# BEST PRACTICES IN INVESTMENT PROMOTION

## An overview of regional state aid and special economic zones in Europe

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This paper assesses good practices and lessons learned in investment promotion in European Union (EU) Member States. It focuses on two specific areas of investment promotion: State aid for regional development under EU law and special economic zone frameworks. It provides an overview of the concept of State aid and compatibility of regional aid with the internal market, as well as lessons learned from the case law determining the existence of State aid in regional development measures. It also outlines the calculation of the gross grant equivalent of State aid. The paper explores special economic zone policies, identifies success factors and describes the complementary framework conditions to maximise their spillover effects on local economic development.

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# Foreword

This paper provides an overview of good practices in investment promotion in Member States of the European Union (EU) and related lessons learned. It focuses on two specific areas of investment promotion: State aid for regional development under EU law and special economic zone frameworks. Following an introductory section, the second section explains the concept of State aid and compatibility of regional aid with the internal market, and identifies good practices and common mistakes to be avoided by EU Member States. The third section provides an overview of special economic zone policies, including their location, governance, services and legal framework, it identifies success factors and describes the complementary policies and framework conditions to maximise their spillover effects on local economic development. The annex provides an overview of the calculation of the gross grant equivalent of State aid.

The paper was prepared at the request of the Government of Bulgaria in the context of a project on *Improving Bulgaria's investment promotion framework to enhance competitiveness and foster economic recovery*. The action was funded by the European Union via the Technical Support Instrument, and implemented by the OECD, in co-operation with the Directorate-General for Structural Reform Support of the European Commission. The paper aims to support the Government of Bulgaria in its efforts to design and implement adequate investment promotion tools to attract large-scale and high-quality foreign investment projects. It follows on the *OECD Investment Policy Review of Bulgaria* published in 2022 in view of Bulgaria's adherence to the Declaration on International Investment and Multinational Enterprises which assesses its investment climate. The paper has served as background for the other components of the project, notably Guidelines to prepare and implement regional State aid for large scale investors in Bulgaria and an Action Plan for the establishment of a special economic zone framework in Bulgaria.

The paper benefitted from multiple rounds of consultations and discussions with the Government of Bulgaria and the European Commission. The section on regional State aid was presented and discussed at a virtual workshop on 11 October 2022 and the section on special economic zones was presented and discussed at a virtual workshop on 23 November 2022.

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# Table of contents

Foreword 3

1 Introduction 5

1.1. Investment promotion for growth and sustainable development 5
1.2. State aid and special economic zones can support investment promotion objectives 6

2 Regional State aid 8

2.1. Concept of State aid and compatibility of regional aid with the internal market 8
2.2. Lessons learned from the European Commission's decisional practice on large investment projects 18
2.3. Lessons from the case law and mistakes to be avoided 24

3 Special economic zones 26

3.1. Key characteristics and objectives of special economic zones 26
3.2. SEZ governance and legal frameworks 32
3.3. Maximising positive SEZ spillover effects 40

Annex A. Calculation of the gross grant equivalent of State aid 42

References 54

## FIGURES

Figure1. The role of FDI in the EU's economy, 2011-21 5

## TABLES

Table 1.1. Main policy tools to promote, facilitate and retain FDI in remote or less developed regions in OECD countries 7
Table 3.1. Examples of different SEZ typologies 29
Table 3.2. Traditional SEZs versus more preferred SEZs 30
Table 3.3. Tax, financial and non-tax incentives in SEZs 38

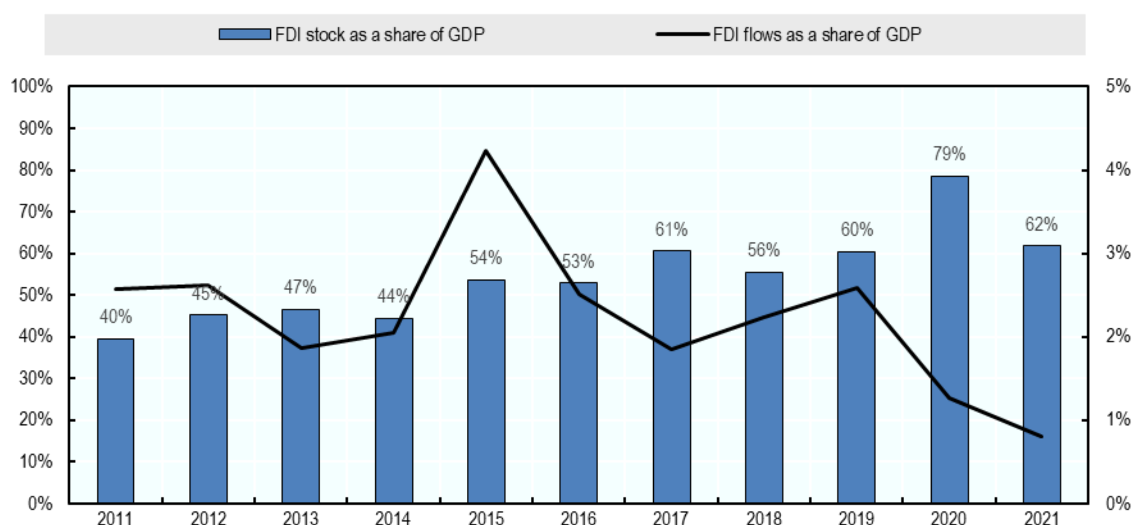
# 1 Introduction

## 1.1. Investment promotion for growth and sustainable development

Governments seek to attract foreign direct investment (FDI) to foster growth and prosperity, generate quality employment, reduce regional disparities and support sustainable development outcomes. Under the right policy conditions, international investment can provide host economies with several spillover effects such as productivity growth, skills development, transfer of knowledge and technologies, which can ultimately lead to an increase in countries' standards of living and support the green and digital transitions. FDI can also provide benefits beyond its direct contribution by serving as a conduit for domestic firms to access international markets and global value chains (GVCs) through links with multinational enterprises (MNEs).

Members of the European Union (EU) have been actively attracting FDI to support their economic development. Although FDI flows have been declining over the past few years, their stock as a share of the EU's gross domestic product (GDP) has been on an upward trend, thus reflecting international investment's continuous key role in the bloc's economy (Figure 1.1). In line with the European Green Deal of the European Commission, EU member countries are counting on private investment, including FDI, to support a green and digital economic transformation while reinforcing competitiveness and reducing regional disparities across and within countries.

### Figure 1.1. The role of FDI in the EU's economy, 2011-21




Note: For FDI stock, the data for the 27 countries of the European Union begins on 1 January 2020.
Source: OECD International Investment Statistics Database.

Governments seeking to attract FDI need to create a favourable business environment and to continuously enhance their investment policy framework to allow the private sector, both domestic and international, to operate and expand. A broad range of policy actions can contribute to shaping the investment climate, including in the areas of investment liberalisation, the legal framework for investment, investment promotion and facilitation, and other areas covered in the OECD Policy Framework for Investment (PFI).

The PFI aims to mobilise private investment that supports steady economic growth and sustainable development, contributing to the economic and social well-being of people around the world. Drawing on international good practices, it proposes guidance in 12 policy fields critically important for improving the quality of a country's enabling environment for investment. It also includes elements of good public and corporate governance, notably rule of law; transparency, consistency and predictability of laws; non-discrimination; respect for property rights; stakeholder engagement; and whole of government approaches. The overall enabling environment determines first and foremost the attractiveness of a host economy to FDI, but it also plays a role in determining the effectiveness of specific investment promotion measures discussed in this paper. A sound investment policy framework is not only key to attract international investment, but also to enhance the sustainable impact of investment on the host economy. Investment promotion activities thus need to take place within the context of, and not as a substitute for, sound investment policies.

Public policies in market-oriented economies are geared towards achieving national socio-economic objectives. Investment promotion is no exception and consists of government interventions to influence firms' location decisions to attract FDI that can meet public policy objectives (e.g. job creation, productivity growth, linkages with domestic companies, transfers of skills and know-how, reduction of regional disparities, etc.). In this context, governments compete fiercely with one another for each investment decision and have a wide array of initiatives and policy tools at their disposal to fulfil their investment promotion strategy.

Most jurisdictions have chosen to establish an investment promotion agency (IPA). In the OECD area, all countries have established national or subnational IPAs, which carry out a range of services aimed at marketing their economy, targeting investors, facilitating business establishment and providing aftercare services to investors (OECD, 2018[1]).

The rationale for investment promotion finds its roots in the need to correct or mitigate market imperfections, particularly to overcome information asymmetries (Wells and Wint, 2000[2]; Loewendahl, 2001[3]). International investors, who intend to invest in a foreign market, often lack specific information, including on operational costs, capital expenditures, business partners, competition, taxes and legislation in potential locations (OECD, 2015[4]). The nature of – and need for – investment promotion undertaken by governments has changed over time, however. While in the 1980s and 1990s, IPAs were primarily engaged with disseminating information on their country's investment opportunities and business climate, countries have engaged in more sophisticated activities to gather business intelligence and attract MNEs (OECD, 2015[5]; OECD, 2018[1]). Governments currently offer a wide array of different services – that go far beyond information dissemination – to both potential and existing investors and are also often involved in business climate reforms.

## 1.2. State aid and special economic zones can support investment promotion objectives

In addition to policy reforms and services to investors, policy makers can also leverage targeted policy tools to effectively attract FDI to support their growth and sustainable development objectives. These include the provision of tax and non-tax incentives and the establishment of special economic zones (SEZs) or industrial parks. If used wisely and under the right conditions, these tools can be powerful means to attract FDI projects, particularly those that can have a transformational role. By focusing on specific

investment projects – notably large-size and high value-added FDI projects – state support can help reinforce the competitiveness of specific segments of the economy and support sustainable development outcomes. They are also widely used policy tools to promote investment in support of regional development objectives (OECD, 2022[6]). A recent survey of IPAs found that beyond the IPA services, the main tools used by governments across the OECD to attract and retain FDI in remote or less developed regions are non-tax incentives, tax incentives and industrial parks (Table 1.1).

## Table 1.1. Main policy tools to promote, facilitate and retain FDI in remote or less developed regions in OECD countries

Responses from IPAs ranked on a scale from 1 to 8

| Ranking | Policy tools |
|---|---|
| 1 | Investment promotion agency's services |
| 2 | Non-tax incentives (e.g. grants, loans, guarantees) |
| 3 | Tax incentives |
| 4 | Industrial parks |
| 5 | Provision of infrastructure |
| 6 | Local business environment improvements |
| 7 | Special economic zones |
| 8 | Local / regional fairs |

Source: OECD survey on investment promotion and regional development, 2022.

Tax and non-tax incentives in the EU are often provided under State aid schemes that must be validated by the European Commission. By providing government support to companies, State aid is seen as distorting the internal market as the recipient companies gain an advantage over their competitors. Therefore, State aid is, in general, prohibited except when it is justified by reasons of general economic development. Section 2 of this paper reviews the application of this concept to regional development.

As described in Section 3, common features of SEZs include a geographically defined area, streamlined procedures – such as for customs, special regulations and tax holidays – which are often governed by a single administrative authority. A zone-based strategy may be effective in attracting investors in the short run by offering adequate infrastructure, services and duty-free access for capital goods and other inputs. By directly influencing the location choice of MNEs, they can also contribute to promoting regional development and reducing regional inequalities within the host country.

Investment promotion frameworks vary greatly from one country to another, with different institutional settings, policy tools and strategies reflecting the country's political and institutional context and economic geography. This paper hence focuses on two specific investment promotion mechanisms: regional State aid and SEZs. In the EU context, regional State aid can help attract large investment projects that can boost the competitiveness of the economy and help integrate it in the EU single market and international supply chains. The development of SEZs, within the right frameworks, can gradually upgrade or replace the existing post-industrial properties, and boost local economic development.

An enhanced investment promotion framework is particularly important to respond to the crisis induced by the COVID-19 pandemic, triggering the most severe economic recession in nearly a century, as well as Russia's war of aggression against Ukraine, which is slowing the recovery and causing a global cost of living crisis due to intense inflationary pressures. A sophisticated approach with tailor-made investment promotion tools can help address the economic contraction and drop of FDI flows by generating a resilient and sustainable economic recovery.

# 2 Regional State aid

This section of the paper provides an overview of the concept of State aid and compatibility of regional aid with the internal market as well as lessons learned on the issues in the case law that determine the existence of State aid in regional development measures and, primarily, the compatibility of regional aid with the internal market. It is divided in three parts:

- The first part explains the concept of State aid and the application of this concept to regional development measures.
- The second part provides lessons learned and common mistakes to be avoided on the European Commission's decisional practice on large investment projects.
- The third part draws lessons for Member States on the case law.

## 2.1. Concept of State aid and compatibility of regional aid with the internal market

According to the 2020 version of the State Aid Scoreboard, State aid for regional development was the third most important type of aid before the COVID-19 pandemic, accounting for about 8.5% of all State aid granted to industry and services in the EU (European Commission, 2021[7]). In Bulgaria, regional development aid was the most important policy objective absorbing about 45% of all aid.

The 2020 Scoreboard also indicates that close to 80% of the aid for regional development in the EU was granted on the basis of the General Block Exemption Regulation (GBER) (i.e. Commission Regulation (EU) No 651/2014) that relieved Member States from the obligation to notify their aid measures to the European Commission for prior authorisation.[1] In Bulgaria, 60% of all GBER-based aid was provided in the context of regional investment schemes, mainly under Article 14 of the GBER.

The 2021 edition of the Scoreboard that was published in September 2022, indicates that regional development became the second most important horizontal policy objective with a total of EUR 18.3 billion granted by Member States (European Commission, 2022[8]). In Bulgaria, public support for regional development was about 0.17% of the national GDP in 2020. Regional State aid was the third most important policy objective after measures to combat COVID-19 and to support agriculture. In 2020, regional State aid accounted for only 12% of all State aid. However, regional aid was the most important objective among GBER-based measures, reaching almost 40% of all GBER aid.

As explained below, regardless of policy objective and need for State aid, all public measures that qualify as State aid are in principle prohibited unless they are exempted.

### *2.1.1. The EU system of aid control*

Article 107(1) of the Treaty on the Functioning of the European Union (TFEU) declares "any" State aid, in "any form", to be incompatible with the internal market. This means that State aid is in principle prohibited.[2]

[1] The Regulation can be accessed at: http://data.europa.eu/eli/reg/2014/651/2021-08-01.

[2] The TFEU can be accessed at: http://data.europa.eu/eli/treaty/tfeu_2012/oj.

Article 107 TFEU forms part of the competition rules of the Treaty. Article 3(b) TFEU confers exclusive competence to the EU to define “the competition rules necessary for the functioning of the internal market”. Article 3 of the Treaty on the European Union (TEU) requires the EU to “establish an internal market”. According to Article 26(2) TFEU, the internal market comprises “an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured”. Protocol 27 that is annexed to the TFEU declares that “the internal market as set out in Article 3 of the Treaty on European Union includes a system ensuring that competition is not distorted”.

Therefore, the objective of the EU rules of competition, including those on State aid, is to protect the integrity of the internal market by preventing distortions caused by corporate practices or decisions of public authorities.

Public authorities can distort competition by granting special or exclusive rights to certain enterprises or by subsidising market operators. This is the reason why State aid is deemed to be incompatible with the unfettered functioning of the internal market.

Any public measure, irrespective of its objective or form, that satisfies all the criteria defined in Article 107(1) TFEU is categorised as State aid. However, the prohibition contained in Article 107(1) TFEU is not absolute. State aid may be exempted from this prohibition if it fulfils the conditions which are laid down in Article 107(2 & 3), Article 43, Article 93 or Article 106(2) of the TFEU.

There are at least two reasons why State aid may be exempted. First, the market does not always function perfectly or efficiently. Therefore, it may be necessary for the state to intervene in the economy with State aid instruments to remedy a market failure. Second, the TFEU, by exempting certain types of State aid from the principle of the incompatibility of State aid with the internal market, implicitly acknowledges that the benefits from pursuing certain public policy objectives may outweigh the costs caused by the distortion of competition in the internal market. In the case of support of individuals in the context of social policy, or compensation for damage caused by natural disasters or exceptional occurrences such as COVID-19, the Treaty presumes that the benefits always outweigh the costs and declares such aid to be compatible with the internal market. In all other cases, the European Commission has to verify that the benefits of State aid exceed the costs of the distortions it causes in the internal market or that the aid is necessary, appropriate and proportional.

Regardless of the legal basis of exemption, State aid must comply with the substantial and procedural requirements defined in the Treaty and the relevant regulations and guidelines of the European Commission.

Article 108(3) TFEU imposes an obligation on Member States to notify to the European Commission all new public measures containing State aid. Non-notified measures are automatically illegal. A measure in this context means both “schemes” which provide for multiple aid awards and “individual aid” which is granted to particular undertakings.

According to Article 1(c) of Regulation 2015/1589, that lays down the procedure for notification of State aid, “new aid means all aid, that is to say, aid schemes and individual aid, which is not existing aid, including alterations to existing aid”. Existing aid is defined in Article 1(b) of the same Regulation as aid that was granted before a Member State acceded to the EU, aid that is authorised by the Commission or aid that was not State aid at the time it was granted (because one of more of the criteria of Article 107(1) TFEU was not satisfied such as absence of trade before a sector is liberalised). Alteration of aid is any change in the terms of the aid measure that can affect its compatibility with the internal market or an increase of its budget by more than 20%. Therefore, the obligation of notification of new aid extends to existing aid measures – e.g. measures approved by the Commission – that are altered or measures that become State aid as a result of the opening up of markets that were legally closed to intra-EU trade. The latter possibility is now very rare.

