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review of Community guidelines for national regional aid

final report to DG COMP
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Contents

1. Management summary

This study was commissioned by DG Competition, as part of an exercise to prepare for a review of Community guidelines for national regional aid.

The objective of the study is to consider if the aid instruments available in regions classified under Article 87(3)c should change after 2006, and if so, how.

The study looks at the development needs of regions in this category, with a view to establishing the best options from the regional development perspective. It looks at the evolution of policy in development and in competition in order to assess the responses to development needs. We consider specific instruments which could be introduced under state aid, and evaluate how these perform now. The study concludes by identifying issues and implications of changing aid instruments.

The key conclusions of the study are :

- member states will continue to need state aid to address regional disadvantage. Our underlying principle therefore is that there will be an on-going need for assistance for areas which are characterised as disadvantaged

- the key question then is to consider how this may be done effectively and efficiently. Our analysis suggests that regional requirements and current state aid solutions do not match up. This is highlighted when we look at how regional policy is changing within the Community, where there is a clear trend away from large infrastructural programmes towards softer initiatives. This is supported by a much more strategic approach to development.

- it would seem logical that the rationale for regional state aid would respond to the same line of analysis of change in regional requirements. In this case, aid for initial investment would not be enough in itself, and would probably not be the first choice of instrument. The economic development benefits of initial investment are not persuasive, and companies which are most likely to benefit from such investment are larger companies. This increases the possibility of market distortion

- for state aid to be tied in more closely with regional requirements, aid rules would facilitate a range of instruments which could be used by member states according to particular development needs

- there would be obvious benefits in introducing more consistency between regional state aid and regional development, and member states could link state aid with their regional development strategies.

When we look at the needs of member states, state aid would be most effective economically if designed to more closely meet regional requirements. In practice, this means that aid instruments would be more flexible, and would include a range of softer instruments.

2. Introduction

Background

This study was commissioned by DG Competition, as part of an exercise to prepare for a review of Community guidelines for national regional aid. The current Guidelines cover the period 2000-2006, and DG Competition wishes to review these guidelines before the start of a new aid period. The review needs to take into account the operation of the current guidelines, and to assess the implications of change in the post-2006 period, notably following the accession of new member states.

DG Comp has commissioned three linked but separate studies. All three studies focus on the derogation in Article 87(3)c of the EC Treaty, which allows aid:

"... to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest"

that is compatible with the common market. This allows member states to grant aid in specified areas under specified conditions, without contravening rules on competition.

The purpose of the three studies is to examine the ways in which areas and conditions are specified, with a view to analysing the implications post-2006. Two of the studies are to do with different aspects of the ways in which member states select and define assisted areas. The third study, and the subject of this report, is to examine the aid instruments which are used in regions eligible to the derogation in Article 87(3)c.

Study Objectives

This study focuses on aid instruments used in regions eligible for a derogation under 87(c).

The key questions to be addressed are :

- Do the current instruments meet the needs of assisted areas?
- What can other types of instrument offer?
- What are the implications of change post-2006?

Approach

Our approach to the study has endeavoured to undertake a broad analysis within a short timescale and a tight budget. We have carried out desk research, and backed this up with discussions in several member states with people responsible for implementing state aid, and with people responsible for regional development. Given the size of this study, these discussions do not constitute a representative interview programme. Rather, they are a set of informal discussions which sought to clarify and extend some of the points presented in our research.

Our central concern is to emphasise the purpose of state aid, and in the areas eligible under Article 87(3)c, that purpose is to allow interventions which will support economic development. While this may seem very obvious, it is not always explicit, and the recognition of the primacy of economic development aims provides a useful benchmark against which to test a discussion of aid instruments.

When the aim of state aid is established, we must consider the conditions under which it can be granted. It is essential that the analysis is located within the broad trend of EU policy, which seeks to minimise the potential distortion to the market which can be caused by state aid. This means that we must take into account the relationship between different types of aid instrument and competition.

Our starting point, then, is to consider the impact which different types of aid instrument have, and the potential they can offer. In order to build our analysis, we have looked at approaches to economic development, and in Chapter 3 we examine how and why approaches to regional aid are changing. This provides a context for the discussion in Chapter 4 of specific types of aid instrument. Our main concern is to ask what lessons have been learned on what instruments work – and what don't.

The final chapter of the report assesses the implications of change in the types of aid instruments available to Article 87(3)c areas. The assessment takes into account the economic development impact, and the impact on competition.

3. Current situation

Policy goals

The overall policy aim on state aid was clearly stated by the European Council in March 2002, as a "*call to Member States to reduce the overall level of State aid as a percentage of GDP by 2003 and onwards, taking into account the need to redirect aid towards horizontal objectives of common interest, including economic and social cohesion, and target it to identified market failures*[1]*. Less and better targeted State aid is a key part of effective competition."*

As an indication of progress towards these goals, the latest figures to which we have access are for 2000[2]. Data shows that 11 out of 15 Member states have reduced their overall level of state aid as a percentage of GDP. The composition of aid has also begun to change, with a clear increase of 13% in aid for horizontal objectives such as R&D, environment, training, and SMEs between the periods 1996-8 and 1998-00. The focus on horizontal objectives is seen as targeting areas of greatest market failure with the least possible distortion of the market.

The biggest reduction within the overall downwards trend in state aid has been in the level of aid allocated to regional objectives (Article 87(3)a and Article (87)3)c). As a percentage of total aid allocated, this fell from 19% in 1996 to 14% in 2000.

Care must be taken in interpreting these figures, as to some extent the data masks differences in how aid schemes are actually defined and classified. For example, a scheme may be classified as regional aid, and have regional aid as its primary objective, but may consist of a series of measures supporting R&D in small companies. In this case, the scheme is targeted towards horizontal objectives, but may be classified under regional aid. Of course, this can work the other way, where an intervention designed to address a horizontal objective may have a significant regional development impact.

The conclusion we would come to is that we should not rely too much on an interpretation of statistics, as the classification of aid as regional or horizontal is not black and white.

Aid under Article 87(3)c

The Community Guidelines on national regional aid outline the method to be used by Member States to select areas where aid can be allowed under

[1] In this report, we are using the concept of market failure in an economic context to identify areas where the competitive market fails, whether due to uncorrected externalities, or to imperfect knowledge.

[2] *State aid scorecard*, Spring 2002 Update, Brussels

the derogation in Article 87(3)c. Aid maps for all member states have been agreed, mostly for the period 2000-06. The EU average level of aid classified under Article 87(3)c has increased slightly, from 8% of all state aid in 1996-98, to 10% in 1998-00.

