
Estonia	44.9	**137.1**	121.9	**104.7**
Greece	74.6	**99.5**	110.4	**109.6**
Spain	92.9	**88.3**	123.0	**104.3**
France	113.8	**79.8**	102.2	**113.8**
Ireland	129.6	**75.3**	49.3	**150.0**
Italy	110.4	**81.0**	100.7	**114.6**
Cyprus	85.7	**92.1**	42.2	**150.0**
Latvia	37.3	**156.5**	132.2	**101.0**
Lithuania	40.6	**147.3**	158.9	**93.7**
Lux	214.6	**62.3**	30.0	**150.0**
Hungary	56.2	**118.2**	64.4	**146.7**
Malta	74.8	**99.4**	80.6	**128.9**
Neths	122.6	**77.2**	32.6	**150.0**
Austria	123.0	**77.1**	43.7	**150.0**
Poland	45.9	**135.1**	213.7	**84.4**
Portugal	77.0	**97.7**	56.7	**150.0**
Slovenia	74.4	**99.6**	71.1	**138.4**
Slovakia	49.4	**128.6**	205.9	**85.4**
Finland	114.0	**79.8**	100.7	**114.6**
Sweden	116.9	**78.9**	57.8	**150.0**
UK	115.6	**79.3**	55.9	**150.0**

Source: Own calculations on the basis of Annex IV of the Draft Communication and Eurostat data.

(ii) NUTS III qualifying population

The second stage of the process involves setting aside regions already designated as Article 87(3)(a) or Article 87(3)(c) on the basis of other criteria (see Sections 3.2 and 3.3.1 above).[37] From the remainder, the 'qualifying' NUTS III regions are identified on the basis of the adjusted GDP and/or unemployment thresholds.

[36] Case 248/84 Federal Republic of Germany v Commission of the European Communities [1987] ECR 4013, p.4042.

[37] As noted earlier, the draft communication gives Northern Ireland 'economic development' status under Article 87(3)(c), but the total population for economic development for EU25 and the UK appear not to include it. This has implications for the population to distribute and for double-counting of eligible regions. In the calculations presented here Northern Ireland has been counted in the earmarked Article 87(3)(c) population and excluded from the assessment of disparities. The justification for this approach is that Northern Ireland would otherwise be double-counted since most of the province displays the necessary GDP or unemployment disparity.

In practice, the process of identifying regions displaying the disparity required is hampered by gaps in the data, notably:

- There is no unemployment rate for EU25 for 2001 – this is needed for determining the 2001-3 average on which basis the unemployment indices are calculated.[38]

- There are gaps and discontinuities in the NUTS III unemployment rate data, specifically:

    - breaks in series: all Spanish regions; all Swedish regions[39]

    - unreliable data for a number of regions in: Denmark, Netherlands, Austria

    - no NUTS III data: Portugal (whole period – 2001-3); UK (2002-3, ie. 2001 data only).[40]

- There is no NUTS III GDP data for Portugal for 2000-1 (ie. 2002 only).[41]

Clearly these lacunae impede the application of the methodology, but there is no means of second-guessing the information which the Commission has at its disposal or the estimates that have been made in the absence of information.

The results of applying the thresholds are set out in Figure 9. As can be seen, there are wide variations between countries in the extent of NUTS III regions with the requisite disparities. Leaving aside Member States wholly covered by Article 87(3)(a) or earmarked Article 87(3)(c) regions, several Member States have no qualifying population: Cyprus and Luxembourg have no NUTS III division and therefore no basis for assessing disparities; for Portugal there is no published statistical data; and there are no qualifying regions in Ireland. Among countries with coverage, this ranges from just 2.4 percent of the population (Italy) to 49.2 percent (Austria).

Within countries, the use of GDP per head and unemployment rate data at NUTS III produces some anomalous results. For example, Brussels, Berlin and Vienna contribute to the qualifying unemployment population for their respective countries; and the 'commuter effect' of using small area GDP data is reflected in the inclusion of parts of outer London and the Glasgow hinterland.

[38] In the absence of this figure, the calculations in this paper use the 2002-3 average.
[39] Breaks in series and the fact that data is considered unreliable have been ignored for the purposes of the calculations here in the absence of any alternative sources.
[40] For Portugal, it has been assumed that no NUTS III regions can qualify on the basis of unemployment rates; for the UK, the 2001 rate (as a percentage of the EU average) has been assumed to apply across 2001-3 (in fact, the national rate expressed in EU25=100 terms changes very little over this period).
[41] 2002 GDP levels expressed as a percentage of the EU25 average have been assumed to apply across the period.

Figure 9: Qualifying population for Article 87(3)(c)

	Qualifying pop GDP ('000s)	Qualifying pop EU unemp thresh ('000s)	Total qualifying population ('000s)	Distribution key (share of qualifying pop) %
EU25	53464.9	32567.0	79447.2	100.0
Belgium	2038.7	1734.0	3609.1	4.5
Czech Rep	0.0	0.0	0.0	0.0
Denmark	840.7	44.3	840.7	1.1
Germany	19998.2	6424.5	26064.4	32.8
Estonia	0.0	0.0	0.0	0.0
Greece	0.0	0.0	0.0	0.0
Spain	0.0	1111.4	1111.4	1.4
France	12005.0	11628.6	19546.2	24.6
Ireland	0.0	0.0	0.0	0.0
Italy	908.7	1095.7	1393.5	1.8
Cyprus	0.0	0.0	0.0	0.0
Latvia	0.0	0.0	0.0	0.0
Lithuania	0.0	0.0	0.0	0.0
Luxembourg	0.0	0.0	0.0	0.0
Hungary	0.0	0.0	0.0	0.0
Malta	0.0	0.0	0.0	0.0
Netherlands	1350.4	417.1	1767.5	2.2
Austria	2416.4	1556.8	3973.2	5.0
Poland	0.0	0.0	0.0	0.0
Portugal	0.0	0.0	0.0	0.0
Slovenia	0.0	0.0	0.0	0.0
Slovakia	0.0	0.0	0.0	0.0
Finland	430.8	824.1	1254.9	1.6
Sweden	258.1	277.6	535.7	0.7
UK	13217.9	7452.9	19350.4	24.4

Note: Regions are counted either on the basis of GDP per head or unemployment disparities – ie. regions are not double-counted so that the 'total' column is not necessarily the sum of the three preceding columns; shaded Member States are those entirely covered by Article 87(3)(a) or earmarked Article 87(3)(c) status.
Source: Own calculations from Eurostat data based on Draft Communication Annex IV.

(iii) Share of population above/below thresholds and safety net application

The share of each Member State in the total qualifying population (see Figure 9 final column) is used as a distribution key for allocating the Article 87(3)(c) quota among the Member States. France, Germany and the UK together account for over 80 percent of the EU25 total.

According to the Draft Communication, 6.7 percent of the EU25 population is available to be distributed in this way. However, this figure is calculated on the basis of an initial ceiling of 42 percent, less Article 87(3)(a) and earmarked Article 87(3)(c) coverage of 35.3 percent. As already noted, this appears to exclude Northern Ireland, which would push this up to around 35.7 percent of the population, leaving about 6.3 percent to be distributed (before the application of the safety net). Assuming that the lower figure is correct, this leaves a population of some 28.7 million to allocate.

Applying the key shown in the final column of Figure 9 produces the coverage shown in the first column of Figure 10. This is added to the Article 87(3)(a) and earmarked Article 87(3)(c) population (shown in the second column) and set against the existing coverage (see Figure 3) in order to determine Article 87(3)(c) safety net coverage – to ensure that no Member States loses more than 50 percent of current (ie. 2000-6) coverage.

Figure 10: Article 87(3)(c) quotas and safety net additions

	Article 87(3)(c) quota (% of national population)	Article 87(3)(a) and (c) total (% - pre-safety net)	Safety net addition (%)
EU25	6.3	42.0	1.0
Belgium	12.6	25.0	0.0
Czech Rep	0.0	88.6	0.0
Denmark	5.6	5.6	2.9
Germany	11.4	30.0	0.0
Estonia	0.0	100.0	0.0
Greece	0.0	100.0	0.0
Spain	1.0	59.5	0.0
France	11.5	14.4	3.9
Ireland	0.0	26.5	23.5
Italy	0.9	34.0	0.0
Cyprus	0.0	0.0	50.0
Latvia	0.0	100.0	0.0
Lithuania	0.0	100.0	0.0
Luxembourg	0.0	0.0	16.0
Hungary	0.0	100.0	0.0
Malta	0.0	100.0	0.0
Netherlands	4.0	4.0	3.5
Austria	17.8	21.2	0.0
Poland	0.0	100.0	0.0
Portugal	0.0	74.0	0.0
Slovenia	0.0	100.0	0.0
Slovakia	0.0	88.9	0.0
Finland	8.7	32.4	0.0
Sweden	2.2	15.2	0.0
United Kingdom	11.8	23.7	0.0

Source: Own calculations based on Eurostat data, Draft Communication Annex IV and Figure 3.