The Commission is the only authority in the EU vested with powers to determine whether State aid satisfies the conditions for exemption. If the aid does satisfy those conditions, it is considered to be compatible with the internal market; otherwise, it may not be granted. If aid has already been granted in violation of Article 108(3) TFEU, it must be recovered with interest from all of the recipients. It is worth noting that the Commission may order recovery of aid that was granted up to ten years before it noticed or inquired about its existence. Interest is charged as of the date of the granting of incompatible aid. The interest rate that must be charged on recoverable aid is defined by the Commission and adjusted from time to time. See the Commission 2008 Communication on reference and recovery rates of interest.

The TFEU requires Member States to notify aid measures to the European Commission for prior authorisation but does not compel them to grant aid. It is their prerogative whether to grant aid or not (see the order of the General Court in case T-670/14, Milchindustrie-Verband et al. v European Commission, EU: T:2015:906, paragraph 29). Moreover, according to the opinion of the Advocate-General in case C-526/14, Kotnik, EU: C:2016:102, paragraph 79, “under EU State aid rules, no undertaking can claim a right to receive State aid; or, to put it differently, no Member State can be considered obliged, as a matter of EU law, to grant State aid to a company.” This principle has been recently confirmed in cases T-378/20, Ryanair v Commission, EU: T:2021:194, paragraph 24; and T-677/20, Ryanair v Commission, EU: T:2021:465, paragraph 57.

In order to reduce administrative burden, EU rules relieve Member States from the obligation to notify new State aid when the measure falls within a block exemption regulation issued by the European Commission or when the aid remains below the de minimis threshold of EUR 200 000 per undertaking over a three fiscal-year period (Commission Regulation (EU) No 1407/2013).[3]

De minimis aid is considered not to satisfy all of the criteria of Article 107(1) TFEU and therefore it is not formally regarded as State aid. If the amount of aid exceeds the de minimis threshold or if the aid measure does not fall within a block exemption regulation, Member States must notify their measures to the Commission.

Although Member States are not obliged to notify measures that do not contain State aid, if a Member State is not certain whether a public measure does not contain State aid, it may still notify the measure to the Commission for purposes of legal certainty and request a no-aid decision.

Member States remain responsible for all State aid they grant on the basis of a block exemption regulation or after they receive the approval of the Commission (see case C-349/17, Eesti Pagar, EU: C:2019:172). As explained at length later on, they need to ensure that aid is granted before a project starts so that the aid can incentivise the recipient to carry out extra investment, for example, and that the aid supports only eligible costs up to the allowable aid intensity.

### *2.1.2. The concept of State aid*

The text of Article 107(1) TFEU is as follows: “Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.” The prohibition of State aid is therefore not absolute. State aid may be exempted from this prohibition if it fulfils the conditions that are laid down in Article 107(2) and (3), Article 43, Article 93 and Article 106(2) TFEU. For example, aid for regional development can be exempted on the basis of Article 107(3)(a) or (c).

It is well-established in the case law that Article 107(1) lays down four criteria that together define what constitutes State aid (see, for example, the judgments in cases C-379/98, PreussenElektra, EU: C:2001:160; C-482/99, France v Commission, EU: C:2002:294; C-329/15, ENEA, EU: C:2017:671;

[3] The Regulation can be accessed at http://data.europa.eu/eli/reg/2013/1407/2020-07-27.

C-405/16 P, Germany v European Commission, EU: C:2019:268). Any public measure, regardless of its objective or form, that satisfies all four of those criteria is classified as State aid. In other words, the criteria are cumulative, not alternative. They are also exhaustive. Nothing else needs to be taken into account in order to determine whether a public measure constitutes State aid.

In 2016, the European Commission published a Notice on the Notion of State aid, which contains an extensive and detailed explanation of the case law on the four criteria of Article 107(1). The criteria laid down in Article 107(1) are the following:

1. state resources are transferred to an undertaking
2. the recipient undertaking obtains an advantage, in the form of reduction of its normal costs, that it would not have enjoyed in the absence of state intervention
3. the advantage is selectively offered only to certain undertakings instead of all undertakings that are in a comparable situation
4. the recipient undertaking operates in a sector where there is cross-border trade and the aid distorts competition by placing the recipient in a more favourable position than its competitors.

The Court of Justice of the EU has ruled that the concept of State aid is “objective” in the sense that it does not depend on the motives or reasons for which a public authority grants State aid, its policy objectives or social aims (see, for example, the judgments in cases 173/73, Italy v European Commission, EU: C:1974:71; C-487/06 P, British Aggregates v European Commission, EU: C:2008:757). A public measure that intends, for example, to remedy market failure or stimulate the creation of new knowledge or support poor regions can very well be categorised as State aid. What matters is whether the four criteria outlined above are satisfied regardless of the necessity of state intervention.

It is important to note, however, that the aims, objectives or targets of public measures are relevant and taken into account at the stage where the Commission assesses the compatibility of the aid with the internal market (see judgments in cases T-356/15, Austria v European Commission, EU: T:2018:439; C-594/18 P, Austria v European Commission, EU: C:2020:742).

### *State resources*

For a measure to constitute State aid, resources which belong to the state or are under the control of the state must be transferred to an undertaking (see judgments in cases, C-329/15, ENEA, EU: C:2017:671; C-405/16 P, Germany v European Commission, EU: C:2019:268).

Resources which belong to the state are those that come from the budget of any public authority at any level of government. Revenue raised from taxation is naturally a state resource. Other levies or charges imposed by a public authority on users of a product are considered to be state resources. They are also state resources even if they are collected by entities which are not public authorities but which are appointed for that purpose by the state or act on instructions of the state without discretion to decide on how those resources are to be used (see, for example, cases 173/73, Italy v Commission, EU: C:1974:71; C-262/12, Association Vent De Colère, EU: C:2013:851).

Resources which come under the control of the state include those which belong to entities that are owned, managed or supervised by the state such as Managing Authorities for EU structural funds or public research foundations.

In this connection, it is important to note that EU funds that are co-managed at Member State level by a national public authority are classified as state resources, regardless of the fact that their origin is the EU, because they come under the control of the state in the sense that the eligible beneficiaries and the terms on the basis of which they are disbursed are defined by national legislation or decisions of public authorities.

The resources of a company that is owned by the state are considered to be state resources. So are the resources of an entity which is controlled, managed or supervised by the state in the sense that, without being the owner, the state can appoint or dismiss the board or management and therefore, can influence the decisions of the entity.

However, the Court of Justice has ruled that it is not enough for the state to be able to exercise control in principle over the management of an entity which is not a public authority in order for its resources to be classified as state resources (see judgment in case C-482/99, France v European Commission (Stardust Marine), EU: C:2002:294). Since entities which are not public authorities may have significant decision-making autonomy, even if they are legally owned by the state, the Court of Justice has stipulated that it is also necessary to “attribute” or “impute” to the state their decisions to provide funding to a third party. If they act independently, they cannot be considered to further the aims of public policy through the funding they provide to third parties (see case C 425/19 P, Commission v Italy, EU: C:2021:154).

For a decision to be attributed or imputed to the state it is not necessary that the state issues specific instructions. The state may be able to steer the decisions of a state-owned company or a non-state entity through its general links with that entity, the general obligations it imposes on that entity or through other channels of influence. In its judgment in case C-482/99, France v European Commission, paragraph 55, the Court of Justice defined a number of indicators, each of which need not be decisive, that can be used to infer whether a decision of a state-owned undertaking, agency or any other entity can be imputed to the state. Such indicators are, for example:

- the degree of integration of the entity in question into the structure of public administration
- the nature of the activities of the entity (purely commercial or having social aims)
- the legal status of the entity (public law or ordinary company law)
- the intensity of the supervision exercised by public authorities over the management of that entity.

A transfer of state resources in the meaning of Article 107(1) TFEU occurs not only when the state grants a subsidy or makes a monetary transfer but also when the state assumes a liability without adequate remuneration such as when it grants a free state guarantee or forgoes money that it is owed by undertakings such as taxes or forgives payments that are due to it such as loans or forgoes revenue from the renting or sale of state assets such as land or fails to receive a market price for goods and services it supplies such as electricity (see judgments in cases C-276/02, Spain v Commission, EU: C:2004:521; C-341/06 P, Chronopost and La Poste v UFEX, EU: C:2008:375).

### *Undertakings*

The recipients of state resources must be undertakings. An undertaking is an entity that engages in an economic activity, regardless of its legal status or the way it is financed. An economic activity is the offering of goods or services on a market for remuneration (see judgments in cases, C-138/11, Compass-Datenbank, EU: C:2012:449; T-138/15, Aanbestedingskalender v European Commission, EU: T:2017:675; C-622/16 P to C-624/16 P, Scuola Elementare Maria Montessori v European Commission, EU: C:2018:873). If the recipient is not an undertaking, its public funding does not constitute State aid that falls within the prohibition of Article 107(1) TFEU (see cases C-656/20 P, Hermann Albers v European Commission, EU: C:2022:222; C-666/20 P, GVN v European Commission, E: C:2022:225).

For example, intra-state transfers (i.e. from one public authority to another) fall outside the scope of Article 107(1). Public funding of public hospitals or public universities that offer free health care or education under the direction of the state also fall outside the scope of Article 107(1) as such hospitals and universities do not offer services on a market for remuneration. They fact that they may charge a small, nominal fee is not relevant, as such a fee is not a market “consideration” for the services they provide.

The definition of undertakings is activity based, not status based. This means that a non-undertaking can become an undertaking if it engages in an economic activity. An entity that carries out both economic and non-economic activities must keep separate accounts so as to prevent any public funding of the non-economic activities from spilling over into the economic ones (see cases C-622/16 P to C-624/16 P, Scuola Elementare Maria Montessori v European Commission, EU: C:2018:873). By contrast, cross-subsidisation of non-economic activities by economic activities is not contrary to State aid rules.

*Advantage*

A state subsidy confers an advantage to the recipient undertaking when it relieves it fully or partly of its normal costs. Normal costs are those caused by the activities of undertakings and are borne in the budgets of undertakings in the absence of state intervention (see judgments in cases C-124/10 P, Commission v EDF, EU: C:2012:318; C-73/11 P, Frucona Košice v Commission, EU: C:2013:32).

The following arguments are not relevant in the classification of a benefit conferred by the transfer of state resources as an advantage in the meaning of Article 107(1):

- The reduction of costs is small.
- The costs are imposed by the state or are incurred in order to comply with new legal requirements such as those safety at the workplace.
- The reduction is not sufficient to confer a competitive edge over the rivals of the recipient.
- Other undertakings receive larger subsidies, enjoy other benefits or other privileges.
- Other undertakings bear lower costs or have access to larger markets.
- The market is imperfect.

(see cases C 238/20, Sātiņi-S SIA, EU: C:2022:57; T-394/08, Regione autonoma della Sardegna v European Commission, EU: T:2011:493).

*Selectivity*

A public measure is selective when it is not general. A general measure applies to all undertakings of all sizes, in all sectors and in all regions of the country, which are in a comparable situation. A general measure does not discriminate between undertakings on the basis of their size, legal status, type of economic activity, sector or region in which they operate (see judgments in cases C-518/13, Eventech, EU: C:2015:9; C-15/14 P, European Commission v MOL, EU: C:2015:362; C-270/15 P, Belgium v European Commission, EU: C:2016:489).

Discrimination occurs when similar undertakings are not treated equally or when dissimilar undertakings are treated equally. Therefore, to determine whether a public measure is selective it is first necessary to identify, in view of the objective of the measure, the undertakings which are in a comparable legal or factual situation. Then it must be verified whether comparable undertakings are treated differently so that certain of them are favoured over others. This implies that the remaining undertakings are subject to unfavourable discriminatory treatment.

For example, a measure that subsidises investment in poor regions discriminates against comparable companies in rich regions. It is irrelevant that companies in rich regions may not need subsidies. The concept of State aid is objective in the sense that it is not based on an assessment of need. The aims or motives of an aid measure are not taken into account for the purpose of determining whether that measure falls within the scope of Article 107(1) TFEU.

State intervention that is necessary to achieve an important public policy objective can still confer a selective advantage. For example, public measures that aim to protect the environment or reduce CO2 emissions can also be selective if they discriminate in favour of particular technologies or sources of

energy. It is irrelevant that protecting the environment or preventing catastrophic climate change are public policies with high priority.

Also irrelevant is the possibly very high number of beneficiaries. A policy that favours many undertakings can still be selective.

#### *Effect on trade distortion of competition*

A subsidy constitutes State aid only when it is capable of affecting cross-border trade and distorting competition (see the judgment in case T-728/17, Marinvest v European Commission, EU: T:2019:325).

The effect does not have to be large, direct or actual. Aid to a company with a small market share may also affect trade. The recipient may not export any product itself. Nonetheless, aid may indirectly make it more difficult for competing imported products to be sold in local markets. The effect on trade need not actually occur. It is sufficient that an effect can be reasonably expected (see cases C-659/17, Azienda Napoletana Mobilità, EU: C:2019:633; C-385/18, Arriva Italia, EU: C:2019:1121).

Aid can affect trade at the level of the aided product, but also at the level of investors who may be incentivised to establish presence in the aid-granting Member State in order to benefit from its subsidies.

Only measures with purely local effect fall outside the scope of Article 107(1). The threshold for the effect to be purely local is very low. Although there is no formal threshold below which trade is considered not to be affected, the Commission has found aid not to be capable of having an appreciable effect on trade where the aided company had a very small share of the relevant market and the aid did not incentivise cross-border investment or movement of consumers or users (see case SA.48582 concerning funding of the Maritim Group for the operation of a new congress centre in Ingolstadt).

When cross-border trade is affected, in most cases competition is also considered to be distorted (see case T-747/17, Union des Ports de France v European Commission, EU: T:2019:271). This is because the aid favours certain undertakings over their competitors. It is very rare for aid to affect trade without distorting competition. In theory this is only possible when aid is granted to all competitors regardless of where they are established.

It appears that no case exists where the Commission or EU courts have concluded that aid for regional development had no effect on trade or did not distort competition.

### *2.1.3. The application of Article 107(1) TFEU to regional aid*

The EU Court of Justice has held in numerous judgments that the objective or motive of a public measure is irrelevant with respect to its classification as State aid. The only thing that matters is whether the criteria of Article 107(1) are satisfied. Therefore, the fact that an aid measure aims, for example, to promote regional development is not sufficient to exclude it from the scope of the prohibition of Article 107(1).

Accordingly, in case T-291/11, Portovesme v European Commission, EU: T:2014:896, the General Court ruled, in paragraphs 98 and 104, that a measure that seeks to offset regional handicaps (e.g. remoteness, insularity, inadequate infrastructure, small labour pool) or the higher production costs caused by the less favourable conditions in a region in comparison to those prevailing in more prosperous regions, still confers a selective advantage and cannot escape from being classified as State aid.

The prohibition of State aid applies not only to regional measures implemented by national authorities but also to aid measures implemented by regional or local authorities. A measure promoting investment in poor regions that is implemented by a national (i.e. central) authority is prima facie selective in the meaning of Article 107(1) TFEU. By contrast, a measure implemented by a regional or local authority is not automatically selective. This is because the geographic scope of application of a sub-national authority is

necessarily smaller than the national territory. Measures adopted by different sub-national authorities may vary without giving rise to selectivity and, therefore, without constituting State aid.

EU courts and the European Commission have made a distinction between "material selectivity" and "regional selectivity" (see case C-524/14 P, European Commission v Hansestadt Lübeck, EU: C:2016:971). Material selectivity means that a public measure differentiates between undertakings regardless of their location. Regional selectivity means differentiation according to the location of undertakings. This implies that a measure decided and applied by a sub-national authority may not be selective if it does not materially distinguish between undertakings established or operating in the area of jurisdiction of that authority. Then, such a measure would be "general" in that area and would escape being classified as State aid, even though it may be different from a measure that is implemented by another sub-national authority (e.g. property taxes or waste disposal charges levied by local authorities).

It must be noted, however, that the Court of Justice has laid down certain criteria for determining the absence of selectivity for measures adopted by sub-national authorities, the most important of which is that they are empowered to decide autonomously without interference from the central government and that the central government does not compensate them for the funds that are used to promote, for example, investment in the region (see case C-88/03, Portugal v European Commission (Azores), EU: C:2006:511).

### *2.1.4. Compatibility of regional aid with the internal market*

*Powers of the European Commission*

The European Commission is the sole public authority in the EU with powers to determine the compatibility of State aid, including regional aid, with the internal market.

As recently confirmed by the General Court, in case T-263/15 RENV, Gmina Miasto Gdynia v European Commission, EU: T:2021:927, paragraph 207, the assessment of the compatibility of aid measures with the internal market, under Article 107(3) TFEU, falls within the exclusive competence of the Commission (see also C-654/17 P, Bayerische Motoren Werke and Freistaat Sachsen v European Commission, EU: C:2019:634, paragraph 79 and the case-law cited therein).

In case T-778/17, Autostrada Wielkopolska v European Commission, EU: T:2019:756, the General Court ruled that "(179) the Commission enjoys a broad discretion in the application of Article 107(3) TFEU, the exercise of which involves complex economic and social assessments". And, the Court of Justice has confirmed that the Commission enjoys "wide discretion" in this regard (C-654/17 P, BMW v European Commission, paragraph 80).

Moreover, the Commission is not bound by its past decisions, as State aid is an objective concept and each case must be assessed on its own merits.

In addition, the Commission may change the regulations and guidelines it adopts. As held by the Court of Justice, "(73) the Commission cannot be deprived of the opportunity to lay down stricter conditions for compatibility if developments in the common market and the objective of ensuring undistorted competition on that market so require" (case C-110/03, Belgium v European Commission, EU: C:2005:223).

However, the discretion of the Commission is not unlimited. Its decisions may not deviate from the principles laid down in the Treaty and the case law of the Court of Justice. They are also subject to review by the courts of the European Union.