There is a large disparity amongst member states in the proportion of aid allocated under Article 87(3)c. Those countries which have a higher than average proportion of aid directed at areas assisted under 87(3)c tend to be the more prosperous member states. For example, Luxembourg has 50% of its total state aid directed under 87(3)c; Sweden has 26%; Belgium has 26%; UK has 18% and France has 17%.

It can of course be argued that the member states listed above do not have a high a proportion of aid targeted at areas classified as 87(3)a, and therefore that the focus of their development aims will be closer to the definitions of 87(3)c. In the cases of Luxembourg, Sweden and Belgium, no areas are eligible for aid under Article 87(3)a. In other words, any aid with a regional aim which is extended in the more prosperous member states is more likely to be within the 87(3)c assisted areas.

We can note also that around half of the member states which have a higher than EU average aid allocation to 87(3)c have reduced this allocation between 1996-98 and 1998-00, while increasing the aid directed to horizontal objectives. However, the other half have recorded an increase in aid to 87(3)c areas, most notably in France (12% increased to 17%) and Austria (23% increased to 29%).

Given our concerns discussed above about the way in which aid is classified and the effect on data, we suggest that the only strong conclusion which can be drawn from an analysis of the data is that the more prosperous member states are continuing to use Article 87(3)c as a mechanism for state aid, and that the regional dimension remains important.

Aid instruments used in Article 87(3)c

Under the current guidelines, member states may only assist in initial investment, and to job creation linked to initial investment, in regions eligible under Article 87(3)c.

The designation of a region as an area which can be assisted under 87(3)c often allows a higher intensity of state aid funded under one of the horizontal actions, so that, for example, an SME in an assisted area may receive a higher percentage of funding than an SME which is not in an assisted area. Horizontal actions do not have geographical limitations, except in the level of aid which can be applied.

The current situation is therefore that a member state can choose to offer state aid for initial investment in an assisted area, and can choose to increase the level of horizontal aid to undertakings in an assisted area.

We have reviewed the actual funding practices of several member states, but note that the restriction on the size of this study means that our review is not comprehensive. For the member states we have studied, the main use of this article is to fund large companies in assisted areas. This is a consequence firstly of restricting aid to initial investment, as the companies which are most likely to benefit from such investment are larger companies. It is a consequence secondly of member states seeing this article as their only means of funding large companies.

This raises some interesting questions for our study. If we are correct in seeing that most aid classified as "regional" is used to assist large companies, then this is aid where there is a high possibility of market distortion. As such, it is an area which the EU would seek to discourage. However, should the response to this be to stop regional aid altogether, or should the response be to redefine it, perhaps to link it more closely with regional economic goals?

For the largest investment projects, regional aid is subject to the Multisectoral Framework. The Framework recognises that large-scale investments have the highest potential to distort competition, as well as to widen the gap between the richer and poorer member states. Under the Framework, the Commission can determine the maximum aid intensity by adjusting the regional aid ceiling in the aid map.

A study carried out for DG Enterprise[3] looks at the competition criterion for assessing large projects under the Multi-sectoral Framework. Its overall conclusion is that the aid intensities should be reduced, as subsidies to companies where there is serious structural overcapacity and/or a decline in demand are especially harmful to competition. The study notes that some elements of regional aid should be accepted even if this does distort competition, but only where there are clear benefits which can be set against the disadvantages.

Work carried out in the Walloon region of Belgium[4] is critical about the value of investment aid. The study notes that investment aid has not been capable of stopping the economic decline of the region, and that economic performance has stayed below the average Belgian and EU levels. The conclusion is that investment aid alone cannot address the deficiencies in economic development and investment in the region.

Drawing together some of the elements of these studies, there is an interesting consensus from an economic development viewpoint and from a competition viewpoint that aid funding for large companies is not constructive. From the development perspective, support for large

[3] *Avoiding distortion of competition from regional aid for large investment projects – theory and application in the Multi-sectoral Framework*, L Sleuwaegen and E Pennings for DG Enterprise, August 2001

[4] Capron, H. (ULB) "*Evaluation de l'impact des aides à l'investissement en Région wallonne au cours de la période 1986-1999*, Rapport auprès de la Région wallonne, Octobre 2000

companies tends to be an attempt to use aid to cover major structural problems, and the regional benefits of this approach are not convincing. From the competition perspective, aid for larger companies increases the possibility of distorting competition.

This would suggest that aid for initial investment, which tends to be most used by larger companies, is problematic both in its regional economic impact and in its impact on competition.

Aid in the candidate countries

Up until 2006, the Candidate countries are to be regarded as Article 87(3)a, in terms of their relationship between GDP and the EU average. This situation will not necessarily continue after 2006, and it is worth outlining the key points in their current aid regimes which may be relevant.

The first point to make is that there is not much homogeneity amongst the candidate countries in terms of their levels of aid, or in terms of the composition and direction of aid. Generally, the candidate countries are spending less per capita on aid than the EU member states. This may reflect the good practice introduced through the preparation for accession, or may simply be a consequence of lack of public finance. There is a wide variation in the sectoral distribution of aid. For example, overall, manufacturing accounts for 46% of all aid in the candidate countries, compared with an EU average of 35%. However, within this, 10% or less of aid goes to manufacturing in Estonia and Lithuania, while the proportion is over 50% in Cyprus, Hungary and Romania.[5]

The proportion of aid classified as aid for horizontal measures also varies widely, but in general is clustered around EU average, with extremes such as Hungary where over 50% of aid is for horizontal measures, and Bulgaria, which has 1% in this category. The level of aid allocated to regional measures is generally below the EU average.

Bearing in mind our reservations about how aid is classified, we can draw out some points from this which are important for our analysis.

First of all, the experience in the candidate countries tends to be in directing aid to specific sectoral objectives, and for rescue and restructuring. This does not apply to all candidate countries, but is a general point. Secondly, where aid is directed towards horizontal objectives, the emphasis is on SMEs rather than R&D or training or environment, and instruments are generally to do with tax exemptions rather than grants or other schemes.

This overall pattern of aid becomes important when we consider what sort of instruments may be most useful after 2006, and we will return to this in Chapter 5.

[5] *State aid scoreboard*, Autumn 2002 update, Brussels 27.11.2002 COM(2002) 638 final

Summary

This chapter has summarised the current situation in terms of:

- Policy goals
- Issues in extending aid under Article 87(3)c
- Instruments currently used
- Issues in the candidate countries.

Our overall conclusion is that there are drawbacks to the current situation, and that these include the type of instrument which is available, and the way in which the instruments are being used.