As Figure 10 shows, five countries (Belgium, Germany, France, Austria, UK) receive Article 87(3)(c) population quotas equivalent to more than 10 percent of the national population. In addition, six countries (Denmark, France, Ireland, Cyprus, Luxembourg and the Netherlands) gain from the safety net clause.[42]

[42] The Draft Guidelines note that six countries benefit from this (see paragraph 25) but the Member States are not specified.

Figure 11: Regional Aid Coverage 2007-2013 (Author's calculations)

	Article 87(3)(a)	Statistical effect	Econ dev & Low pop density	Other Article 87(3)(c)	TOTAL
EU25	27.7	3.6	4.4	7.3	43.0
EU15	15.0	4.3	4.5	8.6	32.4
Belgium	0.0	12.4	0.0	12.6	25.0
Czech Rep	88.6	0.0	0.0	0.0	88.6
Denmark	0.0	0.0	0.0	8.6	8.6
Germany	12.5	6.1	0.0	11.4	30.0
Estonia	100.0	0.0	0.0	0.0	100.0
Greece	36.6	55.5	7.8	0.0	100.0
Spain	36.2	5.8	16.6	1.0	59.5
France	2.9	0.0	0.0	15.5	18.4
Ireland	0.0	0.0	26.5	23.5	50.0
Italy	29.2	1.0	2.9	0.9	34.0
Cyprus	0.0	0.0	0.0	50.0	50.0
Latvia	100.0	0.0	0.0	0.0	100.0
Lithuania	100.0	0.0	0.0	0.0	100.0
Luxembourg	0.0	0.0	0.0	16.0	16.0
Hungary	72.2	0.0	27.8	0.0	100.0
Malta	100.0	0.0	0.0	0.0	100.0
Netherlands	0.0	0.0	0.0	7.5	7.5
Austria	0.0	3.4	0.0	17.8	21.2
Poland	100.0	0.0	0.0	0.0	100.0
Portugal	70.1	3.8	0.0	0.0	74.0
Slovenia	100.0	0.0	0.0	0.0	100.0
Slovakia	88.9	0.0	0.0	0.0	88.9
Finland	0.0	0.0	23.7	8.7	32.4
Sweden	0.0	0.0	13.0	2.2	15.2
UK	4.0	0.6	7.3	11.8	23.8

Source: Own calculations from Eurostat data based on Draft Communication Annex IV.

The final outcome, based on attempts to replicate the calculations subject to the caveats mentioned, is set out in Figure 11. There are a number of features to note in comparing these figures and DG Competition calculations given in Figure 7. In particular:

1. The figures for Article 87(3)(a) and statistical effect coverage coincide exactly.

2. There is a discrepancy in the economic development and low population density coverage in respect of the UK (which is obviously reflected in the EU total). As discussed, this probably concerns the treatment of Northern Ireland which, the Guidelines imply, should be classified as an economic development region. This appears not to have been done in Figure 7, but has been in Figure 11.

3. For seven countries (Belgium, Spain, Italy, Austria, Portugal, Finland and Sweden), the outcomes shown in Figure 11 are lower than in Figure 7. In the case of Portugal, as noted earlier, the absence of published NUTS III GDP and unemployment data make it impossible to calculate the relevant disparities. For the remaining countries, the discrepancies are more modest, but cannot readily be accounted for.

4. For Germany and the UK the outcomes shown in Figure 11 are higher than those given by DG Competition.

3.3.4 Selection of eligible areas

The Draft Guidelines distinguish two types of assisted area that may be designated within the Article 87(3)(c) population quotas. Those where large firms may be assisted, comprising comparatively large geographical areas meeting EU-level criteria; and those where assistance is more tightly focused on localised disparities and is restricted to SMEs. In principle, the list of regions notified is to apply throughout the period 2007-13, but there is provision for a mid-term review in 2009. However, changes should not involve more than 50 percent of Article 87(3)(c) coverage.

(i) Eligible areas for aid to large firms

Areas which can be designated for aid to large firms are specified in the Draft Guidelines as follows:

1. Economic development regions (ie. Article 87(3)(a) areas for 2000-6 now above even the statistical effect threshold).

2. Low population density regions. These are made up essentially of NUTS III regions where the population density is less than 12.5 persons per km^2. However, under the provisions concerning transport aid, some flexibility is introduced to enable parts of adjacent NUTS III areas to be designated, provided that the overall population coverage is not increased.

3. Contiguous areas with a minimum population of 100,000. These must be within NUTS II or III regions where either GDP per head is less than the EU25 average or unemployment is more than 115 percent of the *national* average.

4. NUTS III areas with a population of less than 100,000 where either GDP per head is less than the EU25 average or unemployment is more than 115 percent of the *national* average.[43]

5. Islands and “other regions categorised by similar geographical isolation” where either GDP per head is less than the EU25 average or unemployment is more than 115 percent of the *national* average.

6. Border areas. These concern all or parts of NUTS III areas that are adjacent to regions eligible for Article 87(3)(a) and those which share a land border with a country that is not a member of the EEA or EFTA. It is unclear, however, whether the Article 87(3)(a) areas in this case include the statistical effect regions.

Taken together, these parameters provide considerable flexibility for the Member States to select their assisted areas within the overall population quotas and much less interference

[43] Given their small size, for Cyprus, Luxembourg and Malta it is considered sufficient that the areas designated within these countries have either GDP per head less than the EU25 average or unemployment more than 115 percent of the *national* average.

in the details of the area designation system appears to be envisaged under the 2005 draft than under the 1998 Guidelines.

The extent of flexibility is reflected in the proportion of the population in NUTS II or III with GDP(PPS) per head of less than the EU average and an unemployment rate more than 15 percent of the national average. This is illustrated in Figure 12, set alongside the Article 87(3)(c) population quotas.

Figure 12: Article 87(3)(c) quotas and potentially eligible NUTS II and III areas

	Article 87(3)(c) quota	Potentially eligible under Article 87(3)(c)
Belgium	13.2	43.1
Denmark	8.6	45.7
Germany	11.2	60.7
Spain	1.1	4.2
France	15.5	61.0
Ireland	23.5	10.8
Italy	1.0	5.1
Cyprus	50.0	~
Luxembourg	16.0	~
Neths	7.5	39.3
Austria	19.5	59.2
Portugal	2.8	26.0
Finland	11.1	41.7
Sweden	2.4	30.3
UK	12.5	56.9

Note: Cyprus and Luxembourg have no NUTS II or III breakdown. This table concerns only NUTS II and III areas meeting the GDP and unemployment criteria; islands and 'other isolated regions' (see point 5 above) and some regions bordering Article 87(3)(a) areas and non EEA countries (see point 6) would be in addition to the potentially eligible population indicated here.
Source: Own calculations and Figure 7.

(ii) Micro-targeting of SME aid

In addition (but still within the Article 87(3)(c) population quota), the 2005 Draft Guidelines offer scope to target aid below NUTS III at areas that do not meet the criteria outlined above, provided they involve a minimum population of 20,000. It is for the Member State to demonstrate the need for such targeting using indicators such as GDP per head, employment and unemployment levels or productivity and skills indicators. Assistance in areas designated on this basis would be restricted to SMEs and to projects involving eligible investments of less than €25 million. The relevant SME rate of award bonus will also apply to projects in these areas.

This proposal reflects the suggestion made by the UK authorities in their March 2005 position paper to enable the targeting of additional aid at SMEs in pockets of deprivation.

3.4 Aid values

As noted earlier, the rates of award proposed under the 2004 proposals were the subject of much criticism from the Member States, aspects of which are reflected in the 2005 Draft Guidelines. However, some Member States are likely to express disappointment at the absence of significant changes to the definition of eligible investment, especially regarding the possibility of controls over relocation which some had sought. As presaged in the early proposals, the Commission plans to incorporate provisions on aid to large projects into the Regional Aid Guidelines, introducing some detailed changes in the process. Last, the provisions on operating aid are broadly retained, although some aspects are tightened and reporting requirements formalised.