*The status of regional aid guidelines*

In the exercise of its discretion, the Commission may issue guidelines to help Member States to design aid measures that it can authorise when they are notified to it (see case C-526/14, Tadej Kotnic, EU: C:2016:570, paragraph 39; C-654/17 P, BMW v European Commission, paragraph 81).[4]

Commission guidelines must also comply with the principles in the Treaty itself, as interpreted by EU courts, such as that the aid must be necessary and proportional. In case T-27/02, Kronofrance v European Commission, EU: T:2004:348, the General Court examined whether the Commission had enforced correctly the so-called "multisectoral framework on regional aid for large investment projects." It held that "(89) while it is certainly true that, on the basis of its wording alone, the multisectoral framework could be understood in the sense claimed by the Commission, the framework must none the less be interpreted in the light of Article (107 TFEU) and of the principle of incompatibility of public aid set out therein, in order to attain the objective sought by that provision, namely undistorted competition in the common market." On appeal, the Court of Justice added that guidelines must "(65) not depart from the proper application of the rules in the Treaty, since the texts cannot be interpreted in a way which reduces the scope of Articles (107 TFEU) and (108 TFEU) or which contravenes the aims of those articles" (C-75/05 P, Germany v Kronofrance & Commission, EU: C:2008:482).

Even though guidelines are not binding on the Member States, the Commission, as the institution that adopts them, may not deviate from them (see case C-431/14 P, Greece v European Commission, EU: C:2016:145, paragraphs 69 and 70; C-654/17 P, BMW v European Commission, paragraph 82).

The same applies to the guidelines on regional aid. "(147) Although the Guidelines on regional aid, (which are) internal measures adopted by the administration, cannot be regarded as rules of law, they nevertheless form rules of conduct indicating the practice to be followed from which the administration may not depart, in an individual case, without giving reasons which are compatible with the principle of equal treatment […] Such rules may produce, under certain conditions and depending on their content, legal effects" (T-60/06 RENV II, Italy v European Commission, EU: C:2016:233).

In other words, if the Commission deviates from its own guidelines, affected Member States and undertakings that are individually and directly concerned may initiate legal action under Article 263 TFEU for the annulment of a Commission decision.

This is because "(43) the effect of the adoption of the guidelines […] is equivalent to the effect of a limitation imposed by the Commission on itself in the exercise of its discretion, so that, if a Member State notifies the Commission of proposed State aid which complies with those guidelines, the Commission must, as a general rule, authorise that proposed aid" (C-526/14, Tadej Kotnic).

This immediately raises an important question. What happens if a Member State wants to deviate from Commission guidelines? The Court of Justice has given several answers to this question. First, Member States are always free to request the Commission to assess their measures directly on the basis of the Treaty. "(43) Member States retain the right to notify the Commission of proposed State aid which does not meet the criteria laid down by (the guidelines) and the Commission may authorise such proposed aid in exceptional circumstances" (C-526/14, Tadej Kotnic). However, Member States must explain why the guidelines are not suitable for the assessment of the compatibility of the aid with the internal market. Moreover, if the Commission refuses to grant that request, it must explain its reasons (C-431/14 P, Greece v European Commission, EU: C:2016:145, paragraphs 71-72).

[4] For an assessment of the 2014-21 Regional Aid Guidelines, see: (Wishlade, 2013[40]), (Todino and Zanazzo, 2013[32]) and (Otter and Balasingham, 2013[33]). For a detailed explanation of the currently applicable Regional Aid Guidelines, see (De Marez and Pielmus, 2022[34]). For analysis of the effectiveness of regional State aid, see (Ambroziak, 2016[24]), (Ambroziak, 2014[35]) and (Friederiszick and Merola, 2015[36]).

Second, even if the Commission assesses a measure directly on the basis of the Treaty, it is incumbent on it to exercise the discretion it enjoys and to comply with the requirements of the Treaty. “(83) The Commission cannot, by adopting guidelines, waive the exercise of the discretion that Article 107(3) TFEU confers on it. Therefore, the adoption of (guidelines) does not relieve the Commission of its obligation to examine the specific exceptional circumstances relied on by a Member State, in a particular case, for the purpose of requesting the direct application of Article 107(3) TFEU” (see C-654/17 P, BMW v European Commission, paragraph 83; see also C-526/14, Tadej Kotnic, paragraph 41).

In other words, even though Member States are not bound by Commission guidelines and even though they may ask the Commission to apply the provisions of the Treaty directly, the Commission still retains discretion and may refuse to authorise the aid that it finds not to be necessary or proportional to the attainment of the objectives of the Treaty.

### *Combining aid for investment costs and aid for wage costs*

The rules on regional aid allow Member States to support investment or job creation or a combination of the two. Article 14(4) of the GBER stipulates that: “The eligible costs shall be as follows: (a) investment costs in tangible and intangible assets; (b) the estimated wage costs arising from job creation as a result of an initial investment, calculated over a period of two years; or (c) a combination of points (a) and (b) not exceeding the amount of (a) or (b), whichever is higher.”

Article 4(12) further stipulates that “Where the aid intensity is calculated on the basis of paragraph 4(c), the maximum aid intensity shall not exceed the most favourable amount resulting from the application of that intensity on the basis of investment costs or wage costs. For large investment projects the aid amount shall not exceed the adjusted aid amount calculated in accordance with the mechanism defined in Article 2, point 20.”

It follows from the above that if, say, the investment costs of a project are 80 and the wage costs over two years are 60, the total eligible costs are 80, not 140. If the regional aid intensity is, say, 25%, then the maximum amount of aid that can be granted to the project is 20 (= 80 x 0.25).

This result conforms with Article 14(12) of the GBER because the maximum aid for investment is 20 while for aid is 15 (= 60 x 0.25). Article 14(12) allows aid up to the maximum possible for investment aid separately or wage aid separately, whichever is higher.

In this hypothetical example, a Member State may decide to grant, say, 15 for investment and 5 for the cost of jobs. But whichever combination of investment and wage aid is used, the combined total amount of aid may not exceed 20.

Paragraph 24 of the RAG lays down a similar definition of eligible costs. Accordingly, “the eligible costs are as follows: (1) investment in tangible and intangible assets; or (2) the estimated wage costs arising from job creation as a result of an initial investment, calculated over two years; or (3) a combination of part of the costs referred to in point (1) and (2) but not exceeding the amount of (1) or (2), whichever is higher.”

Therefore, the same rule on the combination of investment and wage costs applies to large investment projects. If, say, the costs are EUR 120 million and EUR 60 million, respectively, and the regional aid intensity is 35%, the maximum scaled-down amount of aid can be derived by applying the formula for scaling down to the amount of EUR 120 million, not EUR 180 million. That is, the maximum amount of allowable aid is EUR 28.63 (= (50 x 0.35) + (50 x 0.35 x 0.5) + (20 x 0.35 x 0.34) = 17.5 + 8.75 + 2.38). The derived aid intensity is 23.9% (=28.63/120).

## 2.2. Lessons learned from the European Commission's decisional practice on large investment projects

### *2.2.1. Preliminary considerations*

Article 2(52) GBER defines as "large investment project" any initial investment whose eligible costs exceed EUR 50 million. The same amount is fixed at point 20(l) of the RAG 2014-20 and at point 19(18) of the RAG 2022-27.

Pursuant to Article 4(1) GBER, Member States must notify individually any regional investment award whose amount exceeds "the 'adjusted aid amount' of aid, as calculated in accordance with the mechanism defined in Article 2, point 20 for an investment with eligible costs of EUR 100 million". Furthermore, Article 14(12) GBER on regional investment aid stipulates that the maximum allowable aid for large investment projects may not exceed the scaled-down amount derived from the mechanism defined in Article 2(20) GBER.

The mechanism in Article 2(20) adjusts downwards aid amounts on the basis of this formula:

**R × (A + (0.5 × B) + (0 × C)), where:**

R is the standard aid intensity defined by the Regional Aid Map for the area where the investment takes place.

A is the initial EUR 50 million of eligible costs.

B is the part of eligible costs between EUR 50 million and EUR 100 million.

C is the part of eligible costs above EUR 100 million.

For example, in an area with standard aid intensity of 20%, the relevant threshold is 0.2 x (50 + 25) = EUR 15 million. For areas with aid intensity of 30%, the relevant threshold is 0.3 x (50 + 25) = EUR 22.5 million.

The RAG also make use of the same formula to scale down the maximum allowable aid. However, it differs from the formula defined in the GBER in one important aspect. Instead of zero-rating amounts over EUR 100 million it allows aid at a factor of 0.34 of the standard aid intensity applicable to the region concerned; i.e. the RAG formula is:

**R × (A + (0.5 × B) + (0.34 × C)).**

The use of this variable formula has three implications. First, projects exceeding EUR 50 million receive proportionately less aid than projects which are smaller than EUR 50 million. For example, the proportion of aid for a project of EUR 50 million in an area with aid intensity of 20% is 20%, while for a project of EUR 100 million in the same area the proportion of aid is 15% ((50 x 0.2) + (50 x 0.1) = 10 + 5 = 15, which is 15% = 15/100).

Second, the absolute size of a project is irrelevant if the thresholds derived from the application of the formula above are exceeded. The projects must all be notified individually and are all subject to the same degree of scrutiny by the Commission.

Third, Member States can avoid notification by reducing the amount of aid they grant. For example, Article 14(2) GBER stipulates that the maximum amount of aid for a project of EUR 150 million, in an area with aid ceiling of 20%, may not exceed EUR 15 million (= (50 x 0.2) + (50 x 0.34 x 0.2) + (50 x 0)) without notification. If instead the aid measure is notified and the aid is assessed on the basis of the RAG, then the scale-down amount is EUR 18.4 million (= (50 x 0.2) + (50 x 0.5 x 0.2) + (50 x 0.34 x 0.2)). Since the higher amount would trigger notification, given that that amount aid exceeds the threshold of EUR 15 million derived by the formula in Article 2(20) of the GBER, the Member State concerned can avoid

notification by granting aid of less than EUR 15 million. Provided all the other conditions of the GBER are satisfied, this is not illegal circumvention of State aid rules because, as less aid is granted, competition in the internal market is less affected or distorted.

In the period 2014-21, the Commission assessed about 25 large investment projects (LIPs) in only a handful of Member States: the Czech Republic, Germany, Hungary, Italy, Latvia, Portugal, the Slovak Republic and Spain with Hungary, Poland and the Slovak Republic being the most active Member States.

When the Commission assesses the compatibility of State aid for a LIP, it applies both the formal or general requirements of the RAG and the specific requirements concerning LIPs.

Formally, the Commission assesses the compatibility of notified regional aid in three stages:

- **Stage 1**: It checks compliance with the formal requirements of the RAG such as the contribution of the aid to regional development, the appropriateness of the aid, the credibility of the counterfactual scenario, the presence of an incentive effect and the proportionality of the aid. The amount of aid must comply with two caps. It must be less or equal to the maximum aid intensity laid down in the regional aid map and it must also be less or equal to the derived cost disadvantage from locating the investment in the assisted region in relation to an alternative location or not carrying out the investment.
- **Stage 2**: It verifies that the negative effects of the aid are kept to the minimum possible for the objective it seeks to achieve and that the aid does not lead to manifest negative effects that would prohibit the granting of aid such as the creation of overcapacity in a market in absolute decline, closure of facilities in other regions or relocation of the investment from a more disadvantaged region.
- **Stage 3**: It carries out the balancing of the effects of the aid to ensure that the contribution to regional development outweighs the negative effects on trade and competition.

In practice, the Commission verifies that certain positive conditions are all present, certain negative conditions are all absent and certain other negative effects are minimised (Box 2.1).

### Box 2.1. Conditions on large investment projects

**Necessary conditions: does the aid measure satisfy all of the conditions (all of the conditions below must be present):**

- The aid contributes to regional development (most often confirmed in terms of new jobs created).
- The aid is an appropriate instrument of state intervention as other instruments are less effective.
- The aid has an incentive effect because without it the project is unprofitable or more profitable in an alternative location.
- The aid is proportional in the sense that it does not exceed the minimum amount necessary to make the project profitable or cover the cost disadvantage of the assisted region.

**Prohibited conditions: does the aid measure cause unnecessary distortions or manifest negative effects? (none of the conditions below can be present)**

- The aid measure subsidises ineligible costs.
- The aid induces relocation from a more disadvantaged region or closure of a similar facility in another European Economic Area (EEA) location.

- The aid creates overcapacity in a declining sector (except where the investment would anyway take place in an alternative location).
- The aid discriminates against certain technologies without objective justification.
- The aid is inseparable from violation of other EU rules.

**Minimisable effects: does the aid have negative effects that are kept to the minimum and are outweighed by the positive effects**

- The aid strengthens the market power of the recipient or creates impediments to market entry (except where the investment would anyway take place in an alternative location).

### *2.2.2. Good practices, lessons to be drawn from the Commission's decisional practice in assessing large and single investment projects and avoidable problems*

*Good practices*

The review of Commission decisions on large investment projects leads to the following lessons:

- State aid must contribute to regional development. It must address in a coherent manner identified regional handicaps (e.g. high unemployment, low level of labour skills, rudimentary infrastructure). Typical indicators of contribution to regional development are: the number of direct and indirect jobs created, provision of training to improve local labour skills, network effects (i.e. attraction of other investors), engagement of local researchers in research and innovation projects, etc.
- State aid must be an appropriate instrument. For regions eligible for aid under Article 107(3)(a), State aid is normally considered to be appropriate to address quickly and effectively regional handicaps and bottlenecks (e.g. as opposed to public spending in improving the local infrastructure or the skills of the local workforce). Aid in the form of a grant is normally justified on the grounds that other aid instruments such as soft loans or guarantees contain less aid in terms of the gross grant equivalent and that the smaller amount of aid is not sufficient to bridge the financing gap between the aided region and the best alternative location or to bring the NPV of the project to positive territory with sufficiently high internal rate of return (IRR). Annex A provides an overview of the calculation of the gross grant equivalent of State aid. It examines various instruments of state intervention to support regional economic activities and explains how the presence of State aid can be determined and how the amount of State aid that is embedded in such instruments can be calculated.
- No State aid has ever been approved in the absence of an incentive effect. This is even more so in the case of large investment projects which are subject to more intense scrutiny by the Commission. The aid recipient must do something extra with the aid. That is, the investor must carry out a project that is not viable without the aid or choose a different, more prosperous and less costly location without the aid.
- Aid recipients must comply with both the formal and the substantive incentive effect. The formal incentive effect is demonstrated when the aid application precedes the start of work, while the substantive incentive effect is proven by counterfactual analysis.
- For the vast majority of large investment projects, the decisive element is the existence of a substantive incentive effect. However, it may be difficult to prove that the formal incentive effect is satisfied when the investment is intended to diversify the output of an existing capacity by using the output of that existing capacity as input into the new process. In this case, it is necessary for the aid applicant to provide documentary evidence that shows that its supervisory or management board had not considered the possibility of diversifying into the new product when it decided to carry out the first investment.

- The substantive incentive effect of aid for large enterprises must be established even when the aid is granted on the basis of the GBER and the amount falls below the individual notification threshold.
- There are two different counterfactual scenarios. In "scenario 1" (or "investment scenario") cases, the counterfactual is that where without the aid the investment is not undertaken in any location because its NPV is negative or the IRR is lower than the weighted average cost of capital (WACC) of the project (see below). In "scenario 2" (or "location scenario") cases, the counterfactual is that where the investment takes place in an alternative region with a positive NPV or with IRR exceeding the WACC of the project (see below). More than one alternative location must be considered. Scenario 1 cases are rare (e.g. SA.49580: BorsodChem (HU)). In fact, the vast majority of cases reviewed to prepare this paper are based on scenario 2.
- Scenario 2 cases have an inherent advantage over scenario 1 cases. Because the investment would take place anyway, but in an alternative location, the aid itself is considered not to have a negative effect on competition. Therefore, it is easier for Member States to prove the compatibility of the aid with the internal market.
- In scenario 2 cases, State aid offered by other regional authorities in the EEA may not be taken into account. The aid intensity in the alternative location cannot be the same or higher than that of the chosen location. However, State aid offered by countries outside the EEA may indeed be taken into account in order to determine the finance gap between two locations.
- The necessity and proportionality of aid is shown by the "financing gap" of the project without the aid (i.e. negative net present value). The financing gap must be realistic in the sense that it must not be too large and be based on reasonable assumptions. The amount of aid must not exceed the double cap of the financing gap and the maximum allowable regional aid intensity.
- Aid that is granted in instalments must be discounted at the relevant discount rate (= base rate + 1%). Investment costs and future operating revenue and costs must all be discounted at the aid recipient's WACC. The relevant WACC is the actual capital cost of the recipient (e.g. the cost of a loan and/or equity), or the internal hurdle rate of the recipient, or the typical WACC in the sector. All this information must be based on documentary evidence. Adjustments are accepted if properly justified (e.g. lower or higher WACC for an unusually innovative project or unusually risky project, respectively). State aid has an incentive effect only if the WACC exceeds the IRR of the project before aid is granted.
- The notification documents must prove the credibility of the counterfactual situation. The aid recipient must present a realistic and detailed description of its decision-making process that is documented with minutes of board meetings in the relevant time periods and other internal and external feasibility reports.
- The claimed best alternative location must be a real option that is demonstrated with contemporaneous financial calculations taking into account all quantifiable costs and revenue of investment in various possible locations. Non-quantifiable and qualitative advantages and disadvantages may also be used, but must be credible, documented and explained. Typical factors taken into account are availability of land, regulatory requirements, distance from headquarters, distance from customers, distance from suppliers, energy costs, waste-disposal costs or waste-treatment costs, available workforce with the required skills, taxes, transport costs and risks of handling hazardous chemicals, exchange rate risk, etc. Such factors vary from sector to sector, depending on their significance for different industries. Qualitative factors may also be taken into account such as political risk or security risk.
- The investment project must never be launched before the application for State aid and before the company board officially chooses the claimed preferred location.
- The "start of work" is the date on which the investor commits to carry out the project. In practice it can be established through various indicators: a decision of the board, the date of order of

equipment or machinery, the date of signing of contracts, the date of borrowing of the required funds, etc. Feasibility studies and other preparatory work are not considered to be start of work.