The orientation towards horizontal goals is readily understood from a competition perspective. However, we must ask if the same reasoning holds for regional development. That is, do horizontal objectives best meet the economic needs of European regions?

4. Approaches to aid

Background

The objective of this chapter is to assess in general terms the impact of different types of aid. This chapter forms a basis for the discussion in the next chapter of the impact of specific types of instrument.

There is a wealth of experience at regional, member state and Community levels of intervention designed to target economic and social goals. Particularly over the last ten years, we have seen an increasing concern to ensure that intervention is effective and efficient. For example, in regional policy, there has been an emphasis on a much more strategic approach to development.

Taking Information Society as an example we have observed two interesting changes in the way that national governments view regional economic policy. First, there is a commitment to involve the regional government in the planning of regional economic policy. Second, there is a strategic decision to treat Information Society as a horizontal activity that has an impact on many, if not all, economic sectors. One explanation for this change is the nature of Information Society actions which affect all types of economic activity. However, there is also the recognition that an adaptation to the planning approach will improve the efficiency and effectiveness of policy intervention.

The nature of development needs continues to change in response to the wider environment. We looked at some useful modelling work on drivers of prosperity in regional economic growth[6]. In every Member State, national indicators obscure variations in regional prosperity. Prosperity is generally a function of two constituent parts, employment rates and productivity. It has been argued that high employment generally cannot co-exist with high productivity – there is an economic trade-off between the two. However, this modelling work found no evidence to support this theory, and provides data which shows that many of the least prosperous regions have low employment rates and low productivity, while regions which are above the EU average in prosperity tend to have high levels of both employment and productivity.

When trends are modelled in more detail at a regional level, in regions where prosperity has improved, it is usually down to raising employment rates. There is far less correlation between improving prosperity and productivity.

This has an interesting implication for the types of instrument which may be used, and for the target of regional development policies. It would suggest that the emphasis should be much more on job creation and maintenance, and less on improving productivity. Obviously, it does not

[6] *What makes European regions prosper*? Business Strategies, November 2001

come down to a choice between one and the other, and indeed it would be a mistake to neglect productivity, as there is a clear relation between productivity and competitiveness. However, as a question of emphasis, the modelling does indicate that the balance should tip towards employment generation.

When we look at regional differentials in employment rates, the most significant determinants of employment rates are past rates and industrial structure. We would expect that those regions with a history of high levels of employment would be in a better position to maintain this, and this is not only due to their current economic position, but also to softer externalities such as business and investment confidence. The significance of past rates as a determinant of employment rates is that tracking the growth of employment rates, we can see that high growth regions are in a position to generate more income for their workforce, and to attract migrant and/or commuting labour. The modelling work shows a closer correlation between employment rates and prosperity when the rates are analysed over time rather than when only current levels are compared.

The second significant characteristic of industrial structure is characterised as high levels of employment in business services, and high levels of employment in public services. Both these sectors have been recent growth areas, and strength in both also indicates a lower level of dependence on traditional and declining industries. Generally, the modelling work indicates that regions which have an industrial mix which includes high growth areas within a range of industries and services will have higher levels of demand for products and services, which will consequently help to raise the employment rates.

Significant factors which follow behind past performance and industrial structure in determining a region's employment rates are availability and quality of infrastructure, access to state funds (especially structural) and education.

The usefulness of this model is not really in its predictive ability. Having modelled drivers of economic prosperity, this is then used to forecast up to 2006. The conclusion is that we cannot expect to see significant change. There is a belt of prosperity running down the middle of the EU, from Ireland through northern France and northern Italy, and regions above it are generally above EU average, while SW and southern Europe are below.

This is pretty much stating the obvious, and does not offer real insight. If we leave out the predictive ability, the model is useful in providing shades of meaning to regional differentials. It can provide some interesting insights into why and how some regions become more prosperous, and can help to disentangle the contributing factors.

Work carried out last year by DG REGIO addresses this theme of the changing nature of regional development, and suggests some of the

corresponding changes which are necessary at the levels of policy and intervention.

Changing approaches to regional development

In a recent evaluation of structural fund innovative actions[7], the need for a shift in regional development approaches is clearly stated. A strong case is made for change brought about by increasing globalisation, technological change and enlargement meaning that the traditional regional policy objectives no longer apply.

In the old economy, the key factors were costs and scale. In the new economy, the organisation of production is more flexible, speed of response to the market is important, and non-cost factors are essential to maintain a competitive position. The intangible factors then become a priority. This poses a challenge to regional policy, which has previously been concerned primarily with providing the infrastructure which is a necessary prerequisite to regional development.

The evaluation of structural funds actions asks what conditions will most directly and immediately affect the ability of companies to create jobs? The conclusion is that policies should go well beyond tax incentives, R&D infrastructure, and training programmes. They require new policy delivery systems, including financial engineering, and should be based on co-operation and partnership between the public and private sectors. They are aimed at building the capacity of companies to innovate. The contrast is highlighted between this new approach and the old approach of public subsidies to business through horizontal (and often automatic) programmes of public aid.

This is a radical rethink of approaches to regional development. The analysis begins by looking at broad economic change, and then at more specific factors which affect how regions may develop. The focus on job creation is in line with the results of the modelling exercise discussed above, and this focus shapes the policy recommendations. The definition of a new approach to regional development has as its core objective the need to remove barriers to market entry, and to support entrepreneurs at all stages of the business creation process.

The overall argument put forward by DG REGIO is supported by a report looking at the experiences of Objective 2 regions. An analysis of Objective 2 regions[8] suggests that, over the last decade, almost all Objective 2 regions have shifted away from promoting "traditional" economic development measures towards softer and more innovative measures. This includes, for example, advice and support; training and

[7] *Regional innovation strategies under the ERDF Innovative Actions 2000-2002*, DG REGIO, Brussels 2002

[8] *Objective 2 : experiences, lessons & policy implications*, European Policies Research Centre, University of Strathclyde, Glasgow, July 1999

network building. The study notes the realisation that investment in basic infrastructure offers relatively poor value for money either in terms of employment created or the impact on competitiveness. Generally, investment in infrastructure has reduced in favour of measures to release the potential of indigenous businesses by intervening directly in firms (especially SMEs) and/or improving the collective business environment. These measures include the establishment of incubators, technology brokers and so on.

The importance of this analysis for our study is that it provides a clear indication of a shift in thinking about how best to support regional development. Building on an assessment of how economies and markets are changing, it signals an accompanying change in the types of measure which can best support development, and we would extend this to note that it also identifies measures which may best deal with market failure. Explicit concern with innovation, financial engineering, and public-private partnerships are intended to address notable areas of market failure, particularly for SMEs.