3.4.1 Rates of award

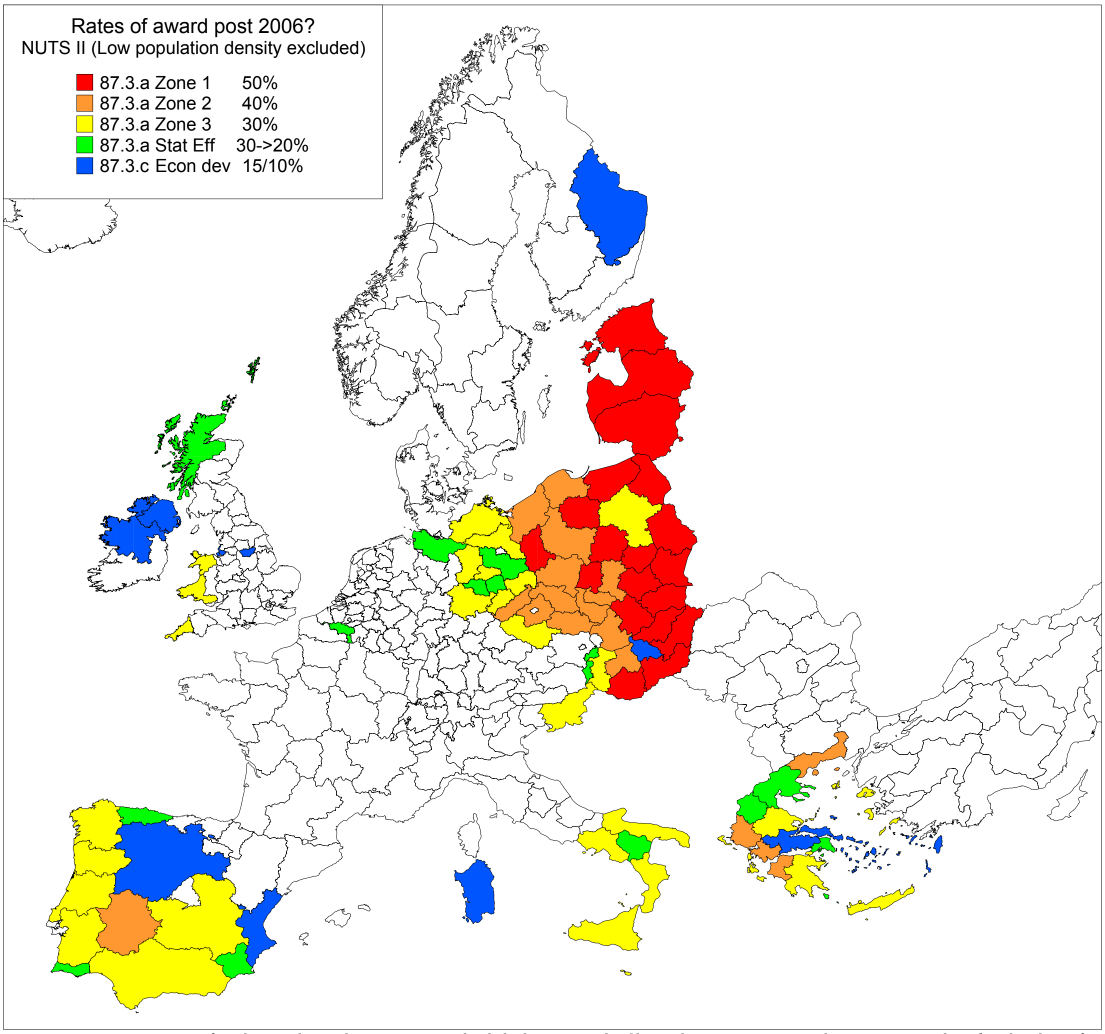
The Draft Regional Aid Guidelines retain the principle that maximum rates of award should be reduced. However, the evolution of the proposals has clearly attempted to take account of the concerns raised by the Member States. Many of the EU15 had criticised the high rate differentials between the Article 87(3)(a) areas and the rest as set out in the Working Paper (see Figure 1). There were particular concerns at the impact of these differentials on neighbouring regions. The later Non-Paper reduced rate differentials by lowering rates in the poorest regions and introducing maximum limits on the rate differentials between neighbouring regions. This in turn was criticised by some of the new Member States which viewed the Article 87(3)(a) rates as justified by the scale of the disparities; however, some of the EU15 countries considered that the maximum rate differential proposed (30 percent) was still too high. In broad terms, the 2005 Draft could be seen as reconciling these concerns by returning to the higher rates proposed in the Working Paper *and* reducing the aid rate differential between neighbouring regions to 20 percent (as well as by extending the scope of Article 87(3)(c)).

Figure 13: Rates of award by firm size post 2006? (gross grant equivalents)

	Large	**Medium**	**Small**
Article 87(3)(a) < 45% GDP; OMR < 75% EU25 GDP	50	60	70
Article 87(3)(a) < 60% GDP	40	50	60
Article 87(3)(a) < 75% GDP; OMR > 75% EU25 GDP	30	40	50
Article 87(3)(c) statistical effect	30[a] → 20	40[a] → 30	50[a] → 40
Article 87(3)(c) sparse pop	15[b]	25[b]	35[b]
Article 87(3)(c) economic development	15[b]/10[c]	25[b]/20	35[b]/30
Article 87(3)(c) other	15[b]/10[c]	25[b]/20	35[b]/30
Non-assisted	0	10	20

Notes: a) Until 1 January 2010 when the rate falls as indicated. **b)** This may be raised in the case of areas adjacent to Article 87(3)(a) regions to ensure that the rate differential does not exceed 20 percentage points. **c)** The lower rate applies to eligible areas where GDP(PPS) per head is higher that the EU average and unemployment below the EU average measured at NUTS III. Some further transitional arrangements apply to Article 87(3)(a) and economic development areas where the fall in award rates would otherwise be especially sharp.
Source: Assembled from information in the Draft Communication.

Figure 14: Proposed rates of award in Article 87(3)(a) and former Article 87(3)(a) areas (under 2005 Draft Guidelines)



Notes: Low population density areas (which are defined at NUTS III) are not included. Also not illustrated are any rate changes owing to exceptional transitional provisions or border rate differentials.
Source: Assembled from information in the Draft Guidelines and Eurostat data.

The 2004 proposals from DG Competition had consulted the Member States on the issue of expressing aid values as gross (GGE) rather net grant equivalents (NGE); this had been accepted by most Member States, although some argued that the relative tax situations should be taken into account. The 2005 Draft Guidelines make clear that the Commission intends to define aid in gross terms, following on from a Court of First Instance ruling that "The Commission is not empowered, under the State aid monitoring system established by the Treaty, to take into consideration the incidence of tax on the amount of financial aid allocated when it assesses whether it is compatible with the Treaty".[44] The Draft Guidelines also note that GGE is used for calculating the intensities of other types of State aid.

[44] Case T-298/97 *Alzetta and Others v European Commission* [2000] ECR II-02319, para 89.

3.4.2 Eligible expenditure

The changes to eligible expenditure proposed in the 2005 Draft Guidelines appear modest. Land, buildings and plant/machinery all remain eligible – it had been proposed that land be excluded, but a number of Member States had opposed this. The reference to a standard expenditure breakdown for each Member State between land, buildings and plant/machinery has been dropped – presumably this is no longer required since aid values are calculated in gross terms and the differing depreciation schedules for tax purposes are no longer relevant.

For large firms, the limit on intangible assets expenditure (technology transfers, patent acquisition, licences, know-how and unpatented technical knowledge) has been raised from 25 percent to 50 percent of eligible expenditure.[45]

The Draft Guidelines also set out a definition of initial investment. This covers:

- setting-up a new establishment
- extending an existing establishment
- diversifying the output of an establishment into completely new product markets
- fundamental change to the overall production process of an existing establishment

This does not appear to be significantly different from the current Guidelines, which also explicitly exclude replacement investment. As before, the Guidelines require aided assets to be retained for at least five years;[46] however, in the 2005 Draft Guidelines, it is made clear that this does not preclude the replacement of plant or equipment that has become outdated, provided that the economic activity is retained within the region concerned for the minimum period.