- Separate aid awards to sub-projects within a three-year period that make up a single investment project must be discounted to the date on which the aid to the first sub-project is granted. For Member States whose currency is not the euro, the aid must be converted to euro using the exchange rate of the date of the first award.
- Aid in all forms must be quantified and the sum must remain below the maximum allowable aid intensity for the region and the scaled-down amount. Any land that is sold to the aid recipient must be at market rates that must be established in advance by independent experts on the basis of an established methodology. Access to infrastructure or utilities must also be at commercial rates that reflect the full costs of the infrastructure or utilities.
- State aid measures that induce relocation or closure of a facility in another region have manifestly negative effects that are not compatible with the internal market. However, potential relocation outside the EEA may be accepted as a reason in favour of State aid. Similarly, closure of a facility in the EEA may not be considered to create a manifestly negative effect if the closed production and the new, aided production are not substitutes and if no assets or staff are transferred from the closed facility to the new facility.
- Company documents should ideally be in English and accompanied by independent expert valuations with respect to the value of land or buildings.
- Successful notification requires close co-operation between the aid granting authority and the aid recipient. Ideally, they should present the same “story” to the Commission and avoid inconsistencies in their explanations or their data. The aid granting authority should have pre-notification contact with the Commission. The aid recipient may be involved in pre-notification meetings with the Commission. Both the aid granting authority and the aid recipient should be prepared for a several meetings that may take place over a period of 10-12 months.

### *Avoidable problems*

A number of avoidable mistakes emerge from the analysis, which are summarised below. Member States can follow a checklist to avoid these mistakes (Box 2.2):

- **Aid is not necessary for regional development**: Aid duplicates underutilised infrastructure [Decision 2015/1586, Gdynia Airport (PL)].
- **Excessive amount of aid**: The aid exceeds the maximum allowable ceiling or does not take into account other aid previously granted to a SIP. This problem is particularly relevant to State aid granted in the form of tax incentives that can only be used in the future when the project is completed and starts generating revenue [SA.38330, PCC MCAA (PL); SA.53903, LG Chem 2 (PL)].
- **Non-credible counterfactual scenario**: The aid subsidises exaggerated local costs [SA.48556, Samsung SDI (HU)]. The alternative location is identified on the basis of an alleged and unconfirmed aid offer [SA.53903, LG CHEM 2 (PL)]. The counterfactual scenario does not make a clear distinction between scenario 1 and scenario 2 situations [SA.49579: Peugeot-Citroen (ES)].
- **Questionable or inconsistent data and analysis**: The counterfactual analysis is based on partial or incomplete data or inconsistent statistics and calculations [SA.34998, Ford España (ES); SA.47662, LG Chem Wrocław Energy (PL); SA.49579: Peugeot-Citroen (ES)].
- **Ad hoc aid**: The contribution of ad hoc aid to regional development may be questioned by the Commission. But it appears that aid for ad hoc projects that create new jobs can be compatible with the internal market [SA.38532, Parker Hannifin ESSC (PL); SA.38746, Michelin Polska (PL)].

- **State aid for extension of existing capacity of large enterprises in "c" regions**: In this situation State aid is allowed only when there is diversification into new economic activities (SA.48556, Samsung SDI (HU); SA.49579: Peugeot-Citroen (ES)).
- **State aid in the form of tax reductions or exemptions is less constrained by available budgets but more difficult to implement correctly**: This is because the authority that grants the tax exemption must not only confirm the eligibility of the investment but must also take into account other State aid that may have been granted by other authorities to the same project and must explicitly impose a limit on the amount of the tax exemption that conforms with the maximum allowable aid ceilings for regional investment [SA.53903, LG CHEM 2 (PL)].
- **Manifestly negative effects**: They must be avoided, and other negative effects must be avoided or minimised. No case involving manifestly negative effects has been approved by the Commission (i.e. counter-cohesion effect, relocation or closure). Aid to undertakings in declining sectors and to undertakings with market power should also be avoided. It appears that no case of aid in a declining sector or of aid that strengthens market power has been approved by the Commission [SA.49579: Peugeot-Citroen (ES)].

### Box 2.2. A simple checklist to avoid common mistakes

- Is the project clearly defined, are the eligible costs broken down in detail, are all positive and negative effects of the project identified and quantified?
- Are all the formal and substantive requirements of the GBER & RAG satisfied?
- In particular, has the incentive effect and the proportionality of the aid been demonstrated?
- Are all the statements/calculations substantiated with independent expert reports?
- Are the internal decisions and decision-making procedures of the aid applicant clearly presented with documentary evidence?
- Is inflation adjustment of the aid amount specified in the aid decision?
- Are manifestly negative effects excluded (violation of other EU law, capacity increase in a declining market, counter-cohesion effects, relocation)?

### *2.2.3. Dealing with large enterprises that request State aid*

Several important conclusions that bear on the dealings between public authorities and large enterprises may be drawn from the review of State aid for LIPs.

First, companies use apparently familiar terms which, however, may have a different meaning to them. Aid granting authorities should be aware that companies define projects according to their business strategy, not according to a credible counterfactual without aid, as required by regional State aid rules. Similarly, the costs they take into account are not necessarily the same as the eligible costs in State aid rules. Nor, do they start projects according to the definition of start of work in State aid law. Therefore, aid granting authorities need to ensure that the companies and themselves refer to the same concepts and numbers.

Second, it may be easier for the large enterprises to exploit State aid rules to their advantage. All of the aid beneficiaries in the cases that were reviewed to prepare this paper were not only large, but also multinational enterprises. This meant that they had multiple plants in multiple locations. This may have made it easier for them to identify an alternative location that appeared to be more suitable or cheaper than the European location in an assisted region.

It may also have made it possible for them to break down investments in distinct stages and carry out the second or third stage at a later date so that they could receive more than the maximum amount of aid that was allowed for SIPs.

Whereas quantifiable costs and revenue of alternative locations were more transparent and easier to compare, qualitative differences between alternative locations were less comparable and certainly more difficult to weigh. Unless revealed by the aid applicants, they are also more difficult to identify for granting authorities.

The amount of requested aid and the calculations deriving that amount must be scrutinised in detail. The amount of State aid is a "residual" in the sense that it is what must go into the valuation of a project to make it financially viable. The cases reviewed reveal the many different factors that companies take into account (e.g. the cost and level of skills of labour, infrastructure, country risk, ease of doing business, etc). This means that the derived amount of aid is affected by many other factors each of which on its own may not be decisive or may appear undisputable, but inevitably affects the outcome of the financial projections.

Many of the aid beneficiaries had received multiple awards of aid. This suggests that they became adept at presenting attractive cases to aid granting authorities. The promises of aid applicants in terms of jobs, training, research, etc, need to be fact-checked and be confirmed at specified milestones.

Third, the cases reviewed to prepare this paper can be summarised in two observations: i) the vast majority of the cases are based on scenario 2 analysis and ii) the alternative location was another assisted region. These two observations taken together imply that the aid applicants had already decided to launch their projects and that they were looking for the most favourable location, which is not always the cheapest. Therefore, location advantages were important. The role of State aid was to neutralise disadvantages.

Therefore, public authorities can attract foreign investment by improving their business environment without necessarily granting State aid (e.g. training the labour force, improving the infrastructure, reducing bureaucratic procedures, etc).

## 2.3. Lessons from the case law and mistakes to be avoided

Over the past decade, the Commission lost only a single case on regional aid. Another case that was lost before the General Court was subsequently won on appeal. Therefore, it is safe to conclude that in practice it is difficult for Member States to prove that the Commission's assessment of regional aid is wrong. When the Commission expresses doubts as to the compatibility of a regional aid measure with the internal market during the pre-notification stage or during the preliminary examination of the measure, the Member State concerned should amend it to eliminate those doubts before the assessment of the Commission is completed rather than challenge a negative Commission decision before EU courts.

The main issues that emerge from the review of the case law are the following:

- EU courts have reiterated in numerous judgments that Member States must notify to the Commission all regional aid that falls outside the scope of the GBER (currently Regulation 651/2014). A State aid measure falls outside the scope of the GBER either because it does not comply with all of the relevant requirements – both formal and substantive – or because the amount of aid exceeds the threshold for individual notification. Normally, State aid for large investment projects (LIPs) has to be notified individually because it exceeds the notification thresholds.
- Member States are responsible for the correct implementation of regional aid on the basis of the GBER and for determining the veracity of information submitted by aid applicants.
- An aid measure that is not fully in conformity with the GBER is automatically illegal. Illegal aid plus interest must be recovered by the granting authority of its own motion.

- The use of the GBER by Member States does not prevent the Commission from assessing aid measures. The Commission may order recovery of incompatible aid, regardless of any assurances that may have been granted to the aid recipients by Member States.
- The Commission is bound by the regional aid guidelines (RAG). However, a Member State that considers that the RAG are not applicable to its aid measure may ask the Commission to assess that measure directly on the basis of the Treaty [Article 107(3)(a) or (c)]. This is not an easy task because Member States have to explain and justify why the RAG are inapplicable. Nor, is it an option that can be recommended because it creates legal uncertainty for the notifying Member State as it is difficult to predict how the Commission may assess the measure in question.
- The Commission enjoys wide discretion in assessing the compatibility of State aid with the internal market. The Commission may assess differently regional aid under Article 107(3)(a) and under Article 107(3)(c). It may also assess differently or more strictly aid to LIPs or large enterprises. While Member States may appeal against Commission decisions, challenging the legality or validity of Commission guidelines has never been successful.
- EU courts have also reiterated in numerous judgments that:
  - A region is eligible for State aid only when it is included in the regional aid map (RAM) of the Member State concerned.
  - State aid must be capable of promoting regional development.
  - State aid must change the behaviour of the recipient so that it does something it would not do under normal market conditions.
  - The amount of aid must not exceed the minimum necessary for the achievement of its objective.
- Operating aid normally lacks incentive effect. It is only exceptionally allowed for regions eligible on the basis of Article 107(3)(a) and for a few other regions with very special characteristics and only under certain conditions. Investment aid that subsidises ineligible costs is considered as operating aid that is normally prohibited.
- Investment projects may not be artificially divided to evade State aid ceilings or to claim that the project started on a later date. Even if State aid granted before the submission for the aid application is classified as de minimis aid, the project lacks incentive effect.
- Aid to LIPs must be the minimum necessary even if the GBER allows higher aid intensity.
- Extra State aid to cover the cost overruns of LIPs is not normally permitted.

# 3 Special economic zones

## 3.1. Key characteristics and objectives of special economic zones

### 3.1.1. Introduction: trends in special economic zones and definitions

Special economic zones (SEZs) broadly refer to geographical regions – within a country or across borders – often characterised by liberal laws and special regulations to attract foreign investment, frequently for export. They have often been used as industrial policy measures to counterbalance costs of doing business and to offer enclaves of stability and efficiency. They merit particular attention given their rise in popularity over recent decades and often play a prominent role within overall efforts to attract private investment, especially foreign direct investment (FDI).

Today there are many forms and types of SEZs or economic zones (EZs). They have developed over the last 40 years and have evolved into what we now increasingly see in many emerging countries: SEZs that are not purely focused on manufacturing and export-led activities and with the objective of creating jobs in a country. The modern SEZ is not only a vehicle to attract investment and create jobs but is also implemented to generate economic growth, diversify an economy and to facilitate investments through high quality infrastructure and services aimed to limit the administrative burden of investors – often through a One-Stop-Shop (OSS).

Since the establishment of the first modern SEZ in Shannon, Ireland in 1959, the number of SEZs has increased exponentially. Early East Asian experience with export processing zones (EPZs), starting in the late 1960s, was central to the region's successful industrialisation and was followed by the reliance on SEZs by the People's Republic of China (hereafter 'China') in liberalising its economy and starting to open to FDI in the 1980s (Altenburg et al., 2020[9]). In 1986, the database of the International Labour Organization (ILO) recorded 176 zones in 47 countries (ILO, 2007[10]) but by 2006, this figure had increased to 3 500 zones in 130 countries (Farole, 2011[11]). They often play a prominent role within overall efforts to attract private investment, especially FDI.

UNCTAD has collected data on SEZs worldwide, identifying at least 5 383 SEZs in 147 economies, including almost three-quarters of developing economies and almost all transition economies (UNCTAD, 2019[12]).[5] Their number has grown rapidly in recent years and at least 500 more are in the pipeline. Most SEZs are multi-activity zones. Industry-specialised zones and zones focusing on innovation are concentrated in more advanced emerging markets. Most developed-country SEZs focus primarily on logistics. SEZs are widely used, but only a handful of economies account for the majority of them. China alone hosts over half of all SEZs in the world. Other countries with high numbers of SEZs include India, the United States (Foreign Trade Zones – FTZs) and the Philippines. Most developed economies do not have SEZs apart from free zone programmes, as the business environment in these countries is considered sufficiently attractive. Some studies have also argued that advanced economies tend to opt for

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[5] The data for this research by UNCTAD were from public sources or from relevant institutions in each economy and have been verified with national authorities where possible.

more cluster-based approaches, avoiding the heavy legal and institutional processes associated with setting up SEZs. Overall, SEZs have had a mixed record of success (Farole, Baissac and Gauthier, 2013[13]). In the Western Balkan region, the number of zones has quadrupled over the past eight years. Some governments have expanded their existing zone networks, while others have created new ones.

Despite little consistency in SEZ terminology, a common definition of SEZs is based on the following key criteria for SEZs (UNCTAD, 2019[12]):[6]

1. **Spatial:** A clearly demarcated geographical area of the national territory and/or legal space.
2. **Regulatory:** a regulatory regime distinct from the rest of the economy (most often customs and fiscal rules, but potentially covering other relevant regulations, such as foreign ownership rules, access to land or employment rules). The business environment in the zone is more liberal from a policy perspective and more efficient from an administrative perspective.
3. **National governance of SEZs:** a dedicated governance and institutional structure for efficient management.
4. **Amenities:** Infrastructure support offering physical infrastructure, facility services and provisions as well as (financial or fiscal) incentives.

Little consistency exists in the conceptualisation of "Special Economic Zones". This is often the result of:

- the need to differentiate among different types of zones to highlight differences in form and function
- policy makers and authorities using different conceptualisations to highlight uniqueness of their SEZ programme
- the difference between countries in terms of language and economic terminology.

The lack of consensus on definitions and the absence of comprehensive and reliable data make it hard to measure the true footprint and impact of SEZ programmes. Few comprehensive sets of aggregate data on SEZs exist and these sets are limited in content, geography and depth. The concept has been subject of intense, polarised debates for the last 40 years on almost every aspect of their configuration, raison d'être and impact.

SEZs around the world are similar in the way they function to facilitate trade and investment, but they differ in size, economic development purposes, physical characteristics, government incentives and the final dispensation of their products. In developing countries with little infrastructure, they may be self-sufficient city-like industrial complexes with housing, dining and banking, as well as production and transport. In developed countries, on the other hand, with extensive infrastructure and modern facilities, they are narrowly limited to production and/or transport.

### *3.1.2. The evolution of SEZs and different typologies*

The growth of SEZs over the last 20 years has created different forms and typologies of SEZs. Earlier versions of SEZs focused more on trade facilitation and were often called Export Processing Zones – EPZs).[7] EPZs were often adopted by countries to develop export-driven economies (e.g. China). EPZs

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[6] SEZs are not necessarily clusters just as clusters are not necessarily SEZs. While SEZs are normally constructed through a "top-down" approach by government policies, most clusters are formed in an organic way through a "bottom-up" process. Some clusters, however, have emerged from or within SEZs over time. To design an SEZ using a purely cluster approach might be possible but can also increase the risk of failure unless the market signals are clear and the government has perfect understanding of the domestic comparative advantages and market situations (both domestic and international).

[7] These type of SEZs allow entry of raw materials, components and finished goods of foreign origin and subsequent re-export without being subjected to customs duties. In many zones, foreign traders may warehouse, manufacture, process, label or package goods without the host nation applying its tariffs or import controls on the merchandise in

have evolved substantially since their first inception and have diversified both in terms of form and scope. Geographically, EPZs have evolved from fenced-in zones to include anything from single factory/company zones to zones encompassing a much wider area.

While EPZs used to target foreign investors, increasingly both foreign and domestic companies coexist in the zones. Though export-oriented textile and garment manufacturing has in many countries been the linchpin of their free zones, EPZs have also played host to many other industries such as shoes, jewellery, pharmaceuticals, vehicles, chemical goods, food products, metals, plastics, chemicals, refineries or data entry processing.

Traditional EPZs share common characteristics:

- focus on manufacturing
- location in a fenced-in enclave, often in more remote areas
- a government monopoly on zone development and management
- high minimum export requirements (i.e. 80% or even higher)
- focus on attracting FDI
- duty-free and tax-free inputs for manufacturing production only
- generous fiscal incentives
- often limited processing time (i.e. goods admitted into free zones must be re-exported within a set time, usually six to 12 months, or incur full duties)
- an extended view of extra-territoriality.

The types of activities within EPZs have also evolved: traditional production of goods such as textiles and clothing is still common but many new zones specialise in particular goods sectors such as electronics and chemicals, or in services sectors such as IT and financial services. In addition, ownership patterns have changed: initially, EPZs were owned and managed by governments but there is increasingly private involvement. The requirement that all production must be exported has been relaxed in many new zones and the supply of goods and services is increasingly allowed in the domestic economy upon payment of duties.