Issues in assessing impact

While recognising the value of this broad analysis of change, it is important that our assessment of aid instruments is based on sound economic analysis, and this needs a rigorous examination of the impact of current initiatives.

We noted above that there is a lot of experience of implementing a range of types of initiative across the EU. However, good evaluation material is scarce. Indeed, DG COMP has recently highlighted the need to have evidence from previous interventions on which to base new proposals.[9]

We are fully aware of the weaknesses in the material now available. Data is not always reliable, and is not always collected in a way which makes analysis meaningful. It is difficult to find evaluation material which allows comparison or generalisation. Data is not always timely. Even when evaluations have been carried out following a standard format within an overall framework, these problems listed often conspire to make the eventual results less than useful.

[9] *Progress report concerning the reduction and reorientation of state aid*, Communication from the Commission to the Council COM(2002)555 Brussels 16.10.02

However, there are some areas where we can find useful material. The most obvious is the evaluation of structural fund interventions. The advantages of these evaluations are :

- Scale :generally the evaluation is at regional level, aggregated up to national and then community levels. This means that the sheer volume of material allows a more generally applicable analysis

- Focus : because the structural funds are concerned with regional development, the evaluation looks always at how regional development aims are addressed. This is directly relevant for considering Article 87(3)c actions

- Comparability : for the most part, evaluations are carried out following a common methodology, and this makes it easier to draw broad conclusions from the work.

If we look, for example, at the evaluation of structural funds impact on SMEs[10], the scale of the analysis covers over 1.5 million SMEs in the period 1994-99, which is around 8% of all SMEs in the EU. Estimates of investment are that 21.3 billion EURO was directly invested in SME measures in the period 1994-99, with a further 16.3 billion EURO indirectly benefiting SMEs through improving the overall business environment.

The impact of this level and scale of investment is clearly significant. The key findings which are of most relevance to this study are :

- Quantitative impact is creation of around 2 million created or saved jobs

- Qualitative impact includes absorption of new technologies; networking with other SMEs to share knowledge; improving supply chain links with larger firms; and improving skills

- Significant contribution to addressing market failures, particularly in the provision of support services to SMEs.

The conclusions and recommendations of the evaluation suggest that intervention could be more effective if it were better targeted, and more focused. The proposal is that SME actions need to be more closely tied in with overall regional development strategies. So, for example, intervention should focus on SMEs in key clusters, where an improvement in competitiveness and growth may determine the outlook for the region as a whole.

Of particular relevance for this study is the conclusion that priority should be given to adjusting the balance between grant schemes and refundable finance such as loans and venture capital. This would improve the

[10] *Thematic evaluation of structural fund impacts on SMEs*, Ernst & Young, 1999

sustainability and cost-effectiveness of the intervention. We would add that a refundable element generally causes less distortion in the market.

An evaluation of research, technological development and innovation actions in Objective 2 regions[11] suggests that a balanced mix of capital and revenue measures offers the optimum means of supporting RTD&I. The actual mix would depend on particular regional needs, but could include, for example, direct business funding schemes, with an emphasis on smaller and more flexible schemes; mixed public and private loans or equity schemes; a "self-financing" target, where there is a cut-off date for public funding if the target is not met; and sectoral clustering initiatives to balance the intermediary-driven supply side projects.

Summary

The conclusions we can draw from examining evaluations of funding initiatives is that, in spite of the well-rehearsed problems with evaluation data, there is material which is a useful input to considering the impact of different kinds of funding instrument. However, the material does not directly address the impact on competition, nor can it highlight any distorting effects on the market. (To be fair, this is primarily because it was not intended to answer those questions.)

The lessons we can draw from existing evaluations are to do with the regional impact, in terms of creating and sustaining jobs, and we can see good examples of initiatives which have worked. We can also track the changing approach to funding, with many more examples of softer initiatives, and it is interesting to note that the conclusions and recommendations of the evaluations generally tend to favour an increase in this trend.

[11] *Evaluation of Research, Technological Development and Innovation related actions under Structural Funds (Objective 2)*, ADE, Enterprise plc, ZENIT for DG REGIO, Brussels, May 1999

5. Funding instruments

Introduction

The aim of this chapter is to assess specific funding instruments which are being used in the types of area classified as Article 87(3)c. This will give us a strong basis on which to analyse the implications of changing regional aid.

In the last chapter, we discussed macroeconomic approaches to development and drew out some of the main themes and trends. This chapter is taking a microeconomic approach by examining the impact of particular types of instrument.

Market failure for new companies

A study carried out by Scottish Enterprise[12] looked at different sources of financing for new companies. The work is very detailed, and begins by dividing SME development into 5 stages. These are :

- Stage 0 innovation
- Stage 1 proof of technology
- Stage 2 proof of market
- Stage 3 to breakeven
- Stage 4 exploitation

The study examines the costs associated with each stage of development, the types of innovation involved and the level and type of support required.

The focus of the study is on the creation of companies which will be high growth, will create and sustain jobs, and have the potential to become globally successful. This is a target area for Scottish Enterprise, which sees such companies as being key to its development strategy. We can note that it represents a significant shift away from the focus on inward investment which characterised the agency 10 years ago.

The SE study has tried to quantify the cost of creating a successful and innovative high growth company. Clearly, this can only be a very rough estimate, but it is interesting to see the levels of finance required. Typical set up costs are around £10m. However, real global success costs around a further £50-200m of capital and retained profits.

We can note that the kind of company on which the study focuses is capital-intensive, and that the aim is to think big. However, the level of

[12] *Business financing activity in Scotland*, Scottish Enterprise, Glasgow 2001

funding needed does provide an interesting context for considering the role of state aid.

The findings of this work are very useful when we come to consider the types of aid which may best be applied in article 87(3)c areas, because there is hard evidence of the implications of different sorts of funding. Also, by breaking down the development cycle of a company, the study allows us to see the effect of different types of support at different stages.

The Scottish Enterprise study identifies three main sources of finance. These are business angels, who are generally individuals who invest in new companies; venture capitalists; and banks.

Business Angels represent the fastest growing investment option in Scotland. The SE study notes that it is difficult to be precise about the level of funding from this source, as it is not always recorded through a listed company, may be in the form of equity or a loan, and is usually confidential. The estimate of the scale and growth of business angel funding is therefore likely to be conservative.

For illustration, SE estimates that the number of successful Business Angel deals in Scotland almost doubled between 1998 and 2000, and the actual funding rose from around £4m to over £35m.

A report by DG Enterprise[13] indicates that Business Angels can play a useful role in matching projects and investors. However, the evidence so far is that serious awareness raising is needed of the benefits of being an angel. DG Enterprise's assessment of the role of Business Angels concludes that it is advisable that Business Angels are located within a public-private partnership.