As before, aid can be taken in the form a wage cost subsidy; the same rate of award applies as to initial investment. Eligible expenditure concerns the wage costs for a period of two years arising from job creation as a result of an initial investment project and refers to a net increase in jobs compared with the average over the preceding year. Jobs must be created within three years of the completion of the works concerned and the posts must be maintained in the region for at least five years.[47]

3.4.3 Large investment projects

As indicated in the 2004 proposals, the 2005 Draft Guidelines include rules on aid to large investment projects. These are currently contained in a separate document, the 2002

[45] There is no limit for SMEs.
[46] Member States may lower this to three years for SMEs.
[47] Member States may reduce this to three years for SMEs.

Multisectoral Framework,[48] which would expire on 31 December 2006 and be replaced by the new Regional Aid Guidelines.

The provisions on large investment projects contained in the Draft Regional Aid Guidelines are substantially the same as the 2002 Multisectoral Framework, but include some changes of detail, tightening up the rules in some areas, but relaxing them in others.

The essence of the 2002 Multisectoral Framework is to reduce rates of award under existing regional aid schemes to projects with eligible investment of more than €50 million. This is achieved through a reduction scale (the larger the project, the lower the rate of award) incorporated into the regional aid schemes operated by the Member States. In addition, projects which would receive more aid than that allowable to a project involving investment of €100 million must be notified individually. These projects are not eligible for aid if the beneficiary accounts (or will account) for more than 25 percent of the sales of the product concerned or if the capacity created by the project is more than 5 percent of the market. However, where a notifiable project is eligible for aid, the maximum aid rate can be increased by a factor of 1.15 if the project is cofinanced as a 'major project' under the Structural Funds Regulation. The 2002 Multisectoral Framework also provides for a list of sectors affected by serious structural problems to be drawn up; more stringent rules would apply to these sectors. In practice, owing to the technical difficulties involved, this has never been done, but in the interim the Commission decided that no aid to the synthetic fibres sector should be authorised and that for the motor vehicle sector aid in excess of €5 million should be subject to a maximum of 30 percent of the prevailing regional aid ceiling.

The main changes to the 2002 Multisectoral Framework proposed by the 2005 Draft Regional Aid Guidelines are as follows:

- New provisions are introduced to prevent projects being 'artificially' divided in order to avoid the investment threshold at which the reduction scale applies: the Commission will take into account technical, functional and strategic links and geographical location.
- The notification requirement applies to projects where *eligible expenditure* exceeds €100 million, rather than where the *aid amount* is more than a €100 million project would have received, as previously.
- For regional aid granted to eligible investments between €50 million and €100 million (ie. projects where the reduction scale applies, but prior authorisation is not required) Member States must complete a summary information form. This information will be made available on the DG Competition website.

[48] Communication from the Commission – Multisectoral framework on regional aid for large investment projects, OJEC No C 70 of 19 March 2003.

- It is made clear that the Commission has concluded that it is not technically feasible to produce a list of sectors where serious structural difficulties exist and where stricter aid rules could be applied.

- Slightly different rules apply to the 'passenger car sector'.[49] There is no prior authorisation requirement for projects exceeding €100 million eligible investment, but there is a requirement to submit a summary information form for all passenger car projects involving investments of more than €50 million.

3.4.4 Operating aid

Under the 2005 Draft Guidelines DG Competition continues to regard operating aid as a form of assistance that can only be authorised in exceptional circumstances. For the most part, the provisions on operating aid are substantially the same as under the 1998 Guidelines, although the draft proposes that financial services sector be ineligible for operating aid owing to the high risk of distorting competition and the limited likelihood of promoting regional economic development.[50] It can generally only be offered in Article 87(3)(a) regions[51] and provided that it is justified in terms of its contribution to regional development and proportional to the handicaps it seeks to alleviate.[52] It is for the Member States to demonstrate the existence of these handicaps and to measure their scale. In principle, operating aid must be temporary and phased out over time. Operating aid which is not both progressively reduced and limited in time may only be authorised in the OMRs and the least-populated regions. These are defined as NUTS II regions (and adjacent and contiguous smaller areas) with a population density of 8 inhabitants per km^2 or less. On the other hand, the Draft Guidelines stress the need regularly to re-examine operating aid in all cases; the Commission will only authorise operating aid for the duration of the Guidelines.

Aid partly to offset the additional costs of transport may be authorised in the OMRs and in the low population density regions (basically, NUTS III regions with a population density of less than 12.5 persons per km^2). The criteria for transport aid are substantially the same as before.

The 2005 Draft Guidelines incorporate explicit reporting requirements for operating aid. Member States must submit an annual report for each NUTS II region in which operating aid is granted. This must provide a breakdown of total expenditure or an estimate of revenue foregone for each operating aid scheme; in addition, the ten largest beneficiaries must be listed specifying the sector of activity and the amount of aid received.

[49] The draft Guidelines refer to the 'passenger car sector' whereas the 2002 Multisectoral Framework referred to the 'motor vehicle industry', defined as the development, manufacture and assembly of motor vehicles (meaning passenger cars, vans, trucks, road tractors, buses, coaches and other commercial vehicles), engines for motor vehicles and modules or subsystems whether direct by a manufacturer or by a first-tier component supplier. It would therefore appear that the standard rules apply to the remainder of the motor vehicle sector.
[50] In 2002 the Commission issued a conditional decision on operating aid in the Azores allowing the scheme, providing that the financial services sector was excluded from eligibility. This provision would bring the Guidelines into line with that practice.
[51] The exception concerns the low population density regions, which have Article 87(3)(c) status.
[52] Paragraph 71.

3.5 Aid for enterprise

The 2005 Draft Guidelines propose a new model for aid to promote new businesses in the assisted areas. This would only be available to small firms, limited in amount and declining over time. Aid would be linked to actual expenses incurred in the first five years of a business, but need not be linked to investment. Eligible expenditure would include wage costs, depreciation, interest on external finance, dividends on own capital employed, rental and leasing costs, running costs and taxes other than VAT.

Award values proposed are as follows:

- Article 87(3)(a) regions: 35 percent of eligible expenditure in the first three years and 25 percent thereafter, subject to a ceiling of €3 million (€4 million in regions with GDP per head of less than 50 percent of the EU average)

- Article 87(3)(c) regions: 25 percent of eligible expenditure in the first three years and 15 percent thereafter, subject to a ceiling of €2 million (€3 million in regions with population density of less than 12.5 persons per km^2 and in islands with a population of less than 5000)

Beneficiaries would also, in principle, be eligible for aid for initial investment under the Regional Aid Guidelines.

3.6 Other

There are a few other aspects of the Draft Guidelines to which it is worth drawing attention.

First, the Commission intends to adopt a block exemption regulation for regional aid schemes. This means that transparent aid schemes conforming with the Regional Aid Guidelines and with the national assisted areas map approved by the Commission (which would be considered an integral part of the Guidelines) would not require prior authorisation.[53]

Second, with a view to increasing transparency, the Commission will seek an undertaking from all Member States that the full text of aid schemes will be published on the internet so that third parties can access details of all regional aid schemes operated in the EU.

Third, the Draft Guidelines require the submission of assisted area maps within three months of the publication of the Guidelines. Some Member States, especially those with a tradition of consultation, may find this deadline tight.

Last, there are some interesting new requirements associated with the incentive effect of regional aids. In particular, Member States should make a decision on applications with 12

[53] Operating aid and *ad hoc* aid (ie. aid to an individual firm offered on a one-off basis rather than in the context of an aid scheme) will not be exempt from prior notification. The notification requirements for aid to large projects still apply, even under schemes which are exempted from notification.

months of submission and within 6 months of work beginning on the project. Moreover, an express reference to these requirements must be included in all aid schemes. It is unclear how this requirement is relevant to competition considerations; it might properly be viewed as an internal matter for aid administrators in the Member States.

4. MEMBER STATE REACTIONS

At the time of writing few formal position papers from the Member States were available: some Member States opted to make written submissions only after the meeting, while others submitted papers beforehand, but reserved the right to make further observations. At the 15/16 September multilateral meeting, the Commission services indicated that any further papers should be submitted by end September 2005.

A review of those position papers that are available,[54] and early informal feedback, suggests that agreement on the Guidelines can now be reached with comparative ease. The majority of Member States support the most recent proposal, albeit with reservations on certain aspects. However, the Italian authorities have reacted with some consternation at the u-turn in the Commission's approach and some other Member States, notably Denmark and the Netherlands, favoured the more stringent approach originally envisaged by the Commission.