The variety and complexity of zones have increased over the years as more countries have adopted various trade promotion zones for an ever-larger variety of traded goods and services. Modern EPZs often have more flexible rules with regard to export requirements, e.g. some EPZs allow for domestic supply although these products and services are treated as imports and subject to the same trade rules including tariffs.

Table 3.1 shows the variety of SEZs that has emerged over the years and lists various SEZ typologies. Industrial parks can offer good infrastructure and facilities for incubation without any specific fiscal incentives; Manufacturing-based zones (the traditional EPZs) can provide trading infrastructure, liberalised import-export regulations and incentives; while free trade zones represent duty-free areas with bonded warehousing, storage and trade facilities. More recently, special-purpose zones have emerged to support science and technology activities, while eco-industrial zones, such as the Atlantis SEZ in South Africa, focus on efficiencies in water and energy use and management (Grant, Carmody and Murphy, 2020[14]). SEZs can also combine the offer of better infrastructure with technical capacity building to entrepreneurial and management training, especially if training institutes are strategically located within the zone (Altenburg et al., 2020[9]).

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the zone. Customs duties are levied and import controls are applied only when the foreign goods are removed from a zone for use or consumption in the host country.

## Table 3.1. Examples of different SEZ typologies

| Trade-based zones | Manufacturing-based zones | Service-based zones | Science-intensive zones | Comprehensive and cross-border zones |
|---|---|---|---|---|
| Free Port | Export processing zone | Free banking zone | Incubator | Comprehensive free port |
| Free State/City | Free export zone | Free insurance zone | Research park | Free economic zone |
| Customs free zone | Industrial free zone | Free medical zone | Research triangle | Comprehensive free trade zone |
| Duty free zone | Free production zone | Free tourist zone | Science park | Free zone |
| Tax free zone | Investment promotion zone | Free service zone | Technology park | Growth triangle |
| Free trade zone | Free enterprise zone | | | Cross-border economic co-operation zone |
| Transit zone | Maquiladora | | | |
| Free border zone | Free agricultural zone | | | |

Source: Adapted from Guang-Weng (2005[15]), Evolutionary model of free economic zones, https://link.springer.com/content/pdf/10.1007/s11769-005-0002-1.pdf?pdf=inline%20link.

The rapid pace of global and multilateral trade integration and trade liberalisation and growth of the technology-based and service industry have caused a shift to a much broader view of SEZs than in the past, when SEZs were little more than a vehicle to create jobs and increase exports, and sometimes to create backward linkages, mainly in a remote enclave.

Increasingly, zones are viewed as a mechanism to promote two-way trade and to facilitate liberalisation and modernisation of the host economy. The new emphasis is to integrate free zones with the domestic economy. This view has led to greater specialisation of zones; greater emphasis on cluster development through inclusion of business support services and logistics; and new governance and management structures. The new emphasis on SEZs has resulted in a set of more liberal policy and operational features, common to many new free zone regimes, which were largely absent from earlier generations of free zones. These include:

- expansion of activities permitted within zones to include commercial and professional services (such as warehousing, transhipment, IT) in addition to all types of manufacturing and processing
- equal treatment of foreign and domestic investors and of different forms of incorporation
- incentives for private developers to establish privately-owned and operated zones, sometimes – but not necessarily – in partnership with public sector bodies
- relaxation of minimum export requirements, which facilitates integration of zone production into global supply chains and also conforms more closely to WTO rules. Allowing zone developers and other private entities to supply utilities services and goods to tenants of free zone estates by treating them as indirect exporters
- harmonisation of fiscal incentives for all promoted activities, replacing a separate incentive regime for free zones
- increasing focus on liberalised and streamlined policies and administrative procedures, as opposed to fiscal incentives, as the basis on which free zones compete with one another
- introduction of the concept of “constructive/indirect exports” for suppliers of Free Zone companies located in the domestic economy, in order to encourage greater linkages between the two
- “built-to-specification” infrastructure and policies, whereby zones are tailored to specific needs of targeted economic clusters and sectors of activity

- increased "knowledge" focus, along with improved labour standards and human resource development training schemes.

Many newer SEZ developments have also become specialised by sector, with increased focus on tradable services and logistics. In developing such specialised zones, countries seek to provide much more focused support and facilitation which they hope can help in the creation of internationally competitive clusters. Table 3.2 highlights the differences between the more traditional EPZs and more preferred SEZs.

### Table 3.2. Traditional SEZs versus more preferred SEZs

| Concepts | EPZs and FTZs | SEZ and EZs |
| --- | --- | --- |
| Strategic objectives | Export led growth and industrialisation | Economic diversification and economic growth |
| Motives | Politically driven | Economically driven |
| Location | Developing economies | Emerging economies |
| Organisational structure | Public sector owns, develops and operates the EPZs | Private sector develops and operates the SEZs |
| Services and incentives | Fiscal incentives with export-oriented amenities | Non-fiscal incentives with multiple use infrastructure |
| Type of activities | Trade and traditional manufacturing, production | Goods sector, logistics but increasingly also services |
| Legislation | Rigid and narrow | Liberal and flexible |

Source: van den Berghe (2021[16]), The need for a new FDI model, https://investmentmonitor.ai/global/is-the-fdi-model-still-fit-for-purpose.

Newer SEZs, instead of being conceived principally as export drivers and magnets for FDI, are intended as liberalised platforms for diversified economic growth that not only could but also should spill over into the national economy. This newer conception, which reflects the influences of regional and global trade integration and of the rise of logistics as one of the most critical success factors in international business, has led to newer approaches to the design, management and operation of zones and to the incentives and rules that define their offerings to international and domestic investors. Modern SEZs are largely focused on providing an internationally competitive business environment.

### *3.1.3. Key policy objectives of SEZs*

By the latter half of the 20th century, SEZs had become a widely used tool to promote economic development. Traditionally, the primary objective of SEZs has been to attract investment, often export-oriented FDI (in export processing zones – EPZs – for instance), and to create jobs, by providing various fiscal and non-fiscal incentives for zone investors (OECD, 2017[17]). Promoting regional development is another common objective of SEZs – yet the regional disparities that SEZs are often created to address are frequently also the same factors that can contribute to their failures (Farole, Baissac and Gauthier, 2013[13]). Depending on the policy objectives, SEZs thus come in different forms. These objectives can include facilitating cross-border trading to spurring broad economic reform programmes. Whilst there are many reasons behind the deployment of SEZs, they are typically concerned with achieving one or more of the following economic and policy objectives:

- **Attracting and promoting FDI.** The vast majority of SEZs are created to attract greater levels of FDI within the host country and as such, through its liberalised regimes, can be used to attract more investment to a country. The creation of SEZs can highlight to foreign investors that a country is committed to foreign investment and can incentivise investment and that the country has a competitive and transparent business environment. SEZs in emerging countries can also reduce the risks for investors within locations and markets which are considered challenging.

- **Support economic diversification.** Economic diversification objectives are often a key driver in SEZ implementation, particularly for countries which are over-reliant on specific natural resources, to support long term economic growth and facilitate the transition towards a less resource-based economy.
- **Facilitate knowledge transfer.** A further benefit of SEZs is the transfer of knowledge and innovative processes from investors into the SEZ and wider economy. SEZs often target investors that have the potential to transfer new business and management models and industrial processes into the economy, as well as more efficient business operations and behaviour.
- **Facilitate employment creation and skills upgrading**. A large number of SEZs have been implemented in areas of depressed economic growth and high unemployment to stimulate significant job creation, reduce poverty rates and increase living standards. The creation of SEZs can also facilitate human capital development, reduce social problems, generate government revenue streams (from income taxation), reduce government expenditure on unemployment benefits and provide markets for domestically produced goods and services. Investors can also be targeted on the basis that they will create job opportunities with higher-level skill requirements and that this will in turn improve overall skill levels across the local labour force.
- **Wider economic reform within countries and experimentation.** SEZs can assist in wider economic policy reform by allowing countries to experiment with more liberal policies and regulations. SEZs in this case can be seen as 'boxes of economic experimentation'. This approach is often implemented in countries where reform is contentious, allowing governments to build the political capital necessary for the implementation of nation-wide economic policy reform.
- **Creating hubs or clusters of specialised economic activity.** For many governments adopting SEZ strategies, a key consideration is how to quickly develop clusters of industrial activity that will become specialised, internationally differentiated and create high-value products and services.
- **Deepening and extending industry and global value chains.** A primary objective underpinning many plans for SEZ development is an attempt to extend and deepen industry value chains, often pursued where existing industrial activity provides a basis for moving further into downstream (and sometimes upstream) value chain segments. The SEZ policy in these cases is often geared towards attracting investors that can essentially 'tap' into the value chain gap and create a deeper industry value chain in a country.

### *3.1.4. The success of SEZs and the way forward*

Although there are more than 5 000 SEZs around the world today, the success and economic performance of SEZs are mixed and, as shown below, in many cases SEZs underperform in achieving their initial goals and objectives. Similarly, SEZs have not been able to make the necessary transition in line with the changes in the global economy.

Traditional SEZs could often deliver static gains (i.e. investment attraction, increased exports and job creation) but have not been able to deliver upon the sustainable dynamic gains to facilitate broader economic goals like economic diversification, sustainability, poverty reduction and an upgrade of the economy. This can be related to the fact that these SEZs remained focused on sources of competitiveness that are unlikely to remain sustainable in the future (e.g. cheap labour, preferential market access and fiscal incentives). Such traditional sources limit governments' ability to build competitiveness in parallel through investment in skills development, education and integration of SEZs in the local economy. These zones became over-reliant on particular sectors and locked-in, with little scope for diversification or upgrading. Traditional SEZ models need to innovate with new means of maintaining and developing their competitiveness but have not been able to do so.

A recently developed SEZ model, based on best practices of SEZs of the past 30 years, highlights three dimensions upon which SEZs need to focus in order to be successful in the future (van den Berghe,

2022[18]). Van den Berghe (2022) argues that: “the classical foundation upon which the competitiveness of SEZs rests – the combination of a (tax) incentive package and a real estate solution for investors – has become obsolete. Increasingly, SEZs award a standardised package of incentives that consists of a corporate income tax holiday in combination with preferential import and export duty treatment and other tax exemptions. When striving to diversify their business environment and create unique competitive advantages, SEZs need to move away from overgenerous fiscal incentives that exclusively focus on increasing profit margins. These low-cost and low-tax business environment strategies are easy to copy and replicate and do not equip free zones with a distinctive source of competitiveness.”

The model shows where SEZs of the future should ideally be positioned and operate, at the interface of the following three dimensions:

- **Sustainability**: including the Sustainable Development Goals (SDGs). The potential for many SEZs to contribute to sustainability are large. SEZs can implement sustainable forms of energy production like solar and wind energy on their sites or introduce waste management systems and electrical vehicles on their premises. Although many SEZs are doing so already, several are still behind. The SDGs can also be implemented within the companies operating in SEZs by promoting and enabling responsible business conduct. Creating safe places to work or providing decent pay for workers and equal treatment and pay for all are just some of the practices which can be promoted within SEZ companies
- A high-class **infrastructure** and focus on **innovation** and services and facilities. SEZs should move beyond the provision of fiscal incentives and focus more on the facilities and services they provide to SEZ companies. An obvious example is the provision of OSSs for inward investors, but it could also be cloud storage and onsite data management. Some SEZs are already starting to provide recruiting services for SEZ companies.
- **Economic development** aiming to have the highest possible development impact. Future SEZs need to increase the economic impact in host economies. They should not operate in isolation but be part of the national economy. Working with local suppliers or universities are just some of the forms through which this can take place. In addition, SEZs should also be open for domestic companies.

The implementation of this framework and model by existing and newly established SEZs may lead to a new generation of SEZs over the coming years.

## 3.2. SEZ governance and legal frameworks

### *3.2.1. SEZ stakeholders*

The governance of SEZs largely depends upon the main stakeholders (and associated institutional structure and organisation) as well as the ownership of SEZs. There are multiple key stakeholders within the SEZ environment and the smooth interface between them will determine the success of any SEZ.

#### *Regulator or authority*

This is the body responsible for designing and administering the zone regime, which is often from the public sector. Ideally, a country should have dedicated and specific SEZ laws or the regulator should establish a SEZ authority with specific SEZ governing laws and regulations. Its short-term goals are generally focused on attracting investment, generating exports and creating local employment (static). In the longer term, the regulator is concerned with the socio-economic impact on the local economy and how the zone programme contributes to meeting wider economic policy objectives, particularly diversification and upgrading (dynamic). Political economy factors may play an important role in government decision making and may

skew the time horizon and goals from those of the wider society (e.g. locating in zones that are remote and rural rather than in locations with economic opportunities).

The regulator usually has the following tasks:

- Designate public and private land as SEZs and public or private landowners or their agents as SEZ developers/operators.
- Facilitate licensing, permitting, and regulatory services within the SEZs, particularly relating to land use, regulation (including foreign work permits), and inspections; This may also include business registration, utility regulation, and dispute resolution. The regulator may set fees commensurate with the cost of service.
- Monitor compliance with the SEZ legal framework, including SEZ policies, standards and requirements, and enforce compliance through appropriate penalties.

#### *Developer*

The developer is charged with developing the infrastructure for the SEZ, whether through a public-private partnership (PPP), joint venture (JV) or privately, sometimes this may include financing the SEZ, designing and constructing the infrastructure and facilities. The developer usually has the following tasks:

- Land use planning: create a final land-use master plan and prepare the land accordingly (grading, levelling, and other preconstruction activity).
- Provision of infrastructure: internal road networks, drainage and sewerage, and conduits and infrastructure for utilities. Note that, in most cases, offsite infrastructure is the responsibility of the government.

The developer may be the zone owner or a separate entity under contract with the owner or authority to physically develop the site. In the case of public SEZs, the government or SEZ authority often acts as the zone developer, providing the master plan and financing for construction. In the case of private SEZs, private companies own and develop SEZs, fronting the necessary capital and assuming financial risks. Hybrid – or PPP models – retain public ownership of a zone but contract with a private developer.

A specific case is the so-called ‘SEZ development corporation’, which is created to operate as an SEZ land bank; launch the development with public funds and administer a country’s flagship SEZs; ensure through collaboration with the concerned bodies that necessary connective infrastructure is in place; outsource public SEZ management; as well as promote SEZs and attract investment. In this case the zone development corporation can be the predominant service provider in the SEZs (at least for a time). An SEZ Development Corporation should ideally be a private-sector firm or a PPP or JV. The entity could own the SEZ in its own name, co-own it with the government, or receive a concession from government to develop and operate it. The entity will then finance, design, plan, and manage the development and operation of the park’s infrastructure and facilities. The entity typically subcontracts for discrete construction and other tasks (i.e. waste removal and treatment, maintenance, security, etc.). It also manages day-to-day service provision within the park, as well as markets, leases or sub-leases its land and buildings.

#### *Operator*

The operator (or manager or administrator) is the entity responsible for day-to-day management of one or more SEZs and may or may not also be the developer. Management will be done through a PPP, JV, or a private structure. The authority will grant licences to operators. The tasks of the operator usually are:

- Facility leasing: manage lease and rental agreements with investors and assume responsibility for main services of the zone (e.g. maintenance, security).

- Utilities provision: ensure provision of onsite utilities (electricity, gas, water, telecommunications) through own provision or via domestic providers.
- Provision of other value-added services: may include a wide range of services, such as business and training centres, medical and childcare services, transport, and recruiting.
- Marketing: experienced private developers often have a network of multinational clients across a range of industries to which they can market new opportunities.

Zone developers and operators may be private or public entities. The objectives of private entities are broadly similar to those of investors: they are looking to maximise profits, which for them come through attracting investors into their zones and, in the longer term, developing new revenue streams that tap into the value-added services required by high-quality investors. Public developers and operators may not have the same profit objectives, but the proximate goals of attracting investors and meeting their day-to-day needs should be the same.

#### *Occupants*

Occupants (or users, tenants or investors) are the companies (foreign and domestic) and private sector investors in the zone. They are the main end-users of the zone but may also include service providers that enhance the zone value-added. These are the investors that will use the SEZ as a platform to conduct their business. They will not be limited to foreign investors, as international best practice indicates that allowing domestic occupancy greatly contributes to the success of a SEZ.

Appropriability of profits is mentioned for several reasons: it captures the effects of tax holidays and other fiscal incentives common in many zone programmes; it takes into account issues of exchange control and the ability to repatriate profits, which most zone programmes guarantee but which are issues for foreign investors in some markets; and it allows for the impact of broader aspects of the investment climate on the risk calculation of investors. The time period will vary depending on the industry and the firm's strategy.

#### *Goods and service providers*

These are domestic business that reside in the customs territory but provide the SEZ with goods and services. The authority shall grant licences to service and goods providers that supply the developer, operator or occupants of the zone. The licence will serve as a mechanism to facilitate the backward linkages into the domestic economy and allow for the ease of monitoring from a customs law enforcement and tax compliance perspective of both goods and persons coming in and out of the SEZs.

#### *Other (governmental) stakeholders*

Other stakeholders include the wider government (Ministry of Economy for trade and company registering and permitting, Ministry of Housing for development permits), port authorities, customs, IPAs, owners and other entities and groups with a vested interest in the zone and its environs. It may include municipalities, community organisations, local leaders, non-governmental organisations, unions, etc.

- *Utility companies:* for the SEZ to operate and get access to water, electricity and other utilities, the SEZ developers and operators need to closely co-operate with (often governmental) utility companies and draft contracts and memorandums of understanding.
- *Agencies:* often ministerial departments involved in the one-stop-shop (OSS)[8] of the regulator.