To date, only the UK has a mature market in Business Angels, and this may be strongly linked to the tax regime. However, we can note that several candidate countries have recently set up Business Angel networks, amongst them Cyprus, Czech Republic, Hungary and Slovenia.

Venture capitalists generally focus on financial engineering. That is, they use capital and debt to acquire and gear up underperforming businesses for 2-3 years, with a view to selling them on, or to floating them. In Scotland, the companies which have attracted VC funding have been technically innovative, and drawn from software, electronics, optoelectronics and life science sectors. There are no companies from the "old economy", and the only service companies represented are in e-commerce.

The Scottish experience suggests that around 80% of all VC investment is to do with financial engineering, and that the remainder is concentrated on exploitation, after the breakeven stage has passed. This clearly illustrates that VC investment has had little impact on the creation of successful

[13] *Highlights of the results of the Best Procedure projects 2001-2002*, Commission Staff Working Paper COM(2002)610 final, 7.11.2002

businesses, and that the investment is much further downstream, when some level of risk has been taken out.

Access to public capital markets is often cited as a barrier to young companies, and an even more forbidding barrier to companies located outside the main financial centres. Access to listed markets has a number of advantages for a young company. It can place a liquid value on the stock, so that IRR on investment can be more readily measured. The listing can be used to raise funds for the exploitation of the products or services, and the listing can help to enhance the company's status in the global market.

The SE work suggested significant barriers to entry for Scottish firms, such that of the 200+ AIM[14] listings of under £50m, no Scottish companies were involved. The main perceived barrier was identified as inability to access informal networks, which are seen as crucial in the lower end of the listings market.

The SE study provides some clear examples of market failure, and is useful for us in that it helps to associate different types of failure at different stages in the development of a company.

The main gap identified in the SE study is between stages 1 and 2, i.e. between the start of proof of technology and the middle to end of proof of market. External capital, from VC, bank or business angel, is unlikely to be interested until well into stage 3. The calculation is that, for the kind of company identified in the study, it costs around £750k on top of a basic stage investment of around £100k to get a company to the point where external funders are interested.

The conclusions we draw from this work is that first of all, there is a bottleneck in funding start-up and stage 1 work. That is, that there is little interest from the market in funding the early development stages of a new company. The first area of market failure is therefore at the beginning, where new companies struggle to find sources of finance.

If a company can get through this stage, the next area of market failure is access to public capital markets. This is a particular problem for companies outside the main financial centres, which would cover almost all companies located within areas classified under Article 87(3)c.

[14] AIM : Alternative Investment Market, UK stock market designed for smaller emerging companies

Addressing market failure

Regional measures

The study of finance for small companies provides us with some clear and quantified examples of market failure. It is worth extending this example to look at Scottish Enterprise's response.

Scottish Enterprise has had a programme running for several years designed to address systemic failure in the market. The key elements are:

- Network building. SE provides support for networks such as Business Forum and LINC, which exist to make connections between companies, and investors, and sponsor the development of Business Angel investment.

- Financial support. This includes tax breaks, Scottish Equity Partnership (stage 2 investment), Scottish Technology Fund, Business Growth Fund, all designed to improve the levels of funding available to companies at the bottom end of the development scale.

- Information. A contact and skills clearing house has been established, and an Information centre for young companies set up.

Specific attempts are also being made to address the market failures discussed above. These constitute a series of measures designed to target problems at each of the stages of development of a new company. Measures include :

- Reduce costs of stage 1 work by

    - Incubators – reduce costs of rent/accommodation. Public funding is used to develop buildings which can be rented out to new companies. Often, this is used to group companies in particular sectors

A review of benchmarking projects carried out by DG Enterprise[15] provides some interesting examples which support the SE experience. On incubators, for instance, DG Enterprise estimates that around 850 European business incubators have assisted in creating over 29,000 new jobs. More than 90% of the start-ups which are located in incubators are still active 3 years later, so that the jobs created are generally sustained better than comparable jobs created outside incubators. The public cost per job is estimated at 4,000 EURO, which is very low.

    - PAYE tax holidays

[15] *Highlights of the results of the Best Procedure projects 2001-2002*, Commission Staff Working Paper COM(2002)610 final, 7.11.2002

- Reduce deal costs. Legal costs can be 10% of investment, and the development agency attempts to find ways of reducing this burden by, for example, use of standardised procedures, encouragement of pro bono work and so on

- Increase supply of cash to stage 1

  - SE has identified the main funding bottleneck is at the early stage of development, when the risk is perceived as too high by commercial investors. Measures to overcome this include :

  - Education and information for investors, particularly for individuals who have the potential to become Business Angels. There is a programme outlining the attractions of investment

  - Financial support for networks, designed to build links between new companies and potential sources of finance, and to build support networks between companies

  - Bank lending

  - Create Scottish retail listed capital market – this is a longer term aim, designed to address problems in Scottish companies trying to attract funding from the main UK capital markets

- Move companies from stage 1 to stage 2

  - Measures in this category aim to move a company which has managed to prove its technology into the stage of proving its market, and so be able to attract investment.

  - Support is provided for training, primarily in management And finance

  - Experience matching works by establishing a database of skills and people which can be accessed by a new company in need of particular expertise

  - Networks – again there is support for networks at this stage of development, with an emphasis on financial sources

Scottish Enterprise therefore provides an interesting example for us of a detailed analysis of market failure in the creation of new companies, and of the response by a regional agency. The type of company which is targeted in this initiative could not be financially supported by state aid – the levels of funding required are simply too large for it to be an option. However, there are crucial steps in the development process which could be supported, and the kinds of measures which SE has put in place show how this can be done.

A detailed evaluation of state aid in the Walloon region[16] has been used as a basis for designing more effective aid instruments. The analysis of current state aid indicates that:

- Investment aid policy should be designed as an integral part of industrial policy and the strategic directions of the region that is to be assisted
- Investment aid should balance the two potentially conflicting criteria for best use of public resources: adherence to the enterprise investment priorities and adherence to regional economic objectives (the more it respects the enterprise investment priorities, the costlier it will be and the higher the risk of distortion. The more it respects regional economic objectives without any consideration of the investment choices of enterprises the less effective aid will be)
- Aid must reinforce the renewal of the region's economic fabric by employing criteria that are better adapted to the structural changes necessitated by economic forces
- Aid must support investment with positive externalities that can help enterprises reorient their strategies towards new market niches.