4.1 Coverage

France, Germany and the UK have all welcomed the Commission's decision to extend Article 87(3)(c) coverage beyond the 'earmarked' regions; this responds directly to the joint demand made to the Commissioner along with Austria. However, the French position expresses concern at the cutback in assisted area coverage in France; it argues for the position of the Member State in an EU context to be taken more into account in determining the Article 87(3)(c) population quota and for the safety net to be set at 70 percent, rather than 50 percent, as proposed by the Commission. France also proposes transitional provisions for those areas losing Article 87(3)(c) eligibility.

The German position questions the validity of using GDP per head data at NUTS III for determining Article 87(3)(c) coverage and proposes that income be used instead. Germany is also critical of the special treatment given to economic development regions: instead, it argues, this population should be distributed on the same basis as the remaining Article 87(3)(c) population or the areas concerned should be given transitional status, without this affecting the Article 87(3)(c) population quota.

4.2 Assisted areas

Regarding area designation, France argues for maximum flexibility in the selection of assisted areas, especially in the context of reduced coverage. Greater precision is sought in relation to the designation of areas affected by "geographical isolation", which the French maintain should include mountain areas. In addition, the French position suggests that the micro-targeting of assisted areas should not involve aid being restricted to SMEs. Last, the French position draws attention to the very short timescale within which it is envisaged that the Member States submit their assisted area map proposals.

[54] France, Germany, Norway and United Kingdom.

The German position also seeks flexibility in area designation; its arguments relate to the nature of many NUTS III boundaries in Germany, which often separate towns from their commuter areas. Germany therefore proposes that it should be possible to take account of the economic situation of a grouping of NUTS II and III areas in selecting areas to be designated.

In contrast, the emphasis of the UK position is on ensuring that aid is targeted at underperforming regions and requiring Member States to explain how their area designation proposals comply with the principles set out in the guidelines.

4.3 Award values

The UK position paper makes several general and specific remarks about the proposals in relation to aid intensities. For domestic political reasons it argues for a single award rate to be applied within Northern Ireland (differences in GDP and unemployment at NUTS III would otherwise mean that rates were differentiated) and for the same rate apply in Northern Ireland and the neighbouring regions of the Republic of Ireland. More generally, it proposes that *national* rates of unemployment should be used to determine whether the 10 percent rate applies in Article 87(3)(c) areas, rather than the EU rate.

The UK paper also makes some detailed points in relation to eligible expenditure. In particular, it opposes the exclusion of second-hand assets, for which there is a well-developed market in some sectors, and seeks clarification of the provisions in relation to leasing. It also notes that the exclusion of previously-assisted assets from eligible expenditure would disadvantage transactions such as management buy-outs following plant closure.

4.4 Operating aid

The Norwegian position welcomes the flexibility in the designation of low population density regions for which it, together with Finland and Sweden, had argued strongly earlier in the consultation. However, with regard to operating aid in these areas, Norway questions the sectoral restrictions implied by the Draft Guidelines. These state that aid to the financial services sector will not be authorised, but also refer to NACE code 74, which includes a wide range of other activities (such as architectural and engineering services, advertising, photography). The Norwegian authorities argue that the sectoral restriction should not apply to schemes that are automatically, without any discretion, applied on the basis of fixed and objective criteria. Norway also argues against the approval of operating aid being limited to 2013, commenting that businesses take a longer-term view and that greater stability and predictability is required for a measure to have an incentive effect.

France argues that transport aid to islands and isolated mountain areas should be allowed in Article 87(3)(c) areas on the same basis as that envisaged for low population density areas.

4.5 Aid for enterprise

France, Germany and Norway all welcome the proposals for aid for enterprise. However, Norway and the UK call for greater precision in the definition of 'start-up' and eligible expenditure. France argues that rates of award under the scheme should be higher in the problem regions and that the measure as a whole be included in the SME aid regulation and be applicable throughout the EU, an argument also made by Germany and the UK in their submissions.

5. OTHER RECENT DEVELOPMENTS IN STATE AID CONTROL

A number of other State aid policy developments of direct or indirect relevance to regional development issues are worth noting. First, the Commission has published its long-awaited State Aid Action Plan setting out a reform agenda for the next five years or so. This will entail a wholesale review of the existing rules. Second, there have been a number of developments in the relationship between the State aid rules and public service and infrastructure provision. This has been thrown into relief by liberalisation and deregulation which have altered the context for providing public services and raised new issues about universal service provision. At the same time, and in parallel with the decline in the use of financial incentives to support firms in problem regions, growing attention has been paid to the quality of the wider business environment. Last, the interface between taxation and State aid has often proven problematic. Special issues arise in the case of taxation levied (or foregone) at the subnational level. In the context of the trend to devolution and decentralisation in many countries, the treatment of regional tax autonomy is a potentially crucial issue. Two recent Commission Decisions, now being challenged before the European courts, highlight some of these issues.

5.1 State Aid Action Plan

The last year has been an extremely active period in State aid control policy. At a formal level, the Commission has presented its long-awaited State Aid Action Plan (SAAP)[55] in the form of a consultation document which sets out a "road map" for changes envisaged over the next five years or so. Responses to the consultation were sought by 15 September 2005, but substantive changes in individual policy areas are, or will be, the subject of individual consultation.

In practice, the SAAP largely 'repackages' a number of elements that were already in hand (such as the reform of the Regional Aid Guidelines and the consultation on innovation aid) into a broader strategic framework. To this extent, much of the SAAP is not new, as such. Nevertheless, its publication signals a determination on the part of the Commission to address inconsistencies and omissions in the existing frameworks and guidelines. Moreover, the substantive reforms to individual codes are likely to involve a significant reorientation of State aid control. More specifically, the SAAP aims to address four sets of issues in current policy practice.[56]

The first of these concerns the so-called Lisbon agenda. The Commission has stressed that State aid policy can contribute to the Lisbon objectives,[57] but there has been criticism that the existing rules do not facilitate the design of aid schemes that contribute to enterprise

[55] State Aid action plan: Less and better targeted state aid: a roadmap for state aid reform 2005 – 2009, available at: <http://europa.eu.int/comm/competition/state_aid/others/action_plan/>
[56] Annex to the State Aid Action Plan – Less and better targeted state aid: a roadmap for state aid reform 2005-2009 (Impact Assessment) – Commission Staff Working Paper, SEC(205) 795, 7 June 2005, Brussels.
[57] European Commission, *A pro-active competition policy for a competitive Europe*, COM(293) final, 20 April 2004, Brussels.

and innovation; it is perceived to be difficult to devise and implement measures that contribute to the Lisbon objectives, even though the measures involved might have only a very limited impact on trade and competition. Related, the SAAP aims to respond to criticism that the current rules are out of touch with economic realities and are insufficiently based on economic analysis; at present, schemes with very limited effects on trade and competition are subject to the same constraints and administrative requirements as those which involve serious risks of distortion.

A second set of considerations relates to impact of the recent (and forthcoming) enlargement. This has implications both for the administration of policy and the need for 'better governance' to ensure effective control and for the tools of economic analysis used for assessing the effects of State aid.

A third series of issues concerns inefficiency within the Commission and the Member States in the administration and enforcement of policy: the Commission's decision-making procedures are often too lengthy; there is a perceived need to involve Member States more closely in the enforcement of State aid policy; and the record on recovering illegal State aid is viewed as unsatisfactory. In addition, the increasing number and complexity of State aid rules has created an imperative to streamline policy to make it more predictable, in order to minimise legal uncertainty and the administrative burden for the Commission and national authorities.

Last, the general understanding of State aid issues, as well as transparency and enforcement at national levels are viewed as inadequate. Notification of State aids is not systematic – Commission decisions on unnotified aid account for 10 percent of all its decisions. The national courts are viewed as having a vital role to play in ensuring (partly through actions brought by third parties) that aid which has not been notified is subject to a 'standstill' requirement.

Against this background, the SAAP identifies a number of substantive priorities to which the reform of State aid control can contribute:

- Targeting innovation and R&D
- Creating a better business climate and stimulating entrepreneurship
- Investing in human capital
- Providing high quality services of general economic interest (SGEI)
- Focusing regional aid policy
- Encouraging an environmentally sustainable future
- Establishing modern transport, energy, information and communication technology infrastructure.

The SAAP also identifies some procedural and administrative priorities. It proposes to address a number of 'governance' issues in State aid control, including a consideration of what role independent national authorities might play. The need for less bureaucracy but better targeted enforcement and monitoring, including through the national courts, is also highlighted. The SAAP outlines some options for adapting the procedural rules in response to enlargement and proposes a comprehensive review of the remaining documents (ie. those not covered by the substantive priorities listed above). Last, an evaluation exercise will be conducted to ensure that the new rules and practice function properly.