[8] A "one-stop shop" is a way to sweep away unnecessary paperwork and create a streamlined and easy-to-use interface between government and citizens or business. Indeed, OSSs can be a very effective way to communicate regulatory requirements more clearly (OECD, 2020[40]). Many SEZs implement OSSs to facilitate inward investment through a more streamlined, structured and efficient administrative process which takes away the hassle for companies to set up a company in a country. In many cases, the SEZ companies, depending on the country in which the SEZ is

- *Urban Support Area Developer:* this developer will be granted a special licence to develop an area adjacent to an SEZ for habitation along with the supporting infrastructure.

Successful SEZ regimes or frameworks are designed in co-operation with these and all other stakeholders.

### *3.2.2. SEZ governance models*

Different governance models can be established. Some of the guiding principles can be followed for effective SEZ governance structures, in particular for the regulatory authority:

- Separate – as much as possible – the regulatory functions of an SEZ regime from the development and operation roles so as to prevent conflicts of interest that might arise if the regulator is providing oversight to its own zone operations.
- Establish the SEZ Authority as a strong regulator of the zone. The regulatory functions of the Authority – planning, licensing, regulatory monitoring – should be well supported, and the institutional structure of the Authority should reflect this
- In some cases, the developer and operator of the zone are the same private entity. In these cases, the zone developer arranges for its own financing, and its investment is paid back over time through land and building leases and rentals and fees charged for other zone services.
- Ensure regulatory authorities are autonomous, empowered, focused, and private-sector-oriented to most effectively designate parks, license and monitor developers, and co-ordinate concerned public agencies.
- Establish the SEZ regulatory authority as an autonomous government agency, with sufficient visibility and responsibility within government.
- Ensure the SEZ authority has, in key areas, authority over other government agencies, with regard to SEZ developers, operators and users. It should have autonomy over human and financial resources, including: flexibility over hiring and termination of employees; ability to offer competitive compensation; ability to procure contractors easily; and financial independence with dedicated budget. It should also have private-sector standards for customer service, and be focused primarily on regulation, rather than on investment promotion or park development (with the latter functions best carried out by other public and private-sector entities).
- Moreover, it should have a corporate organisational structure with the following: a Board of Directors providing oversight; representative officials responsible for industry, labour, finance and the economy, as well as regional, state and municipal officials; and private-sector representation. Finally, it should have professional managing executives leading day to day functions, and a clear, functions-based and client-oriented, departmental organisation.
- Provide the SEZ regulatory authority with the legal authority to perform a wide range of government functions. It should also have a mandate to facilitate functions performed by other government entities, under a full set of Best Practice Interagency Memorandums of Understanding (MoUs) between the SEZ regulator and these bodies. Furthermore, it should provide SEZ users with one-stop access to all government and business services, including: investment licensing and registration; construction permits, expatriate services and work visas, environmental permitting and monitoring; labour compliance monitoring; administrative and commercial dispute or complaint resolution services; tax compliance; customs clearance; utilities connection and management; and business support services (e.g. notarial, legal, accounting, financial advice and ICT services, etc.). Finally, the authority should be responsible for designating new SEZs, selecting developers, and approving master plans.

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located, get a preferential treatment when they establish on a SEZ site. Different services are often provided through a SEZ OSS like: visas for expats, work and trade permits as well as SEZ operating SEZ licenses.

- Consolidate government functions and administer them through an OSS, which should be streamlined and efficient. The regulator designates land as an SEZ and also licenses developers, operators and enterprises, co-ordinates all public agency inputs and monitors and enforces compliance with the SEZ legal and regulatory framework.

### *3.2.3. Ownership of SEZs*

SEZs vary considerably in terms of ownership, management and the type of incentives they offer. These zones are managed along the spectrum of fully publicly owned and managed areas, such as by national, regional or local governments, to fully privately owned and managed (EPRS, 2020[19]). How SEZs are designed, financed, built and operated are sensitive questions that need to be addressed carefully with clear specifications around the respective roles of the government and the private sector. This is particularly important as the rise in the number of SEZs across the world has outpaced the elaboration and implementation of standards, rules and regulations governing activities within the zones (European Commission, 2019[20]).[9]

The government's capacity to manage and finance SEZs and their operations also needs to be evaluated. This calls for in-depth feasibility studies to be undertaken prior to settling on specific governance and development models (Farole, Baissac and Gauthier, 2013[13]). The type of zone management (i.e. public, private or hybrid) does not have a significant impact on SEZ performance (Frick, Rodríguez-Pose and Wong, 2019[21]). The best model depends on context-specific policies and objectives. Some governments have ultimately opted for a mixed approach, depending on the sector and industries to be promoted.

Developing the right type of legal and regulatory framework governing the SEZ is also critical for achieving the desired investment and impact. The SEZ regulatory framework overlaps with a wide array of policy issues, in particular investment promotion and facilitation, trade, land policy, promotion of small and medium-sized enterprises (SMEs), labour and environment, and fiscal policy. Specific SEZ laws, providing special regulations and treatment of firms inside the zones, are common elements of the SEZ regulatory framework. They typically also postulate the rights and obligations of the public and private sector, zone developers, and operators. SEZ laws are globally the most common legal and regulatory instrument governing SEZs, mostly in developing countries (UNCTAD, 2019[12]). Only a handful of advanced economies have dedicated SEZ laws, notably Poland.

In those EU economies which still operate zones, the zone administration is separated from the regulatory function to avoid conflict of interest. Thus, in the EU, the zone administration is typically tasked with promoting investment into the zone and overseeing the development and economic performance of the zones. However, the review of compliance vis-à-vis EU competition and State aid rules lies within the remit of separate public institutions, usually the country's competition authority. This institution has to review and approve every investment deal that involves the granting of State aid of any kind (OECD, 2017[17]).

As in many cases, governments are quick to focus on establishing a new law without having considered the whole array of options available to them to tackle a specific policy challenge. The same applies to SEZs, for which regulations, legislative amendments, administrative approaches or a concession might be better suited than a dedicated law. One concern with drafting new laws is the time and resources that are needed to develop a well-crafted legal instrument, backed by the necessary rules and regulations to ensure implementation, as well as the necessary administrative and institutional competences to oversee the application of the law, not to mention undertaking a thorough stakeholder consultation in the elaboration of the law. Some key elements to consider when seeking to develop the appropriate SEZ legal framework include:

[9] To address this lack of standards and regulations governing SEZs, the EU supports the OECD *Recommendation on Countering Illicit Trade: Enhancing Transparency in Free Trade Zones (2019).*

- SEZ frameworks are highly context specific.
- SEZ frameworks should be linked to the targeted sectors and tackle specific sectoral policy challenges.
- The frameworks should address concrete business constraints.
- They should avoid over-reliance on incentives as the main value proposition of the SEZ.
- SEZ frameworks should be effectively embedded in the national investment policy and fully aligned with other relevant national laws and regulations, such as in environmental and labour laws.
- A new law on its own will not fix the problem identified. Implementing regulations that can take years to be developed will be required in addition to dedicated institutional structures, resources and capacities.
- SEZ legal frameworks require the necessary political support. Should this not be secured, the new law might become subject to too many political compromises, thereby failing to add significant value in addressing fundamental weaknesses in the legal and regulatory framework for investment.

### *3.2.4. Incentives and link with EU State aid rules*

Incentives, both tax and non-tax, are important features of SEZs. Tax incentives have the potential to significantly reduce the tax costs of investment and, as a result, may influence business investment and location decisions. Countries provide a range of different types of tax incentives with design features and targeting strategies varying along several dimensions and these will have varying effects on a firm's tax costs and its incentive to invest in a particular jurisdiction (Table 3.3).

OECD analysis on the impact of investment tax incentives reveals several – potentially unintended – effects of such policies on the tax costs of investment and on revenue forgone across the different periods of an investment's lifecycle; in particular, effects relating to carry-over provisions, benefit ceilings, and interactions with standard capital allowances or investor- and project-specific characteristics (Celani, Dressler and Hanappi, 2022[22]).

Quantifying the impact of non-tax incentives, such as reduced regulatory burden, is potentially more difficult due to the lack of data and the difficulty to establish causality between easing a certain regulation and its direct impact, as the latter might be a function of multiple factors. At the same time, easing regulation in areas such as environmental and social protection in favour of a leaner business climate carries significant sustainability risks that need to be understood and evaluated.

Governments may argue in favour of incentives, particularly in SEZs and especially if neighbouring jurisdictions make extensive use of incentives to try and attract the same investors. At the same time, the arguments against the use of incentives are strong and grounded in evidence. Incentives are ineffective as a source of differentiation and will ultimately result in a race to the bottom in terms of government resource mobilisation and forgone revenue. In planning SEZs, governments should make sure that incentives are not central to the value proposition of the SEZs to investors, but rather that they are very targeted and focused on particular sectors, say research and development (R&D) (OECD, 2018[23]).

In the EU, the creation of SEZs is often seen as a form of public economic support, offering tax and tariff incentives, lean customs procedures – such as via one-stop-shops – enhanced infrastructure, and reduced regulation to attract investment and boost business activity (EPRS, 2020[19]). SEZs in the EU are regulated by the Union Customs Code. As such, the setting up of SEZs, or modifications to existing zones, must comply with the EU State aid rules and the General Block Exemption Regulation (GBER) that aims to streamline State aid rules by encouraging support that stimulates objectives of common EU interest, such as economic growth and job creation (Ambroziak, 2016[24]).

This requires careful consideration by policy makers, as the terminology around SEZs is sometimes used interchangeably (see above); different forms of SEZs have different regulatory implications. Free zones,

for example, are subject to the Union Custom Code, according to which free zones are “enclosed areas within the customs territory of the Union where non-Union goods can be introduced free of import duty, other charges (i.e. taxes) and commercial policy measures.” As of December 2019, there were more than 70 such free zones in the EU. Croatia alone hosts 11 free zones, and Bulgaria has six.[10]

As explained in Section 2 of this paper, the EU regulates the incentives that Member States offer to companies under the competition and State aid provisions of the Treaty on the Functioning of the European Union (TFEU). The EU recognises three broad types of State aid: horizontal, regional and sectoral aid. Horizontal aid is aimed at resolving or alleviating market failures, usually encompassing some sort of externality. Regional aid targets territories where standards of living are noticeably lower than the EU average or regions disadvantaged relative to national averages, for instance due to abnormally high unemployment rates, or problems of other socio-economic, geographical or structural natures. Sectoral aid targets specific sectors undergoing a significant conversion process, such as coal, steel and shipbuilding; or distinct sectors finding it difficult to adjust to the full forces of market competition.

## Table 3.3. Tax, financial and non-tax incentives in SEZs

| Incentive type | Description |
|---|---|
| | *Tax and financial incentives* |
| Corporate tax incentives | **Tax holidays** exempt firms from corporate income tax, and possibly other taxes, for a specified number of years. Tax holidays can be relatively simple to administer and benefit the affected companies in the short run, as they have the option to terminate the relevant business activities at the end of the tax holiday. On the other hand, tax holidays may be problematic particularly if they target sectors or activities, raising the question of the treatment of firms already engaged in that sector or activity or in other sectors or activities that do not qualify. Tax holidays are generally least attractive to firms in sectors that require long-term capital commitments and that cannot realise immediate profits (OECD, 2001[25]).<br><br>**Targeted (or broad based) reductions in the statutory corporate income tax rate** reduce the amount of tax the economy (or zone, if done in the context of a zone) levies on targeted (or broadly defined) taxable profits. This measure is relatively simple to administer and revenue losses are more transparent. As with tax holidays, targeting such measures at income from a subset of activities or investors can be problematic as it can cause tax avoidance and revenue leakage. Statutory corporate tax reduction invites tax avoidance through high-tax enterprises shifting profits to low-tax ones via transfer pricing (intra-country and international) (OECD, 2001[25]).<br><br>**Capital cost allowances** include 1) accelerated and enhanced write-offs for qualifying capital costs; and 2) general or targeted investment tax credits. Accelerated write-offs lower the amount of taxable profits, while investment tax credits provide a straight reduction to the amount of corporate tax otherwise payable. In the case of the former, a specific percentage is deducted directly from taxable income; therefore it also depends on the value of the corporate income tax rate. On the other hand, the value of the corporate tax does have an impact on the value of the investment tax credit (OECD, 2001[25]). The advantage of the capital cost allowances is that the revenue cost is directly related to the amount of the investment, so there is no need for minimum eligibility thresholds. Capital cost allowances tend to favour capital-intensive investment and may be less favourable towards employment creation than tax holidays (Easson and Zolt, 2002[26]).<br><br>**Financing incentives** such as dividend withholding tax rate reductions and imputation relief, provide an offset to corporate tax on distributed profit. In certain cases they may lower the discount rate applied by foreign investors to after-tax cash flows from FDI (OECD, 2001[25]). |

[10] The six Bulgarian Free Economic Zones are: Rousse, Vidin, Plovdiv, Bourgas, Svilengrad, Dragoman (see https://www.healyconsultants.com/bulgaria-company-registration/free-zones/).

| Incentive type | Description |
|---|---|
| Custom duties exemptions | Customs duties are taxes collected on imports of raw materials, components and capital goods (and sometimes on exports) by the customs authorities. They are based on the value of goods (ad valorem duty) or on the weight, dimensions or other criteria of the items. Exemptions on customs duties for capital goods can be particularly relevant for investors, as the taxes collected on capital goods cannot be as easily recovered as those on raw materials and components, so they can substantially raise the initial cost of investment. According to (Easson and Zolt, 2002[26]), "many investors consider this type of incentives to be the most valuable type of investment incentive". This type of incentive is independent of profitability ("up-front benefit") which means investors receive an immediate saving (Easson, 2004[27]). The drawback to incentives of this type is that they encourage imports over local sourcing. Some countries, such as the Czech Republic, Pakistan and Taiwan stipulate that the exemption applies only to goods that are not available locally. There is also a risk that goods imported free of duty will subsequently be sold on the domestic market, rather than being used for production purposes. In such cases, readily saleable products such as automobiles should be excluded from any exemptions (Easson, 2004[27]). Granting such an exemption on a selective basis can be in violation of international trade rules (Easson and Zolt, 2002[26]). |
| Value-added tax refunds | A value-added tax (VAT) is a consumption tax that can be introduced at any stage in production or final sale when value is added to the product. In many specific cases, value-added tax (VAT) can be claimed back by the tax-payer on a later stage. Most countries that grant custom duty exemptions also exempt investors from import VAT on the same items. While such exemptions are costless, they generally do not constitute a major benefit to the importer, apart from cash-flow benefits (Easson, 2004[27]). |
| Property tax exemption / reduction | A property tax is a tax applied to real estate property, and is usually collected by local or municipal administrations. The advantage of property tax exemptions or reductions is that their costs are fully predictable, while normally being limited in duration. Property tax incentives generally fall under regional development policies and are often granted by the same local government authorities that assess them in the first place (Easson and Zolt, 2002[26]). |
| Personal income tax and social security reductions | Some economies use reductions in personal income taxes and social security contributions as an incentive to invest in regions of high unemployment. Their impact is likely to be moderate if personal taxes and social security contributions constitute a large part of the cost of employment. Nevertheless, they are relatively easy to administer. While such incentives add to the overall perception of a favourable investment environment, they are not very likely to play an important role for investors (Easson and Zolt, 2002[26]). |
| Subsidies | Subsidies can include indirect subsidies, like special grants for education and training and direct subsidies like the supply of water and electricity below markets rates (Engman, Onodera and Pinali, 2007[28]). |
| *Non-tax incentives* | |
| Streamlined administrative services | Such services include provision of a single window or one-stop shop for government services, fast-track customs services, simplified license procedures, and, potentially, dedicated legal frameworks and courts (Engman, Onodera and Pinali, 2007[28]). |
| Relaxed legal and regulatory requirements | In some cases, zones can relax legal and regulatory requirements, including those concerning foreign ownership, labour and environmental laws and regulations, foreign exchange regimes, rules on the lease and purchase of land, most favoured nations status, and land lease under preferential terms (Engman, Onodera and Pinali, 2007[28]). |
| Infrastructure | While the offsite infrastructure, such as roads, railroads, airport and seaports and access to energy, is highly relevant, economic zones normally have more influence on the on-site infrastructure, which include training facilities, common bonded warehouse facilities, business services facilities, on-site banking facilities, on-site customs clearance and trade logistics facilities, high-speed telecommunications and internet services, and more (FIAS, 2008[29]). Such on-site infrastructure is often part of more general regional development policies and resources for it can often be granted by local, rather than central, government authorities. |
| Export promotion | Export promotion services include business advice, sales and marketing support, finance, and export credit services (Engman, Onodera and Pinali, 2007[28]). |

## 3.3. Maximising positive SEZ spillover effects

Some central elements that governments need to consider before setting up SEZs include identifying the main policy problem the SEZ is to solve and how. Also, the ultimate selling proposition of the SEZ approach as opposed to other investment promotion and business regulation solutions, as well as vis-à-vis other SEZ regimes in the region, needs to be elaborated. Once these have been established and an SEZ has been identified as the right instrument to tackle a public policy problem, the right governance model (see above) needs to be selected after careful due diligence, especially if the sector is to be involved. All of these are crucial to maximise positive spillover effects from the zone to other parts of the economy, as well as to ensure that it integrates effectively in the overall, but also local, economy.

SEZs, by virtue of being enclaves and their geographically restricted special investment regimes, can often foster the benefits of agglomeration. Some SEZ objectives can include enhancing proximity between enterprises within a certain value chain to stimulate technological and managerial learning through tacit exchanges and business transactions (Altenburg et al., 2020[9]).