The region is actively participating in the EU initiative for the promotion of entrepreneurial spirit as one of the factors improving competitiveness, promoting economic development and creating new jobs, in particular with respect to SMEs[17]. The region has done the following within the BEST context:

- Supported educational programmes at all levels including specific courses for those wishing to start their own businesses
- Established special awards for "enterprise of the year", young EU entrepreneur, etc
- Improved access to funds
- Established better access to Research and Innovation (FIRST: Formation et Impulsion a la Researche Scientifique et Technique, centres of technological excellence, etc)
- Made services that it offers more visible through info centres
- Improved public service through provision of information and guidance to enterprises
- Improved conditions of employment (flexible hours, entrepreneurial spirit)
- Promoted universal access to IS services and applications (guide for e-business)

[16] Capron, H. (ULB) "*Evaluation de l'impact des aides à l'investissement en Région wallonne*, Rapport auprès de la Région wallonne, Août 1998

Capron, H. (ULB) "*Evaluation du système d' aide à l'investissement, Synthèse*", Septembre 1998

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[17] BEST – DG Enterprise , Mandate first defined during the European summit in Amsterdam, June 1997

The overall approach of the Walloon region recognises that investment aid alone cannot bring about a significant difference in the competition among EU regions in terms of attracting inward investment and improving the local entrepreneurial spirit. The question is much larger and should focus on how well the various instruments of regional economic policy complement each other and how effective they are.

Clustering

Clustering is being used in a number of regions as a regional development tool. The rationale (based on Michael Porter's work) is that

- Regions tend to be competitive in terms of clusters of industries, not in terms of individual industries
- Clusters tend to be geographically concentrated, so fit well with a regional development perspective
- The sources of competitive advantage tend to be local, emphasising the importance of localised suppliers and complementary industries.

A cluster would normally include producers, supply industries, and customers. Networks and support frameworks glue the cluster together.

It is not our intention to dwell on the debate about cluster theory, but it is worth recapping the main points of clusters.

- Clusters are built on systemic relationships between firms. These relationships can be based on any shared characteristic, such as sector, or form of production
- Clusters are geographically-bound
- Clusters have life cycles. They are a form of specialisation which has its development phase, its growth phase and its decay. This is crucially important from the point of view of regional development, as it is not enough to successfully nurture a cluster – it is not a permanent solution
- Clusters produce externalities. Some of these are easier to quantify (supplies, skilled labour levels) than others (market knowledge)

One writer[18] has characterised the features of a successful cluster in terms of the "three Cs". These are:

Concepts : all clusters are propelled by innovation, imitation and entrepreneurship

[18] *World Class*, R M Kantor, Simon & Schuster, NY 1995

Connections : this is the need for dynamic movement of ideas and the sharing of best practice, and involves the building of networks and networking practices. Generally this needs strong social capital. For clusters to be successful in less advantaged regions, this area often needs to be supported by public sector intervention.

Competencies : successful clusters need a skilled and specialised workforce, and need industry leaders who will drive development.

The creation of a successful cluster therefore depends on a number of interrelated factors. These factors include the optimal balance of skills, the existence of a critical mass of related industries or enterprises, and a range of elements of social capital, with the drive to succeed.

One region[19] which has carried out a lot of work on clustering over the last 5 years sees clustering as being a useful tool in a regional metropolitan centre, but much less applicable in an area with a dispersed population, or in a geographically more peripheral area. It is easier to build a critical mass when there is a higher concentration of population and of industry. The types of factors which have been used to encourage clusters include:

- Improving the quality of general factors of production, for example, education, infrastructure
- Minimising regulation
- Developing and enhancing clusters through procurement or demand stimulation

A report prepared for DG REGIO[20] looks at cluster-based actions specifically in the context of less advantaged regions. The study identifies three categories of LFR:

1. Older industrialised regions, with labour intensive industries in decline
2. Semi-industrialised regions, characterised by many small craft type industries with low levels of technology
3. Peripheral regions with dispersed populations, resource-based industries, suffering from out-migration

The response to disadvantage is structured as a menu of actions which could be undertaken by a region seeking to introduce or develop clusters. The menu includes actions targeting the following:

- Understanding and benchmarking regional economies

[19] *Diamonds, clusters and competitiveness in the social economy*, Scottish Enterprise, Glasgow 1999

[20] *Creating smart systems : a guide to cluster strategies in LFRs*, Stuart A Rosenfeld, DG REGIO, April 2002

- Organising and delivering services
- Building a specialised workforce
- Stimulating innovation and entrepreneurship
- Marketing and branding a region
- Allocating resources and investments.

This is a good illustration of the various elements which have to be taken into account if the clustering approach is to be successful. The approach depends on a broad strategy, and an implementation plan which will address hard and soft factors.

The objective of our study is to consider what types of regional aid may be most useful in the areas classified under Article 87(3)c, and for the purposes of this study we need to consider whether clustering is a useful measure as a regional development tool, and under what conditions it may best be used.

The barriers faced in areas designated for assistance are well known. At a general level, regions which face barriers to development share weak infrastructure of all kinds, including transport and communications. There are usually structural economic deficiencies, whether due to declining traditional industries, or dispersed resource-based industries. There is often lack of access to capital, and a low level of skills and education. Finally, there are often spatial problems relating to distance from main centres.

Regions which are currently classified under Article 87(3)c may have some but not all of these characteristics, and will vary widely in the severity of the barriers to economic development.

Can clusters help to address these kinds of problems?

First, we need to consider whether and to what extent a region can actually create a cluster.

It is notable that the examples on which cluster theories are based were not intentionally created. Generally, they are examples of fortunate development, where advantage was taken of an already existing congregation of types of organisation or industry.

Over the last 10 years we have some examples of cluster creation in Europe. For example, the growth of electronics in Ireland would constitute a cluster. Here, inward investment was used to encourage very large companies to locate in remoter parts of Ireland. The incentives were supported by a requirement for the locating companies to use local suppliers, and so develop and embed local supply chains. While this strategy has been successful in creating employment and in developing the market, it is a very costly process.

Where a cluster has been created, it is often via a process of inward investment, so that the cluster is built around one or ideally several large companies locating to the region. The strategy then is to work out what the indigenous companies can offer the incoming companies. The examples we know in Europe indicate that the offer is not enough, and that considerable public funding is needed to secure the inward investment.

Second, what if there are no obvious clusters in a region, and it is not clear what could attract organisations which could start to form a cluster?

Cluster theory suggests that even where there are no obvious industrial commonalties to exploit, there may be common areas of knowledge or some other aspect which would allow collective action to develop. However, it may be that clustering as a concept is not particularly suitable for certain kinds of region. The European examples suggest that it is more applicable to industrialised areas, even if these areas are in decline, simply because of the concentration of people.