The SAAP sets out a broad timetable for the adoption of new guidelines, Regulations and other documents over the period 2005-9. As discussed below, it has already adopted three texts relating to services of general economic interest; among the other measures listed in the SAAP the Commission has consulted or is presently consulting on environmental aid, aid to innovation and State aid to risk capital. In most cases, the current frameworks either relax aid criteria or increase award values in the case of projects in the problem regions; one of the issues raised in the consultation is whether this approach continues to be justified.

5.2 State aid, infrastructure and public services

An important issue in the evolving relationship between competition policy and regional development concerns services of general interest.[58] This has come to the fore for a variety of reasons. Liberalisation and deregulation have altered the context for providing public services and raised new issues about universal service provision. At the same time, and in parallel with the decline in the use of financial incentives to support firms in problem regions, growing attention has been paid to the quality of the wider business environment.

Public services *per se* are not a central concern of the EU Treaties; however, their provision is affected by the complex interaction of a number of Treaty articles. The basic principles of the Treaty concerning the free movement of goods, the right of establishment and the freedom to provide services inevitably conflict with the special arrangements introduced by all countries to protect certain activities in the public interest. Moreover, the competition rules in relation to anti-trust, abuse of dominant position and the prohibition of State aids in principle apply to a significant proportion of services with a public interest component. However, there are important derogations from these market integration principles on the grounds of public health or security and to enable the transport sector to fulfil "obligations inherent in the concept of a public service".[59] More generally, and most importantly,

[58] "This covers market and non-market services which the public authorities class as being of general interest and subject to specific public service obligations"; "services of general economic interest… refers to market services which the Member States subject to specific public service obligations by virtue of a general interest criterion. This would tend to cover such things as transport networks, energy and communications" (European Commission, *Services of General Interest in Europe,* COM (2000) 580 final of 20 September 2000, Brussels).

[59] Article 73: Aids shall be compatible with this Treaty if they meet the needs of coordination of transport or if they represent reimbursement for the discharge of certain obligations inherent in the concept of a public service.

Article 86 allows for special treatment of undertakings providing "services of general economic interest."[60] The key provisions in this context are Article 86(1) and (2):

> 1. "In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in this Treaty, in particular to those rules provided for in Article 12 and Articles 81 to 89."
>
> 2. "Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, insofar as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community."

Services of general economic interest have a fundamental role in economic and social cohesion within countries, ensuring the universal provision of key services at costs and of a quality that could not be provided on a commercial basis. This role implicitly underpins that of more proactive regional policies (such as financial incentives to influence the location of businesses) since basic infrastructure, communications and energy supplies are a prerequisite for regional economic development.

Recent developments in policy and case law in relation to services of general interest have focused on two key issues of relevance to regional development and the funding of services of general interest. First, the consequences for public service obligations of liberalising previously State-controlled activities; and second, the question of whether the financial compensation to undertakings for providing such services constitutes State aid. Following a landmark ruling in the Altmark case[61] the Commission adopted a number of texts to clarify the requirements surrounding the notification and approval of compensation for the provision of SGEIs. In addition, it has adopted new rules on the financing of airports and of new routes from regional airports. Related, the Commission has, in several instances, approved aid for the financing of broadband access and other types of infrastructure support in the problem regions.[62]

5.2.1 Services of General Economic Interest

In July 2005 the Commission adopted three instruments concerning the financing of services of general economic interest:[63]

- A Decision specifying the conditions under which compensation to companies for the provision of public services is compatible with the Treaty and does not have to be notified in advance. The public service mandate must be clearly defined and

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[60] Article 86 does not apply to non-economic activities such as compulsory education or matters of vital national interest that are the prerogative of the State, such as security and justice.
[61] C 280/00 Altmark Trans GmbH Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH [2003] ECR-I 7747.
[62] For example, Rapid Press Release, Commission endorses public funding to bridge broadband communications gap in Wales, IP/05/646 of 1 June 2005.
[63] Available at: <http://europa.eu.int/comm/competition/state_aid/others/action_plan/>

the remuneration must not involve overcompensation. The Decision applies to compensation of less than € 30 million a year, provided that the beneficiaries have an annual turnover of less than € 100 million. Compensation to hospitals and social housing falls under the Decision, irrespective of the amounts involved, as does compensation for air and sea transport to islands and for airports and ports, subject to limits related to passenger volumes.

- A Framework setting out the conditions under which compensation *not* covered by the Decision is compatible with the State aid rules. Compensation that does not fulfil the conditions of the Decision has to be notified to the Commission owing to the greater risk to competition, but may still be judged compatible.

- An amendment to the Transparency Directive specifying that undertakings receiving compensation and operating on both public service and other markets must maintain separate accounts for their activities so that the absence of overcompensation can be verified.

These measures aim to increase the certainty surrounding the financing of public services and to address the question of whether and when compensation for the provision of such services constitutes State aid and if, when it does, whether it can be considered compatible with the Treaty.

5.2.2 State aid and the development of regional airports

Also as part of the wider objective of increasing legal certainty and clarity, in September 2005 the Commission adopted guidelines on the financing of airports and start-up aid to airlines departing from regional airports.[64] Earlier in 2005 the Commission had approved a German aid scheme for investment in airport infrastructure in the problem regions,[65] suggesting that it was positively disposed towards such aid in certain circumstances. Regarding start-up aid, the Guidelines follow on from the decision in the Ryanair Charleroi case where the Commission decided that the transactions involved State aid, part of which was incompatible with the Treaty and had to be repaid;[66] the Decision is being appealed by Ryanair, but in the meantime it has generated a degree of uncertainty about what measures require prior notification and in what circumstances the Commission will approve aid. The new Guidelines seek to address this.

Under the Guidelines, the Commission may approve start-up aid for new routes from regional airports meeting certain criteria. The airports concerned are so-called category C and D airports, these being regional airports with annual passenger volumes of less than 5 million. Exceptionally, aid to new routes from larger airports (category B – 5 to 10 million

[64] Note that these were developed by DG Energy and Transport, rather than by DG Competition. The guidelines will come into effect from the data of their publication in the Official Journal. They are available at: <http://europa.eu.int/comm/dgs/energy_transport/state_aid/transport_en.htm#air>
[65] Rapid Press Release, Commission authorises German aid for the development of regional airports, IP/05/58 of 19 January 2005.
[66] Commission Decision of 12 February 2004 concerning advantages granted by the Walloon Region and Brussels South Charleroi Airport to the airline Ryanair in connection with its establishment at Charleroi, OJEC No L 137 of 30 April 2004.

passengers annually) *may* be approved, notably if one of the airports is located in a disadvantaged region. Start-up aid must be limited and decline over time, reflecting the requirement that the route must ultimately be profitable. The amount of aid must be linked to the additional start-up costs incurred in launching a new route including marketing, advertising and installation costs at the regional airport. Standard operating costs such as hire or depreciation of aircraft, fuel, crew salaries, airport charges etc. are ineligible. The standard maximum rate of award is 30 percent of eligible costs over a maximum period of three years. In the disadvantaged regions, this is raised to 50 percent and five years; for these purposes disadvantaged regions are defined as Article 87(3)(a) areas, outermost regions and sparsely-populated areas.

As far as the financing of airports is concerned, these are generally expected to be borne by airport operators from their own resources. However, where State aid is involved, this must be notified to the Commission which may deem it compatible with the Treaty on the basis of Article 87(3)(a), (b) or (c) or Article 86(2) (in relation to the financing of services of general economic interest).

5.3 Regionally-differentiated taxation

Tax and social security exemptions granted on a regional basis have consistently been treated by the Commission as constituting State aid; an early example is the German coal closure areas case.[67] However, the finding that a regionally-differentiated tax or social security measure constitutes State aid is not always uncontentious. In the context of membership of the European Economic Area the Norwegian system of social security was challenged by the EFTA Surveillance Authority (ESA).[68] The system involved different rates of employers' social security contribution based on the zone in which the employee had his/her registered permanent residence. The Norwegian authorities argued that because the regional differentiation was neutral with regard to sector, occupation, size of undertaking, etc. and was linked to municipality of residence, not workplace, it was an integral part of the general tax and transfer system in Norway.