They can thus affect the economy through a number of channels. In the Western Balkan region, for example, zones have attracted almost 400 foreign enterprises and investments worth EUR 2.5 billion. Preliminary evidence from their first decade of operation suggests that these SEZs have had a positive impact on education, training and infrastructure. Evidence on technology transfer to domestic enterprises and on the integration of domestic enterprises in the supply chains of foreign zone investors is, however, more difficult to identify (OECD, 2017[17]).

The competitiveness of the surrounding regional/national economy is a key factor behind the success of an SEZ in terms of spillovers. SEZs on their own are no shortcuts for broader structural socio-economic reforms. At the same time, high quality infrastructure and efficient business, trade and investment facilitation are key to a successful SEZ, whereas low wages and generous fiscal incentives have no link with positive SEZ outcomes. Global experience of SEZs illustrates that they have at times been successful in stimulating export growth and in increasing low skilled employment. However, more strategically, examples of successful enhanced value-added content of exports, linkages between domestic firms and SEZs, and attracting investment into lesser developed and peripheral regions are rare (Farole, 2011[11]).

### *3.3.1. Social and environment impacts*

From the onset, SEZs need to be planned to ensure social and environmental sustainability. SEZs are often criticised for their negative social and environmental impacts, particularly in developing and emerging economies. The ILO has highlighted the treatment of women, labour standards and working conditions in zones as major challenges in SEZs (ILO, 2017[30]). Common labour concerns include the disregard of core labour rights, poor working conditions (e.g. working hours, health and safety standards), lack of training or skill upgrading, and exploitation of women, such as lower wage levels. One should note, however, that these negative impacts do not necessarily stem from the SEZs *per se* but are often linked to challenges in the surrounding economy. One argument in favour of SEZs in this regard is that governments may find it easier to monitor adherence to environmental and social standards in limited and well-defined geographical areas, such as an SEZ.

### *3.3.2. Infrastructure quality*

In most developed and emerging economies, the quality of infrastructure including roads, digital infrastructure, access to energy and water, and trading infrastructure, is good enough to avoid having to revert to SEZs based on the premise that they offer higher quality infrastructure.

Still, the establishment of SEZs is typically coupled with new infrastructure and the optimisation of distribution networks from the manufacturer to destination markets. These give domestic firms and foreign

investors access to better transport and logistics infrastructure and establish new linkages between foreign producers and domestic service providers. Domestic companies can also potentially benefit from intangible know-how and experience of highly export-oriented foreign companies in the field of regulatory compliance and export procedures.

SEZs are often located in or around existing industrial zones. Therefore, even companies located outside the fenced boundaries of an SEZ benefit from improvements such as newly asphalted roads, better street lighting and extended public transport. The zones can also serve as an important driver for additional funding for local governments either through direct budgetary transfers from the central government or indirectly through the financing of infrastructure projects (OECD, 2017[17]).

### *3.3.3. Regulatory environment for enterprises, trade and investment*

This can be considered the "soft" infrastructure component of an SEZ, yet it is equally critical. Here, as opposed to decent quality physical and digital infrastructure which can be taken for granted in EU countries, there is room for reforms and innovation in SEZs. Zones can promote significant administrative burden reduction in licensing and the issuance of business permits, including the establishment of well-functioning one-stop shops.[11] One area that is seeing considerable innovation is Fintech, with jurisdictions competing to attract innovative Fintech start-ups. This sector requires novel approaches to regulation, which, in many cases, are still in their infancy. SEZs can thus be a platform to launch so called regulatory sandboxes[12] that allow for carve-outs of existing regulatory provisions for a defined period under the monitoring of regulator. This can be attractive for firms in strongly regulated sectors, such as in financial services.

### *3.3.4. Sector upgrading*

Some SEZs have focused on specific sectors, such as the automotive, garments or electronics sectors. The financial sector can also benefit from zone-based approaches through the establishment of international financial services centres linked to SEZs such as in Qatar and Dubai. Reforms in the financial sector, even if limited to the SEZs, are complex and sensitive. For example, regulators will need to be able to monitor reforms related to capital account liberalisation, prudential requirements, and other activities, such as OTC derivatives and commodity trading. As with social and environmental protection, zone-based laws and regulations critical to financial sector integrity will also need to be in-line with the national legal and regulatory frameworks – especially pertaining to anti-money laundering, anti-terrorism financing and know-your-customer provisions.[13]

[11] One-stop shops can be considered a panacea for simplifying business procedures, as they are complex to establish. OECD Best Practice Principles for One-Stop Shops for Citizens and Business provides guidance in this regard.

[12] The UK pioneered the sandbox concept in 2016 with Fintech entrepreneurs undertaking time-bound experiments of financial innovations with actual clients.

[13] See the OECD Council Recommendation on Countering Illicit Trade: Enhancing Transparency in Free Trade Zones.

# Annex A. Calculation of the gross grant equivalent of State aid

The purpose of this Annex is to explain how to calculate the gross grant equivalent (GGE) of State aid when the public support of undertakings is provided in a form other than non-reimbursable grants.

Article 107(1) TFEU declares as incompatible with the internal market "any aid" in "any form whatsoever". The Court of Justice has ruled in numerous judgments that the concept of State aid is "objective", meaning that a public measure necessarily constitutes State aid when it satisfies cumulatively the four criteria of Article 107(1) TFEU. The form of the aid, the intentions or motives of the granting authority, the need for the aid or the value-added of the state intervention are all irrelevant issues because the four criteria of Article 107(1) are also exhaustive, meaning that nothing else needs to be taken into account in determining whether Article 107(1) applies to a particular public measure.

For example, in case C-40/85, Belgium v European Commission, EU: C:1986:305, the Court of Justice held that "(12) the provisions of the Treaty concerning State aid apply to aid granted by a Member State or through State resources 'in any form whatsoever'. It follows, […], that no distinction can be drawn between aid granted in the form of loans and aid granted in the form of a subscription of capital of an undertaking. Aid taking either form falls within the prohibition contained in Article (107) where the conditions set out therein are fulfilled."

Furthermore, in case C-89/08 P, European Commission v Ireland, EU: C:2009:742, the Court clarified that "(72) the concept of State aid, whether existing or new, corresponds to an objective situation. […], that concept cannot depend on the conduct or statements of the institutions." And in case T-454/13, SNCM v European Commission, EU: T:2017:134, the General Court further confirmed that "(98) it follows from settled case-law that the concept of State aid is an objective concept, the sole test being whether a state measure confers an advantage on one or more particular undertakings."

Therefore, when state resources or state assets are used to support an undertaking in a form other than a grant, the GGE of that support must be quantified. This quantification must be done for at least two reasons. First, it is necessary to identify the existence of an advantage that is not available under normal market conditions. Normal market conditions are the conditions that prevail before or in the absence of state intervention. Second, it is necessary to calculate the amount of State aid that is provided in a form other than a grant in order to determine the compatibility of State aid with the internal market. This is because, regardless of the legal basis of exemption, all State aid must be necessary and proportional to the objective it seeks to achieve. Without quantifying the amount of State aid, it is impossible to confirm the proportionality of the aid and that it does not exceed the maximum allowable intensity under the relevant State aid rules.

The 2020 State aid Scoreboard indicates that the majority of State aid is provided in the form of grants (about 63%). The second most important instrument of State aid is tax exemptions or reductions (about 31%). Then, in third position come instruments such as guarantees, loans, equity, aid in kind, etc. A decline to 46% in the amount of grants in relation to total State aid is reported by the 2021 State aid Scoreboard. In second position at 33% come tax reductions.

According to the 2020 Scoreboard, in Bulgaria, direct grants and interest rate subsidies accounted for 48% of all State aid, while 17% of aid was in the form of tax exemptions or reductions and about 2-3% in the form of guarantees. The remaining 32% was in the unspecified “other” category of instruments. The 2021 edition of the Scoreboard reports noticeable changes in Bulgaria. Direct grants accounted for 63% of total aid. Grants combined with interest rate subsidies made up another 20% of total aid. Tax advantages dropped to 8%. These changes are probably caused by the COVID-19 emergency.

## The GGE of State aid in tax exemptions or reductions

For a public measure to constitute State aid there must be a transfer of state resources in favour of an undertaking. The fact that a tax exemption or reduction does not result in an actual transfer of resources from a public authority to an undertaking is not relevant. This is because the concept of state resources includes all resources to which the state is entitled to but fails to receive such as unpaid taxes (see case, C-387/92, Banco Exterior de España, EU: C:1994:100, paragraph 14). Therefore, in this case the relevant question is what the state should have received rather than what the state actually grants.

It is also irrelevant that a lower tax could attract more companies to a region and, in the end, generate more tax revenue for the state. What matters is not the broader economic effect on the overall tax receipts but the narrower issue of the loss of tax revenue from applying a lower than otherwise rate of tax on a specific taxable amount or event. The Court of Justice has refused to engage in discussion as to what would have been the tax liability of the undertaking that benefits from the tax reduction or exemption in hypothetical alternative scenarios. The amount of the aid corresponds to the tax that the aid beneficiary would have paid “if the operations at issue had been carried out without the aid measure in question having been granted” (C-705/20, Fossil (Gibraltar), EU: C:2022:680, paragraph 41). Thus, the benchmark for calculating that tax that should have been paid is the tax liability of the beneficiary without the tax reduction or exemption, but for the same operations or profit.

Therefore, the GGE of State aid in a tax exemption or reduction is the difference between the tax that should have been paid and the tax that is actually paid. To calculate the amount of that difference, it is necessary, first, to identify the rate of tax and the taxable amount to which the relevant tax rate should have been applied.

The relevant rate of tax is that which is defined by the “reference” system or “normal” system. The taxable amount is the amount that is actually realised before the lower tax rate is applied. The following argument is not relevant. Aid recipients have on occasion argued that the alternative taxable amount would have been lower because if they were subject to a higher tax rate, the argument goes, they would have chosen to invest less or to invest in an alternative location in another Member State levying lower taxes. As explained above, the alternative scenario is not a different project or different operations but the same project or operations with higher tax.

The same approach applies to exemptions or reductions of direct taxes such as those on income or profit, indirect or sale taxes such as those levied on value added, and product-specific taxes such as those levied on energy products or transfer of land. Once more, the argument that had a higher tax been levied, the consumption, say, of energy would have been lower, is not relevant, even though it may be true that the undertakings concerned would have consumed fewer taxable energy products. This is because the reference or normal tax rate is applied to the actual situation and actual state of affairs, not to hypothetical situations and alternative state of affairs to which the reference tax rate could have applied, which by definition is speculative.

Therefore, the GGE in tax reductions or exemptions is calculated as follows:

**GGE = (reference tax rate – reduced rate) x (taxable amount)**

## The GGE of State aid in soft loans

The GGE of State aid in a loan is the difference between the market rate of interest and the rate of interest that is actually charged multiplied by the outstanding principal of the loan for each year of the duration of the loan and discounted to the date of the granting of the loan. That is:

**GGE = (market rate of interest – actual interest rate) x outstanding loan principal**

The annual amount of the GGE must then be discounted to the present value.

The 2008 Commission Communication on reference and discount rates states: "The reference and discount rates are applied as a proxy for the market rate and to measure the grant equivalent of aid, in particular when it is disbursed in several instalments and to calculate the aid element resulting from interest subsidy schemes. They are also used to check compliance with the de minimis rule and block exemption regulations."[14]

It is important to note at the outset that the methodology for determining the reference rate applies only when an actual market rate cannot be identified. As explained by the Commission Communication, the reference rate is only a "proxy" rate. That is, when an undertaking can provide evidence of the market rate, that rate must be used. Such evidence is, for example, a written and unconditional loan offer by a bank or the rate actually charged by a bank on a recent loan of similar amount, duration and terms.

However, as is also clarified by the Communication, the reference rate must be used when calculating the amount of de minimis aid granted through loans or the GGE of loans granted in compliance with the provisions of the GBER. This is in order to achieve uniform application of the de minimis aid and GBER-based aid across Member States.

The Communication defines the methodology that has to be used by Member States. Accordingly, the reference rate is:

**Reference rate = base rate + risk margin**

Therefore:

**GGE = (reference rate – actual rate of interest) x loan principal**

The annual amount of the GGE must then be discounted to the present value.

The base rate is determined by the Commission and revised periodically. At the time of writing, the base rate for Bulgaria was 0.0% (for the Eurozone it was 1.03%).[15]

The risk margin depends on the credit rating of the borrower and the quality of its collateral. The risk margin can be derived from the table in the 2008 Communication, which provides a matrix of possible combinations of credit ratings and qualities of collateral.

When a rating from credit-rating agencies is not available other ratings can be used, such as those developed by banks or other lenders.

If a rating is not available at all, for example because the borrower is a start-up, at least 400 basis points must be added to the base rate. The risk margin is inversely proportional to the credit rating and the quality of the collateral that can be offered by the borrower.

[14] The Communication can be accessed at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52008XC0119%2801%29

[15] It can be accessed at: https://competition-policy.ec.europa.eu/system/files/2022-09/reference_rates_base_rates2022_10.pdf

The discount rate is used to derive present values:

**Discount rate = base rate + 1%**

It is important to note that, given that the reference rate is a proxy for the market rate, in the case of undertakings in difficulties, as defined in the GBER and the Guidelines on rescue and restructuring aid, a market rate may not exist. Therefore, the methodology of the 2008 Communication would be inapplicable. In this case, the GGE of the aid would be the whole amount of the loan, as no bank would be willing to lend any money to an undertaking whose bankruptcy is imminent.

Lastly, it is clear from the Commission's decisional practice that the values in the table of 2008 Communication cannot be used to calculate the GGE of State aid in subordinated loans or loans without collateral (see, for example, Commission Decision SA.38674 concerning subordinated loans for SMEs in Germany).

## The GGE of de minimis aid in soft loans

Regulation 1407/2013 stipulates that aid not exceeding EUR 200 000 per undertaking per three-fiscal-year period is deeded to be "de minimis aid", meaning that it is considered not to satisfy all of the criteria of Article 107(1) TFEU. Anecdotal evidence suggests that all Member States and public authorities at all levels of government use the Regulation on de minimis aid to provide limited amount of public support to undertakings. De minimis aid can be embedded in a soft loan.

Recital 15 of the Regulation states the following:

"For the purposes of transparency, equal treatment and the correct application of the de minimis ceiling, all Member States should apply the same method of calculation. In order to facilitate such calculation, aid amounts not taking the form of a cash grant should be converted into their gross grant equivalent. Calculation of the gross grant equivalent of transparent types of aid other than grants and of aid payable in several instalments requires the use of market interest rates prevailing at the time such aid is granted. With a view to uniform, transparent and simple application of the State aid rules, the market rates applicable for the purposes of this Regulation should be the reference rates, as set out in the Communication from the Commission on the revision of the method for setting the reference and discount rates."

Then in recital 16 it is further explained that:

"Aid comprised in loans, […], should be considered transparent de minimis aid if the gross grant equivalent has been calculated on the basis of market interest rates prevailing at the time the aid is granted. In order to simplify the treatment of small loans of short duration, this Regulation should provide for a clear rule that is easy to apply and takes into account both the amount of the loan and its duration. Based on the Commission's experience, loans that are secured by collateral covering at least 50% of the loan and that do not exceed either EUR 1 000 000 and a duration of five years or EUR 500 000 and a duration of 10 years can be considered as having a gross grant equivalent not exceeding the de minimis ceiling. Given the difficulties linked to determining the gross grant equivalent of aid granted to undertakings that may not be able to repay the loan, this rule should not apply to such undertakings."

The Regulation allows the granting of loans at a zero rate of interest (even though it does not state so explicitly) on the following two alternative conditions:

1. Either the beneficiary is not subject to insolvency proceedings while larger enterprises must have credit rating of at least B- and collateral must cover at least 50% of the loan and the principal of the loan may not exceed EUR 1 million over five years or EUR 0.5 million over 10 years; or
2. The reference rate must be used to determine the GGE.

With respect to the first condition, if the amount of the loan is less that EUR 1 million (or EUR 0.5 million) or if the duration of the loan is less than five years (or 10 years, respectively), the GGE of the loan is proportionately smaller. For example, if the amount of a five-year loan is EUR 0.5 million, then the corresponding de minimis amount is only EUR 100 000. Similarly, if the duration of the loan is 2.5 years, instead of five years, the de minimis amount is also EUR 100 000. What is not possible to do is, say, to half the amount of the loan and double the duration of the loan.

The second condition applies when the amount or the duration of the loan exceeds the thresholds laid down in the first condition. For example, if an SME has a credit rating of B and it can post a normal collateral, it follows that the risk margin that must be added to the base rate is 4%. If the base rate is, say, -0.19% (as it was until recently), then the reference rate is 3.81% (= -0.19 + 4.00). If the amount of the loan is EUR 6 million, then the interest that must be paid by this SME at the end of the year is EUR 228 600. This amount exceeds the de minimis threshold of EUR 200 000. Therefore, for loans that exceed the thresholds laid down in condition 1, a positive rate of interest must always be charged. Assume that interest of 1% is charged on this loan. It means that the SME will pay EUR 60 000 in interest at the end of the year. If the difference between what would have paid (EUR 228 600) and what it actually pays (EUR 60 000) remains below the de minimis threshold of EUR 200 000, then the GGE of the aid embedded in the loan is de minimis aid. In this case the GGE is EUR 168 600 (= EUR 228 600 – EUR 60 000).

Therefore, when loans exceed EUR 1 million (or EUR 0.5 million) or their duration is longer than five years (or 10 years, respectively), the GGE of the aid can be classified as de minimis aid in conformity with the de minimis Regulation if:

> **(reference rate – actual rate) x annual outstanding principal of the loan (discounted to the date of the granting of the loan at the rate of discount) ≤ EUR 200 000**[16]

## The GGE of State aid in guarantees

It is, first, necessary to explain who the beneficiary is in the case of a state guarantee. The beneficiary is the undertaking that is covered by the guarantee. If the guarantee concerns a loan, the lender is not normally an aid beneficiary for the reason that the interest rate that it charges on the loan reflects the presence of the guarantee. Simply, the guarantee leads to a lower rate of interest, whereas in the absence of a guarantee the interest rate is higher.