Third, a major criticism of clustering is that over-specialisation leads to vulnerability in the global market. This means that if the development strategy is based on creating and sustaining one area of economic activity, it leaves the region vulnerable to external change. This reasoning is implicit in the idea that clusters have life cycles, and that they will all eventually decline. We can see strong examples of this where the cluster is built around an inward investor. If the inward investor decides it can find a more advantageous situation elsewhere, or if the sector is subject to global decline, then the whole cluster is threatened. Car manufacturing provides a good example of the first situation, and microchip production of the second.

From the examples we have discussed, is support for clustering a useful aid instrument?

At the very least, cluster analysis can help understand how economies including regional economies actually work. By looking at regional production and innovation systems, cluster analysis can help identify market failure and systemic weaknesses.

Where a region has a strategic imperative to seek inward investment, clustering offers a good option to embed the inward investor in the region, and to use it to leverage indigenous development. This is most likely to be successful where the region has something to offer, such as a highly skilled workforce, backed up by public funding. It is most likely to be in an area with a concentration of population.

For clustering to be used as a regional development tool, it must not be static, and must be constantly adapting and innovating if it is to survive in a changing market.

Regeneration

Market failures can be caused by and contribute to deprivation. One area where this is especially clear is in rundown urban areas, where often we see economic deprivation manifested in high levels of unemployment, social deprivation where communities are failing, and physical deprivation brought about by long term neglect of the physical environment.

Some member states have tried to break into this cycle of deprivation by establishing regeneration schemes of various kinds. In areas which are not

socially and economically favoured there is generally a low market value for land and property, and a high risk involved in development. These are unattractive places in which to invest, and there is clear market failure in leaving the private sector to develop such areas.

Some examples of the kinds of market failures associated with these areas is provided in a UK report[21] as follows:

- Capital market : investor unable to realise return on investment leading to underprovision of funds

- Labour market : firms unwilling to locate to area due to real and/or perceived dysfunction in the labour market. There is normally also an underprovision of training

- Property market : decayed, derelict and contaminated sites mean that private gain from development may be less than the wider welfare gain brought about by the development. Also, economies of scale in sites to be developed

Some responses to these market failures include direct development carried out by the public sector, where the state buys, develops and sells derelict sites. In this case, usually no state aid is involved. However, some member states have introduced innovative partnerships between the public and private sectors, and a good example of this is the provision of "gap funding". That is, funding which bridges the gap between development costs and the forecast end value of the development. These schemes can be speculative or non-speculative. In the case of the former, the land is developed and sold on the open market. In the case of the latter, the land is developed for an identified organisation who will own the site on completion.

We can see some examples of successful regeneration schemes, where the regeneration has involved physical, economic and social measures.

In France[22], one scheme was set up to improve employment opportunities and to raise the quality of life in an estate of local authority housing with acute problems. The scheme was set up in 1996, and began by establishing a public-private partnership charged with undertaking large-scale regeneration. A package of complementary measures was designed to take advantage of employment opportunities. This included, for example, creating jobs in recycling, and in educating about recycling, so that the one action helped to clean up the estate and provided much-needed jobs.

Where regeneration schemes are successful in development terms, they will have involved a multi-faceted attack on an area's difficulties. In general, the approaches we have looked at begin with investment in infrastructure, and there is often obvious market failure in attracting commercial investment into areas which are derelict or contaminated. Success does depend also on a

[21] "*The need for a new European Regeneration framework*" Office of the Deputy Prime Minister, London UK 27.11.02

[22] Aulnay-sous-Bois, URBAN Initiative

package of actions which support infrastructural development, and this includes measures to create and maintain employment, and often measures designed to improve the social capital.

Business support services

A study carried out for DG Enterprise[23] seeks to understand market failure in the business support market for SMEs looking for support and advice. The study uses market failure as a primary justification for public intervention, and asks how we can identify needs which will not, or cannot, be met by the private sector. We must note that while market failure is seen as the prime rationale for public intervention, it is not the only rationale, and the study does recognise factors such as the need to combat exclusion, the need to create employment and the need to build an SME base.

The study uses market failure as a framework for considering intervention. This helps to ensure that there is no negative effect on closing down the possibility of private sector provision. Further, an analysis of the nature of the market failure can be a useful input to the definition of a response. In other words, assessing the characteristics of failure can provide a good basis for deciding how to best respond to that failure.

When the existence and nature of market failure is established, it is suggested that the next steps will consider how important and how serious the area of failure actually is. It will consider the real impact on SME survival and development, and will then assess the cost of intervention – both the actual financial cost and the opportunity cost.

For our purposes, this study provides an interesting analysis by developing the concept of market failure in the area of business support services. It establishes a good framework for judging whether or not public intervention is justified, and suggests the direction to follow if it is.

There is persuasive evidence of market failure in the supply of business support services, but we have to look elsewhere for evidence of the potential impact of the supply of these services.

A good example of a successful support network for SMEs is that of the creation of a network of inventors in Finland[24]. This project sought to develop a network to promote and provide service at all levels of the innovation process, which would both support indigenous development, and help to stop the drain of inventions going out of the region. Over the course of the projects, the network grew to 350 active inventors, with 785 new inventions. A total of 11 new companies were created, and 30-35 new jobs. The project estimates that the economic growth value of this initiative is over 6 million EURO.

[23] *Business support services and market failure*, Foundation for SME Development, University of Durham, DG Enterprise July 2002

[24] Lansi-Lapin Koulukuntayhtyma, North Calotte, Finland

The need for a range of ICT services prompted work on increasing the use of ICT for commercial development in Jamtland, Sweden[25]. The areas of focus were information and marketing, website production, and the development of internet platforms. A number of information meetings and seminars launched a programme of training and development. Around 3,000 hours of training for SMEs was supplied by the local university and local IT specialists. A business portal was created, offering access to development possibilities. So far, more than 370 small companies are involved, and various networks and co-operative projects have been established.

We can put together the theoretical rationale for intervening to deliver support services for SMEs, and some examples of results from actual projects and initiatives. Our view is that it is particularly important to be very clear about two key issues when considering business support services as a funding instrument.

The first issue is to do with the nature of demand for the service. On the information supply side, it is essential to establish what information is needed and for what purpose, and above all, what is its value. We have seen many examples of companies being interested in "information" but not wanting to pay because in fact it is not valuable.

The second issue is to do with the role of the private sector. Care must be taken to ensure that there really is market failure, and that there is a clear need for a service, which will not be provided by the private sector.