In line with earlier Commission decisions, however, this argument was not accepted by ESA which considered the system to constitute State operating aid.[69] The ESA decision was challenged by the Norwegian authorities, but the EFTA Court upheld ESA's decision.[70] This was not a surprising outcome given the precedents that had already been established, but given the nature of the measure, it does highlight the extent to which the *form* of a measure does, in reality, play a significant role in whether aid is judged to be present. For example, the Norwegian authorities could have opted to transfer significantly higher sums to municipalities in the north, thereby indirectly reducing rates of local taxation, or obviating the need for it altogether. The *effect* of this would have been the same on firms, but the form of the benefit would have placed it outside the scope of Article 87(1). Instead,

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[67] Case 70/72 *Commission v Germany* [1973] ECR 813.
[68] EFTA Surveillance Authority, State aid (95-010) Norway, OJEC No C 38 of 5 February 1998.
[69] EFTA Surveillance Authority Decision No 165/98/COL of 2 July 1998 with regard to State aid in the form of regionally differentiated social security taxation, OJEC No L 327 of 3 December 1998.
[70] Case E-6/98 Government of Norway v EFTA Surveillance Authority.

the assumption is that there is a national level of tax or social security contribution and that certain areas benefit from a departure from that 'benchmark'. In practice, this involves taking a formalistic view of definitional issues and raises some difficult issues where levels of tax autonomy vary within a country.

In Spain, for example, the Basque country has greater autonomy than most of the Spanish regions under a special regime dating back to the 19th century. As a result, the Basque government levies its own taxes in place of the national taxation system. In 1996, this resulted in different (lower) rates of corporation tax in the Basque country than elsewhere in Spain.[71] What then is the benchmark given that the Basque country has the autonomy to set the tax rate? This point does not appear to have been addressed, but the Commission has had occasion to consider tax concessions offered within the Basque country in a number of cases dating back to 1993. A constant theme in these disputes has been the historic tax agreement (*conciertos económicos*) and the issue of fiscal autonomy. In the first of these cases[72] proposals to offer tax concessions were condemned on the basis of Article 43 (then Article 52) since they were restricted to firms with all plants located in the region, a condition which was considered to restrict freedom of establishment. In consequence, the Commission did not need to become embroiled in questions of fiscal autonomy. This was perhaps fortuitous since it seems that the Commission was deeply divided on the issue.

The provisions which contravened Article 43 were, in principle, later addressed by legislation but the concessions became the subject of a preliminary reference to the European Court of Justice from the Basque courts in a case involving the Basque and the Spanish authorities.[73] The question of compatibility with Article 43 was still at issue in the preliminary reference; so too was their status as State aids. Advocate-General Saggio concluded that the concessions still constituted a discriminatory measure for the purposes of Article 43. Regarding Article 87, perhaps surprisingly, the Advocate General addressed the question of whether regional autonomy in taxation could amount to State aid. He observed that:

> "The fact that the measures at issue were adopted by regional authorities with exclusive competence under national law is… …purely a matter of form, which is not sufficient to justify the preferential treatment reserved to companies which fall within the scope of the provincial laws. If this were not the case, the State could easily avoid the application, in part of its own territory, of provisions of Community law on State aid by making internal changes to the allocation of competence on certain matters, thus raising the general nature, for that territory, of the measure in question."

It is not clear why it was necessary to address the issue of regional autonomy in taxation; the measures were arguably sufficiently selective in other respects to be deemed to be

[71] 'Basques' tax plan upsets Madrid', *Financial Times*, 4 February 1997.
[72] Commission Decision of 10 May 1993 concerning a scheme of tax concessions for investment in the Basque country, OJEC No L 134 of 3 June 1993.
[73] Joined cases C-400/97, C-401/97 and C-402/97 *Administración General del Estado v Juntas Generales de Guipúzcoa and Diputación Foral de Guipúzcoa*, Opinion of AG Saggio delivered on 1 July 1999. (Case removed from the register of the Court of Justice on 16 February 2000 following discontinuance of the applicant in the cases in the main proceedings and a compromise over the so-called *Concierto económico*).

caught by Article 87(1). In any event, the reference was withdrawn before the Court reached its conclusion on the matter. However, in subsequent affairs involving tax concessions in the Basque country the matter seems to have been treated more cautiously. For example, the European Commission addressed decisions to Spain concerning *inter alia* tax aid to Ramondín and Daewoo in the Basque country.[74] These were challenged before the Court of First Instance.[75] The CFI confirmed that tax measures operated by an autonomous entity within a Member States can constitute State aid; however, the judgements are careful to stress that fiscal autonomy *per se* is not threatened by the application of the State aid rules, rather it has been the selective nature of the measures (requiring, for example, minimum levels of investment such that the scheme could not be viewed as generally available) which condemned them rather than their regional scope.

More recent developments suggest a more robust approach on the part of the Commission to the exercise of fiscal autonomy. Building on the Opinion of AG Saggio, the Commission rejected part of a tax regime for the Azores[76] and refused the implementation of proposed tax reforms for Gibraltar[77] (the latter partly based on its decision in the Azores case); both of these decisions are being appealed before the European courts.[78] The importance of these cases lies in the fact that the measures proposed were only selective to the extent that they applied in the territories concerned – there was no sectoral or other targeting of the type that had confused matters in the Basque country case. In the Azores case, the Commission noted that "the national legislator began by authorising the regional legislator to grant the tax reductions concerned; on the basis of this authorisation, the regional legislator then actually introduced the reductions." Moreover, the Commission clearly considered that, in spite of the autonomy of the region in tax matters under national legislation, the measures adopted by the regional authorities constituted a derogation from the national tax system, but did not view its decision as calling into question the tax autonomy of the regions.

These cases raise important issues of principle about the precise form of regional autonomy that can be exercised without contravening the State aid rules. In particular, to what extent does devolution require to 'reversible' in order for the State aid rules to apply? Should there be an explicit link between tax autonomy and revenues available to the

[74] Commission Decision of 22 December 1999 on the State aid implemented by Spain for Ramondín SA and Ramondín Cápsulas SA, OJEC No L 318 of 16 December 2000; and Commission Decision of 24 February 1999 concerning State aid granted by Spain to Daewoo electronics Manufacturing España (Demesa), OJEC No L 292 of 13 November 1999.

[75] Joined cases T-127/99, T-129/99 and T-148/88 Territorio Histórico de Álava - Diputación Foral de Álava, Comunidad Autónoma del País Vasco, Gasteizko Industria Lurra SA and Daewoo Electronics Manufacturing España SA v European Commission, not yet reported but provisional texts available on the European Court of Justice WebSite at: <www.curia.eu.int>.

[76] Commission Decision of 11 December 2002 on the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax, OJEC No L 150 of 18 June 2003.

[77] Commission Decision of 30 March 2004 on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform, OJEC No L 85 of 2 April 2005

[78] Action brought on 27 February 2003 by Portuguese Republic against the Commission of the European Communities (Case C-88/03), OJEC No C 112 of 10 May 2003; Action brought on 9 June 2004 by the Government of Gibraltar against the Commission of the European Communities (Case T-211/04), OJEC No C 217 of 28 August 2004.

authority offering the concession? Is uniform institutional geometry a requirement? It remains to be seen how far the European courts will clarify these and other issues in considering the appeals against these decisions.

6. DISCUSSION ISSUES

The principal focus of this paper has been on the reform of the Regional Aid Guidelines for the post 2006 period. Overall, the July 2005 Draft Guidelines can be seen as a carefully crafted document that responds to a wide range of often conflicting pressures and demands (albeit without necessarily satisfying those demands). It sidesteps the Advocate General's criticism of the 1998 methodology, succeeds in reducing award values across the board and limits coverage in the more prosperous Member States, but allows aid to continue in all countries.

The next steps are for the Member States to submit any remaining observations by end September 2005 and for DG Competition services to report to the Commissioner in October. The European Parliament Regional Development Committee is expected to adopt its final report later in the autumn and there will be a plenary debate on the Guidelines early in November. It is expected that the Commission will adopt finalised Guidelines towards the end of 2005.

The keys principles for the reform of the Guidelines are now settled, but some issues of detail remain to be resolved. This section concludes by highlighting some of those issues and considering whether, in fact, the Commission had intended the present outcome all along.

(i) The Draft Guidelines may only be palatable because they are 'less bad' than feared

The 2005 Draft Regional Aid Guidelines represent a significant retreat from the initial tough stance that the Commission had proposed to take. In particular, as discussed earlier, its early proposals had excluded the possibility of any assisted areas being selected by the Member States, with Article 87(3)(c) being limited to certain 'earmarked' regions. Coupled with the statistical effect of enlargement, and the proposal both to reduce absolute award values and express them in gross terms, this dramatically reduced assisted area coverage in the EU15 and cut aid values in all eligible areas; its second proposal in 2004 proposed to reduce aid values even further.