But, if the state guarantee is granted after the loan is provided to the borrower, then it is possible that both the borrower and the lender derive a benefit that would not be available under normal conditions (see the judgment in case C-275/10, Residex Capital, EU: C:2011:814, paragraphs 39-42). For example, if a borrower gets into financial difficulties and cannot repay a loan, then a state guarantee may be help it to obtain the consent of the lender to extend the repayment period of the loan. The borrower avoids default while the lender avoids a possible loss from the forced sale of the collateral that had been pledged by the borrower. In this case a state guarantee would constitute State aid for both borrower and lender because it is unlikely that a market operator would provide the same guarantee to a company that is facing imminent bankruptcy.

If a state guarantee contains State aid that is granted unlawfully, then the guarantee cannot be enforced in a court of law. In effect, the illegality of the aid makes the guarantee null and void. As mentioned above, State aid is unlawful when it is not granted on the basis of a regulation – either the de minimis regulation or a block exemption regulation – or after notification to and approval by the Commission. The consequence of illegality is that the lender whose loan is supposedly covered by the state guarantee may

[16] In the numerical example above, the rate for discounting is 0.81% (= -0.19% + 1%).

not be able to obtain any compensation and the public authority that granted the guarantee may even refuse to honour the guarantee that it itself granted unlawfully (see case C-275/10, Residex Capital).

A state guarantee creates a liability for the budget of the public authority that provides the guarantee. Even if the guarantee is not called, the lability is incurred. This liability implies that there is a risk for a future payment out of the state budget. Market operators do assume risks. But a prudent operator would also charge a fee – a premium – to compensate for the risk. Similarly, in order for the guarantee not to lead to a transfer of state resources conferring an advantage to the undertaking that is covered by the guarantee, the liability must be remunerated. Without a premium that remunerates the liability borne by the state budget there is a burden on the state budget. This burden is equivalent to a transfer of state resources in favour of the company that receives the guarantee.

The market would remunerate the liability by an amount that is equal to or exceeds the expected loss in case the guarantee is called. The expected loss is the amount of the pay-out – i.e. the guaranteed amount – multiplied by the probability of occurrence of the guaranteed event. That is, the premium that would be charged by a market operator is;

**Market premium ≥ (guaranteed amount) x (probability of occurrence of the guaranteed event)**

In reality, however, the market premium includes additional costs, such as administrative costs, and takes into account any security that may be pledged by the borrower. Therefore:

**Market premium ≥ ((guaranteed amount – value of the pledged collateral) x (probability of occurrence of the guaranteed event)) + administrative costs**

The GGE of State aid in a state guarantee is:

**GGE = amount of market premium – amount of premium actually charged**

Or, if the market premium is expressed as a rate per euro that is guaranteed:

**GGE = (market rate of premium – actual rate of premium) x (guaranteed amount)**

The 2008 Commission Notice on State aid in guarantees lays down four cumulative conditions for a state guarantee to be free of State aid.[17] Any deviation from those conditions may confer an advantage to the undertaking that is covered by the guarantee:

1. **The borrower is financially viable**: The borrower must not in financial difficulty in the meaning of the Guidelines on corporate rescuing and restructuring. A borrower who is in financial difficulty is in imminent danger of going bankrupt. In this case, the State aid in a guarantee may be the whole amount that is guaranteed.
2. **The guarantee covers a specific event**: The guarantee must be linked to a specific financial transaction, for a maximum amount and limited in time. In case of a guarantees which is linked to the legal status of the borrower (e.g. state-owned company or a company with special rights/obligations), rather the amount that is borrowed, then the amount of State aid may be equal to the total monetary value of what is guaranteed.
3. **No moral hazard**: The guarantee must not cover more than 80% of the outstanding loan or financial obligation. A guarantee that covers 100% of the loan creates moral hazard. The lender may not assess the loan properly and the borrower may refuse to repay the loan. An exception to the 80% limit is possible in the case of companies providing exclusively services of general economic interest.

[17] The Notice can be accessed at: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52008XC0620%2802%29

4. **Market price**: The premium that is charged for the guarantee must be equal to or exceed the expected loss.

As mentioned above, when conditions 1 and 2 do not hold, it is likely that the amount of State aid in a guarantee is equal to the whole amount of the underlying loan or the total monetary value of what is guaranteed.

When condition 3 does not hold (i.e. the guaranteed amount exceeds 80% of the loan or, as often happens, it is equal to 100% of the loan), it may not be possible to identify a market rate of premium. Also, a market rate of premium may not exist in the case of start-up companies, companies without credit rating, or special purpose vehicles. When condition 3 does not hold and when a market premium cannot be identified, the total cost of the guaranteed loan needs to be calculated and compared to the cost of a loan with the same amount and terms but without the guarantee. That is:

**GGE = (cost of loan without guarantee) – (cost of loan with guarantee)**

For example, the GGE of a guaranteed loan with a duration of one year is:

> **GGE = (principal x interest rate without guarantee) – ((principal x interest rate with guarantee) + (any premium that may be paid by borrower))**

For guaranteed loans with a duration of longer than one year, it is necessary to calculate the sum of the NPV of the GGE of the guarantee in each year. The GGE will progressively decline as the principal of the loan is paid off.

Section 3 of the 2008 Commission Notice on guarantees provides safe-harbour rates for individual guarantees granted to SMEs. These safe-harbour rates are presumed to correspond to market rates of premium. These rates vary from 0.4% for SMEs with AAA rating to 6.3% for SMEs with B- rating. There are no safe-harbour rates for SMEs with credit rating of CCC or lower.

## The GGE of de minimis aid in guarantees

Regulation 1407/2013 also allows de minimis aid to be granted through a state guarantee.

The Regulation offers three alternative options:

1. The beneficiary is not subject to insolvency proceedings (a large enterprise must have credit rating of at least B-, and the guarantee is less that EUR 1.5 million for five years or EUR 0.75 million for 10 years, and the guarantee covers less than 80% of the underlying loan. The conditions in this option are cumulative; or
2. The GGE can be calculated with the use of the safe-harbour premiums which are defined in the 2008 Notice on guarantees; or
3. The GGE can be calculated on the basis of an alternative methodology that must be notified in advance to the Commission.

Option 1 allows the granting of free guarantees (i.e. at zero premium), even though it is not stated so explicitly in the Regulation. Option 1 can be used only when the guaranteed amount is less than EUR 1.5 million. Given that the guarantee may not cover more than 80% of the loan, it follows that the maximum amount of the underlying loan may not exceed EUR 1.875 million.

Option 1 can also be used when the amount of the loan exceeds EUR 1.875 million but the guarantee covers less than 80% of the principal. For example, if the guarantee covers 50% of a loan of EUR 3 million, then the guaranteed amount does not exceed EUR 1.5 million.

Similarly to loans, the amount of de minimis aid embedded in the guarantee is less than EUR 200 000 when the guaranteed amount is less than EUR 1.5 million (or EUR 0.75 million) or when the duration of

the loan is less than five years (or less than ten years, respectively). For example, if the guaranteed amount is, say, EUR 1 million or the duration of the loan is two years, the GGE of the de minimis aid would be EUR 133 333 or EUR 80 000, respectively.

Option 2 can be used when the principal of the loan exceeds EUR 1.875 million or when the guaranteed amount exceeds EUR 1.5 million. Similarly to loans, in such cases a premium must be charged to ensure that the GGE of de minimis aid does not breach the threshold of EUR 200 000.

For example, assume that the principal of the loan is EUR 15 million. The loan has a duration of one year and the credit rating of the borrower is BB+. According to the 2008 Commission Notice, the safe-harbour premium for this credit rating is 2%.

It follows that the maximum guaranteed amount can be EUR 12 000 000 (= EUR 15 million x 0.8). The amount of the safe-harbour premium at 2% is EUR 240 000. If a reduced premium at 0.5% is paid by the borrower, then the GGE of the aid is.

**GGE = EUR 240 000 – EUR 60 000 = EUR 180 000**

The amount of EUR 180 000 is de minimis aid (if all the conditions of the de minimis Regulation are fully satisfied).

Option 3 is rarely used. In unusual situations where premium rates are derived from credit ratings that differ from those in the 2008 Commission Notice, notification to the Commission becomes necessary. However, this is an option that apparently is not favoured by Member States. Over the past decade or so very few alternative methodologies have been notified to the Commission.

## The GGE in the reimbursement of training expenses

Article 31 of the GBER allows State aid for the support of training. The standard aid intensity is 50% of the eligible costs. This rate may be increased up to a maximum of 70% for certain beneficiaries such as small enterprises. The eligible costs are the costs of the trainer and the costs incurred by the undertaking whose employees are trained.

Therefore, the GGE of reimbursement of training costs is:

**GGE = (eligible costs) x (% of costs to be reimbursed)**

It follows that the maximum allowable aid is:

**Max aid = (eligible costs) x 0.5**

It is also important to note that the State aid may only be provided to the undertaking that pays for the training of its personnel. If the State aid is granted to the undertaking that provides the training (i.e. the trainer), then it becomes operating aid which cannot be exempted on the basis of the GBER. This is because the trainer is not investing in anything new or doing something extra. The trainer carries out its normal tasks and is reimbursed for its day-to-day expenses.

### *Training aid in the form of de minimis aid*

Often, Member States fund training with the use of de minimis aid. In this case the GGE may not exceed the threshold of EUR 200 000 per undertaking per three-fiscal-year period and the reimbursement must comply with all of the provisions of Regulation 1407/2013.

Please note that if the aid falls below the de minimis threshold, then a rate of subsidy higher than 0.5 (or 0.7) can be granted (because the subsidy is not considered to be State aid that must comply with the requirements of the GBER). Recently, the Court of Justice ruled, in case C-238/20, Sātiņi-S SIA, EU:

C:2022:57, paragraph 58, that a Member State is allowed to designate any aid as de minimis aid as long as it conforms with the requirements of the relevant de minimis regulation.

### *Competitive selection of trainer*

If, for reasons of efficiency and/or effectiveness, the granting authority wants to reimburse only one trainer or the best trainer, then it must organise a public procurement procedure to select the cheapest/best trainer (i.e. the trainer that submits the economically most advantageous offer). In this case, a competitive selection procedure eliminates advantage for the trainer in the meaning of Article 107(1) TFEU. The reimbursement of the trainer constitutes remuneration for services rendered and is free of State aid. The selection procedure must be open, transparent and non-discriminatory and the selection criterion must the lowest price or the most economically advantageous offer. In this case, the aid flows through the trainer (who is paid by the state) to the employers of the trainees. So, a competitive selection procedure for trainers cannot eliminate the aid for the employers of the trainees.

The GGE of the State aid is the amount paid by the state to the trainer (which is considered to be equivalent to the value of the services at market rates because the trainer has been selected competitively) minus any symbolic or partial payment the trainees have to make. More specifically, the amount of State aid per participant can be calculated as follows:

**GGE (of State aid received by participants) = {((total fee paid by the state to the trainer)/(total number of man-hours of training)) x (hours of training received by each participant)} – (any fee paid by each participant)**

Occasionally, Member States fund technical advice services (e.g. familiarisation with state of the art technology or presentations of new products/processes) that are provided for free by intermediary research organisations such as universities. According to point 22 of the Framework for R&D & Innovation, the intermediary research organisation must pass on to the final beneficiaries the totality of the public funding and a number of other conditions need to be satisfied such as competitive selection. Often, the total monetary value of the services provided for free to the final beneficiaries is kept below the de minimis threshold per beneficiary. In addition, if the intermediary research organisation is appointed without any prior competitive selection procedure, then any indirect benefits derived by the intermediary research organisation must also be kept below the de minimis threshold.

### *Cumulation of training aid with other State aid*

In general, an undertaking may receive multiple awards of State aid as long as the underlying costs are different. In other words, State aid may not subsidise twice the same costs.

Article 8 of the GBER provides that: “Aid with identifiable eligible costs exempted by this Regulation may be cumulated with: (a) any other State aid, as long as those measures concern different identifiable eligible costs”.

This means that training aid can be cumulated, for example, with regional investment aid. The eligible costs for the investment aid are typically the cost of buildings, equipment, machinery, etc. The maximum aid for investment can be derived by multiplying those costs by the applicable regional aid intensity.

By contrast, the eligible costs for training will be the fee of the trainer and the wage cost of the trainees during their period of training. It follows that an undertaking incurs different costs for the training of its staff. The maximum aid for training can be derived by multiplying the training costs by the allowable aid intensity of 0.5.

## The GGE in the operation of infrastructure

When the state confers a right to an undertaking to use publicly-owned infrastructure (e.g. an office building), the GGE of the State aid is the market rate of rent that can be obtained from that infrastructure. If the user pays some rent, then the GGE is:

**GGE = market rate of rent – actual rate of rate**

The GGE of the right to use commercially public-owned infrastructure can also be determined through a comparative analysis. That is, if similar infrastructures operate on the market it may be possible to identify a market rate or, more precisely, the rental rate of such infrastructure.

However, in practice it can be very difficult to compare different infrastructures such as ports, airports, stadiums, arenas, toll roads and bridges, or conference halls. The reason is that they can have different capacity or different utilisation rate, they can be sited in more or less attractive locations and their construction may have been subsidised. All these factors make comparisons difficult, if not impossible. Although the Commission accepts in principle that the comparative method may be used to determine the market rent of infrastructure, it often rejects such comparisons for being faulty.

Therefore, if that infrastructure is unique and no market rate of rent is available, the GGE of the State aid is the present value of the future stream of net revenue (i.e. gross revenue – operating costs – any initial investment costs). In other words, this is the revenue that the state forgoes and, therefore, it is equal to the advantage that is conferred to that undertaking.

The State aid which is embedded in the right to use public property or infrastructure can be eliminated through the competitive selection of the operator of the infrastructure who then makes it available to final users or through the auctioning of the right to use the infrastructure by final users. The selection procedure must be open, transparent, non-discriminatory and unconditional.

Occasionally, Member States also subsidise the construction and operation of privately-owned infrastructure. State aid rules require that the public funding may not exceed the "funding gap" of the infrastructure. The funding gap is the difference between the initial investment cost and the present value of the net revenue stream over the economic life of the infrastructure. The expected annual net revenue is discounted at the cost of capital of the operator, given by the WACC. Therefore, if the state funds 100% of the funding gap, then:

**GGE = Net present value of the funding gap = (initial investment – (operating revenue – operating costs)) over the economic life of the infrastructure, discounted at the rate of WACC**

Of course, the state may choose to fund less than 100% of the funding gap. But in this case, the project may become unviable. In practice, public funding covers slightly less than the full funding gap to induce the beneficiary to be as cost-efficient as possible by reducing future operating costs and increasing future operating revenue.

It should be noted that the economic life of infrastructure is not the period of tax depreciation. Normally, the depreciation period is much shorter than the economically useful life. The latter is the time period during which the infrastructure can generate revenue.

According to the market economy operator test (MEOT), a private owner or operator of airport infrastructure allows a third party to use the infrastructure only if the incremental revenue earned from that third party exceeds the incremental costs incurred as a result of the use of the infrastructure by that third party (Box Annex 1).

### Box Annex 1. Market economy operator test

**MEOT: (Discounted Incremental Revenue) – (Discounted Incremental Costs) > 0**

**Incremental revenue** (per accounting period)

Aeronautical revenue

A = Number of expected passengers x fee per passenger

B = Number of flights x fee per flight

Non-aeronautical revenue

C = Number of passengers x revenue per passenger (shops, parking, etc)

**D = Total revenue = A + B + C**

**Incremental costs** (per accounting period)

Operating costs

E = Number of expected passengers x cost per passenger (handling, cleaning, depreciation, etc)

Extra investment costs

F = Only when they are necessary or required investments over relevant period

**G = Total costs = E + F**

**Net result** (per accounting period)

**H = D – G**

**Net discounted result** [over whole of relevant period (period of agreement)]

$\sum H/(1 + r)^n$

## The GGE of the right to use public land or sale of public land

The GGE of the right to use public land (e.g. agricultural or industrial plots) can be derived in the same way as the GGE of aid in the use of infrastructure. When the market rental rate is available it should be used. If the plot of land in question is different from other plots recently rented out, then the rental rate may have to be adjusted. This must be done by a professional land surveyor who is independent of the landlord. In the case of industrial plots the adjustment may need to take into account such things as access (or absence of access) to utilities, sewage networks, or rail terminals, or the construction of anti-spillage channels or noise barriers.

For very unique plots of land or unique property or for land or property that is seldom rented out, an alternative method of calculating the GGE is to determine, first, the maximum rent a tenant would be willing to pay. For a tenant, rent is an operating cost. Therefore, the maximum rent that the tenant would be willing to pay would be equal to the difference between the maximum profit it can earn and the amount of profit that covers its cost of capital. That is:

**Market rate of rent = (maximum realisable profit) – (profit that just covers the cost of capital)**

Once the market rate of rent can be obtained, then the GGE of State aid is:

**GGE = (market rent) – (actual rent) x number of years of renting (discounted over period of rental agreement)**

In the case of sale of public land, it is also necessary, first, to determine the market price of the land that is sold. The best method of establishing the market price, regardless of the price it produces in the end, is an auction or sale through a competitive process. Even if prior valuations by independent experts indicate higher prices, the Commission and EU courts always accept that an auction or a competitive process corresponds to the real market price. However, the comparative method can also be used. The proper comparison of market prices of similar plots of land always requires input from independent experts who can perform competently and justify convincingly any adjustment they make to prices of similar plots.

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