Summary

In this chapter we have reviewed specific funding instruments, and have assessed their potential contribution to regional economic development. We have focused on regional programmes; clustering; regeneration; and business support services. All of these instruments aim to target areas of market failure. None is suitable for all situations, and none can be successful on its own.

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6. Issues and implications

The objective of this study is to consider if the aid instruments available in regions classified under Article 87(3)c should change after 2006, and if so, how. We have looked at the development needs of regions in this category, with a view to establishing the best options from the regional development perspective. We have looked also at the evolution of policy in regional development, and in competition, with a view to assessing the responses to development needs. Finally, we looked at specific instruments which could be introduced under state aid, and assessed how these perform now.

In this chapter, we are concerned to draw together these different elements of the analysis and identify the key issues and implications of changing aid instruments.

Why do member states want to use regional state aid?

The application of Article 87(3)c funding recognises that there are continuing disparities between regions, and that addressing these disparities is the rationale behind state aid on a regional level. The ways in which member states select the regions which are eligible for funding is outside the scope of this study. However, as a general comment, it would be useful if the economic rationale for specific funding in specific areas was made clearer. It would then be easier to focus the aid on areas of greatest need, which has the double benefit of reducing the size of assisted areas, and of concentrating the aid effort in a more effective manner.

At its most basic, member states must have a means of targeting funding at their more deprived areas, and there is clearly a regional dimension to this.

We therefore suggest that for Article 87(3)c to be most useful, the regional development imperative should be clearer. The main implication of this is that the starting point for considering state aid should be the potential regional development impact, and that this then drives the selection of assisted areas, and the definition of appropriate instruments.

How adequate are current funding instruments?

Under the present guidelines, aid is available only for initial investment, and for job creation linked to that investment. In addition, there is the possibility of funding horizontal measures at a higher level of aid intensity in an assisted area.

Our key question here is the extent to which current instruments meet the economic development requirements of disadvantaged regions.

- A restriction to initial investment does not meet the development needs of the regions. For the member states, aid for initial investment may be one tool they would choose to use in an assisted area, but it addresses a very small subset of development concerns.

- In practice, Article 87(3)c is often being used to fund large companies in assisted areas. This is a key area which EU policy goals are targeting, and our

interpretation of policy aims is that funding large companies, wherever they are located, is a major potential threat to competition.

- From a development perspective, we would note that funding of this kind is not proven to have a significant beneficial effect on job creation and maintenance.

- In addition, large projects generally suffer less from local market failures. So, for example, larger companies can usually access national capital markets and national labour sources. This means that using market failure as a rationale for public intervention would not stand up for most cases of funding larger companies.

Our conclusion on the adequacy of current instruments in addressing economic development goals is that they are not sufficiently broad to deal with the complex factors faced in disadvantaged regions. This is compounded by the way in which current instruments are often used to support larger companies, where there is a major concern from a competition perspective, and also from a regional development perspective.

Is the answer to do away with regional aid altogether?

Given the drawbacks of the current regional state aid rules, and the difficulties in the way in which they are implemented, it may be tempting to consider stopping regional state aid. We could argue that member states would still be able to use structural funds money to intervene in eligible areas, and that effectively this would be the only form of aid which was used in areas of regional disadvantage.

State aid could then focus entirely on horizontal measures. Market failures experienced by SMEs are well-known, and could be addressed via horizontal measures, and this is already happening. Aid for R&D and for risk capital are also addressed by horizontal measures.

There is a certain comfort in sticking to horizontal measures, where there is less risk of distortion, and where there is a good track record of implementation.

To answer this question, we need to go back and consider the whole point of state aid. It is our view that there are serious areas of market failure which are regionally specific, and that these may best be addressed at a regional level. The main problem we see in cutting out regional aid in favour of horizontal measures is that even if all market failures could be addressed by horizontal measures, this may not be the most effective way of doing it. The interaction between areas of market failure can be significant. We would go further in suggesting that the criteria for state aid must be broader than market failure, and should encompass some development goals.

The whole environment of thinking, policy and implementation of regional aid is changing

We have discussed shifts in thinking and shifts in types of funding, where the movement is generally away from large infrastructural programmes towards softer initiatives. This is supported by a much more strategic approach to development.

We discussed the thinking at EC level, and gave examples of how this is reflected at a Member State and regional level.

At present, the approach implicit in regional state aid is out of step with thinking on regional development. It would seem logical that state aid rules would follow the same line of analysis of the change in regional structures, and the need to respond in different ways. In this case, aid for initial investment is not sufficient in itself, and would probably not be the first choice of instrument.

State aid rules could reflect regional development approach

We can see a good argument for state aid rules to reflect changes in the regional development approach, and in practice, this would mean that aid rules facilitated a range of instruments which could be used by member states according to particular development needs. These instruments would include support for softer aid measures such as those discussed in the previous chapter. This approach would tie state aid in much more closely with regional requirements, and would lock aid into development.

We can see benefits in having a much more consistent approach. Member states could link state aid with their regional development strategies, and there would be a greater coherence in funding and support.

The one note of caution we would like to introduce concerns the relationship between instruments and their impact on competition. We can be reasonably confident of the impact on economic development of the different kinds of measures discussed in this report. While the level of evaluation is often not as rigorous as we might like, there is a significant body of work examining the impact of intervention at a regional level.

We have not found a corresponding body of work assessing the impact of different measures on competition. We are aware that this is an area of concern for DG Competition, and it is an area which needs more work. Generally, the softer the instrument, and the more diffuse its potential benefits, the harder it is to judge its impact on competition.

What impact will enlargement have on our conclusions?

Following the analysis we have built up, our main area of concern is the regional economic needs of the new EU members. We have argued that the regional needs of the current member states have been evolving, and that thinking and policy on regional development has responded to this. Also, of course, there has been a long and sustained period of investment in Europe's regions, and a corresponding experience of implementing regional programmes.

Until 2006, the candidate countries are classified in the same way as Objective 1 regions, and so would be eligible for state aid under Article 87(3)a. Post 2006, it is possible that some regions in some of the new members would be in the Article 87(3)c group.

The candidate countries generally have little experience of softer aid measures. This is not surprising, as their overall level of economic development means that a priority will be given to basic infrastructural development.

From a development point of view, there would be no problem in applying softer aid measures alongside the kinds of infrastructure investment which we would expect to see through the structural funds, so long as there is a coherent approach to the region's development. This is a key point, and we would emphasise the need to have an overall regional strategy which would then inform the selection of state aid interventions.

From a competition point of view, the advantage of moving towards softer aid measures would be that it would consolidate the direction of change away from the rescue and restructuring and sectoral focus which characterises the candidate countries at present.

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