Although the 2005 draft involves a softening of this hard line, it is important to note that, for the EU15 in particular, the operation of regional aid will still be considerably more constrained by the rules in future. The tortuous evolution of the 2005 Draft Guidelines may divert attention from their stringency compared the 1998 rules, leading to the overriding conclusion that the new Guidelines are less tough than they might have been.

It seems plausible to conclude that this has been a deliberate strategy on the part of the Commission. In June 2003 Philip Lowe, Director General of DG Competition, had outlined two provisional scenarios for the future of regional aid.[79] In the first, Article 87(3)(a)

[79] Philip Lowe (2003) "State aids and Cohesion Policy" paper to Sub Rosa strategic discussion *Regional Policy after 2006: co-operation, co-existence or conflict*, University Club, Brussels, 13 June 2003; available at: <http://europa.eu.int/comm/competition/speeches/text/sp2003_061_en.pdf>

coverage would be based on EU25 GDP averages and Article 87(3)(c) essentially limited to former Article 87(3)(a) regions, OMRs and sparsely-populated areas, yielding coverage of around 34 percent of the EU population. The second scenario would build on a simplification of the current approach. In addition to Article 87(3)(a) and earmarked Article 87(3)(c) areas, further Article 87(3)(c) areas could be designated, subject to an overall ceiling of 50 percent of the EU population. These would be designated on the basis of a simplified version of the 1998 Guidelines, the only restriction being that a minimum size of geographical unit be used in drawing up the maps.

Philip Lowe argued that the first scenario would be simpler and best satisfy the considerations and constraints on DG Competition's agenda, namely, the objective of less and better State aid, the need to reconcile the reduction of State aid volumes with the aim of economic and social cohesion, the modernisation and simplification of the rules and the experience with the 1998 Regional Aid Guidelines. The past two years has seen many Member States in effect arguing for a shift from the first to the second scenario; it remains to be seen whether the overall population coverage is still to play for.

(ii) The use of revised GDP data will have important consequences for some Member States

The Draft Guidelines note that the same data set will be used for national regional aid as for the purposes of Structural Funds. Current calculations for both policy areas are based on GDP per head data for 2000-2; confirmed data for 2003 is not likely to be available before April 2006. The decision about which data set to use lies largely in the hands of the Council in the context of its negotiations of the new Structural Funds Regulation.

Figure 15: Forecast coverage 20006-2013 using estimated 2003 data (% of population)

	Article 87(3)(a) / Convergence %		Statistical effect (Article 87(3)(a)) / Phase-out		Economic development (Article 87(3)(c)) / Phase-in	
	2000-2	2001-3	2000-2	2001-3	2000-2	2001-3
EU25	27.7	26.2	3.6	4.6	3.6	4.2
EU15	15.0	13.6	4.3	4.9	3.5	4.2
NMS10	92.9	90.2	0.0	2.7	3.8	3.8
Belgium			12.4	12.4		
Czech Rep	88.6	88.6				
Denmark						
Germany	12.5	13.5	6.1	5.1		
Estonia	100.0	100.0	0.0	0.0		
Greece	36.6	23.9	55.5	32.7	7.9	43.4
Spain	36.2	25.1	5.8	16.6	16.3	16.5
France	2.9	2.9				
Ireland	0.0	0.0			26.5	26.5
Italy	29.2	29.0	1.0	3.9	2.9	
Cyprus						
Latvia	100.0	100.0				
Lithuania	100.0	100.0				
Luxembourg						
Hungary	72.2	72.2			27.8	27.8
Malta	100.0	100.0				
Netherlands						
Austria			3.4			3.4
Poland	100.0	100.0				
Portugal	70.1	70.1	3.8	3.8		
Slovenia	100.0			100.0		
Slovakia	88.9	88.9				
Finland					13.0	13.0
Sweden					0.0	0.0
UK	4.0	4.0	0.6	0.6	4.4	4.4

Note: These estimates are based on national GDP data for 2003 and assume that all regions within a country grow at the national rate. The same methodology is then applied to this estimated data.
Source: Own calculations from Eurostat data.

As Figure 15 suggests, Slovenia, Greece and Spain might see a significant (negative) impact on coverage if the estimates used are accurate. In the case of Slovenia, full Article 87(3)(a) status would be lost and the country would be classed as a statistical effect region.[80] Greece and Spain would see large parts of their territories 'downgraded'. The impact of Austria would also be negative with Burgenland potentially losing statistical effect status, which it had only gained on the basis of 2002 data. In Germany and Italy, by contrast, small areas would be 'upgraded'.

It is not clear which data set will ultimately be used for national regional policy and the Structural Funds. On the one hand, some matters of principle have largely been agreed, but

[80] Discussions between the Slovenian authorities and Eurostat are underway concerning the definition of NUTS II areas so that it seems probable that part of the territory would retain Article 87(3)(a) status.

the implications of those principles are closely bound up with choice of statistical data; on the other hand, can it be acceptable explicitly to reject the use of the most recent data available?

(iii) Area designation criteria have been relaxed, but lower coverage and tight timescales may make designation politically difficult and administratively costly

Many of the constraints on Article 87(3)(c) area designation methods under the 1998 Regional Aid Guidelines have been dropped in the new draft. This is doubtless partly because of Member State resentment at the way in which the previous rules impinged on regional policy designs, but was certainly also necessitated by the much lower coverage applying to most EU15 countries. This, together with the three-month deadline within which maps must be submitted seems likely to present a challenge for some Member States. This is especially so in countries with a tradition of wide of consultation on area designation matters.

The reduction in assisted area coverage alone is likely to make area designation a politically-charged affair in some countries. Moreover, the classification of some former Article 87(3)(a) areas as economic development regions may exacerbate difficult choices. There is a certain asymmetry in the treatment of these areas: on the one hand, they are automatically count towards the Article 87(3)(c) coverage of a Member State; on the other hand, whilst their designation will be accepted without question by the Commission, Member States appear to have the flexibility to use the population quota generated by the economic development regions elsewhere. It seems certain that such a decision would be opposed by the regions concerned, which would view assisted area status as an entitlement. However, in Italy and Spain the 'non earmarked' Article 87(3)(c) regions account for around 1 percent of the national population on the basis of current data. Producing a map with this coverage is likely to prove politically difficult, administratively costly and lacking in policy credibility.

(iv) The Commission has placed considerable emphasis on the coincidence of national and Structural Funds maps but this may not be adhered to in practice

The Draft Regional Aid Guidelines increase policy coherence with the Structural Funds to the extent that the statistical effect regions are, in the first instance, included in Article 87(3)(a), echoing the inclusion of the Phase-out regions in the Convergence region strand of the Structural Funds. However, in practice, coincidence may be eroded by Member State decisions not to designate economic development regions in their entirety. Moreover, Council negotiations may undermine coincidence – discussions under the Luxembourg presidency culminated in a proposal to treat Cyprus as a Phase-in region, but under the Draft Regional Aid Guidelines only 50 percent of the territory would be designated. Conversely, although Northern Ireland is to be treated as an economic development region

under the Regional Aid Guidelines, the province has no specific status for Cohesion policy purposes.[81]

(v) The future of special treatment for problem regions under horizontal aid rules remains unclear

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 than generally apply. The loss of assisted area status under Article 87(3)(a) or (c) therefore involves the loss of these benefits under the existing horizontal frameworks. The State Aid Action Plan confirms that many of these horizontal frameworks will be revised in the run-up to 2007; current proposals are short on detail, but consultations raise the issue of whether special treatment of disadvantaged areas under horizontal frameworks is justified. Moreover, it is interesting to note that, even where more generous terms are available in the problem regions, the scope of this may be limited: in the new Guidelines on aid to regional airports,[82] disadvantaged areas are defined as Article 87(3)(a) areas, OMRs and sparsely-populated regions. In other words, the definition is restricted to areas that are clearly defined at EU level and / or are specifically recognised in the Treaty.

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 assisted area status under Article 87(3). On the one hand, the competitiveness agenda promotes horizontal policies 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; on the other hand, the future of EU Cohesion policy, and with it regional aid control, targets assistance at the least-prosperous regions. The net effect of this pincer movement 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 yet sufficiently disadvantaged to qualify for regional aid *per se*, either at the national or Community levels.

[81] Although a specific allocation under the PEACE programme was proposed.
[82] See Section 5.2.2.