<u>Economic Development Committee</u> EDC19-00(p2)

Date:	**13 December 2000**
Venue:	**Committee Room 1 National Assembly for Wales**
Title:	**Operating Aids and Fiscal Variations**

INTRODUCTION

1. At the EDC meeting on 22 June, the Committee asked for further work to be done on proposals for operating aids, taking into account issues raised at the meeting by Treasury.

2. The Partnership Agreement "Putting Wales First " includes a commitment " In order to achieve the maximum impact of Objective 1 status during the programming period we will rigorously pursue the scope for fiscal variations and other special measures which can exploit to the full the benefits of the regional state aid status given to West Wales and the Valleys." On December 6th the Deputy First Minister went to Brussels on a fact finding in order to begin this process.

3. This paper sets out progress on the development of proposals, the key feedback from the Commission and the further work required to reach conclusions.

FINANCE WALES SCHEMES

4. Our expectation is that all Finance Wales loan products will be cleared by DG Comp as containing no Aid element. This would enable identical products to be offered throughout Wales, regardless of the status of the different areas. (This applies equally to the loan funds and the interest relief scheme). To achieve this, Finance Wales will provide loans at market rates. The rates will be subject to annual review and adjustment in the light of the state of the Funds. The Funds should therefore be recyclable on an on-going basis.

Interest Relief Scheme

5. There will be projects for which interest set at market rates would be too high. In these cases, Finance Wales will be able to provide a subsidy. The effect of this would be to reduce the rate and consequently a firm's interest payments. The amount of subsidy would depend on the particular circumstances of the project. Its total would also depend on de minimus rules, in particular the requirement that cumulative de minimus aid cannot exceed 100,000 Euros in any three year period. For illustrative purposes, this ceiling would be high enough to accommodate

a two percentage point reduction on a loan of £1 million. No small loans will be that large. The ceiling covers all forms of de minimus aid in a period, so de minimus aid from a local authority or other organisation would count towards the ceiling and reduce the maximum amount available for interest rate relief.

6. This scheme will be run in conjunction with Finance Wales' Loan and Mezzanine Fund products, which deal directly with agreed market failures. It is a de minimus scheme which does not require DG Comp clearance. DG Comp know about this from our earlier discussions with them on Finance Wales' Objective 1 project.

Subordiniated Equity Fund

7. Part of the Finance Wales Objective 1 project involves the creation of an Equity Fund of £24 million, which again addresses an agreed market failure. As with the Finance Wales Loan Fund, in order to enable identical products to be rolled out across Wales, this fund will be set up so as to contain no Aid. DG Comp has told us that this could be achieved by adopting a pari passu scheme - one in which the private and public sector partners shared the gains or losses equally. With good management, such schemes should also be recyclable.

8. This implies that, since the private sector partner would be looking for an adequate return, such a fund could handle only the most promising projects. To provide equity finance to a rather wider selection of firms - still viable, but less obviously bankable - a Subordinated Equity Fund would be needed. Under these arrangements, public sector partners would guarantee to bear the first losses, so that private sector partners would get a return on their investment. Without a significant measure of good fortune, such schemes will be not indefinitely recyclable and there is a clear implication that the public sector partner's funds will need replenishing from time to time.

9. DG Comp has pronounced such schemes Operating Aid. The aid in question goes not to the small firm in which the equity investment is made but to the private sector institution guaranteed the return on investment. The purpose of the aid would be to persuade institutions to invest in areas that would not be seen as promising - ie Objective 1 areas.

10. Setting up Finance Wales and implementing the related Objective 1 project have been seen as the priorities in this area for National Assembly and Finance Wales staff. Work will commence on this proposal early in the New Year and will follow as exactly as possible an Irish scheme which DG Comp approved a few months ago. We are not therefore anticipating difficulty in getting this Operating Aid approved by DG Comp. ERDF co-funding is not being sought for this scheme. For 2001-02, £5 million is being made available for this scheme from National Assembly resources out of end year flexibility. This should enable the creation of a £10 million fund for the Objective 1 area. Private sector partners will be invited to tender for participation in the fund.

BUSINESS RATES

11. In parallel with DETR in England, the National Assembly is consulting on the future of Local Government Finance. A consultation paper was published on 22 September and the consultation period runs until the end of the year. It is expected that primary legislation will be required to implement proposals arising out of the consultation. The Assembly Cabinet is keen to secure general powers within the primary legislation enabling it to develop distinctive and effective *Made in Wales* solutions.

12. One aspect of Local Government Finance that will be considered when the consultation period ends is whether the proposed rate relief scheme for small businesses should be more generous to businesses in West Wales & the Valleys than in other parts of Wales. There are a number of different factors to consider in this. These fall into two categories: financial and competition.

13. The total net yield from business rates in Wales is around £630 million. The financial issue turns on the question of who would pay for the scheme. The key document here is The Statement on Funding Policy agreed between the National Assembly and the Treasury. Under this Statement, were the National Assembly to use its powers to reduce the yield from business rates, thus automatically increasing Treasury's contribution to local authority spending, the amount of business rate income foregone could be deducted from the National Assembly's block. This adjustment would take account of the change in Wales in relation to the change agreed for England by DETR. The current agreement therefore means that an operating aid implemented on a Wales alone basis would need to be funded from Assembly resources. Clearly, if a similar operating aid was also introduced across Objective 1 areas of England, the case for no abatement of the Assembly’s block would be a powerful one.

14. Either way, it is *possible* that any such scheme would have to be funded from the Assembly's resources. There are two broad options:

- The shortfall in rate income to local authorities to be made good from reductions in other National Assembly budgets.
- The reduction to be funded by an increase in business rates for businesses not benefiting from the reduction. As the proposed scheme is limited to small businesses it might mean small increases for large and small firms in East Wales, but increases instead of decreases for large firms in West Wales & the Valleys. There are other possibilities for how the benefits of lower business rates might be targeted, with corresponding implications for how the dis-benefits would fall.

15. In theory, Objective 1 could be drawn on to offer a third way to fund a business rate reduction for West Wales & the Valleys. However, this would mean that all funding for the most important element of the Objective 1 programme - Business Support in Priority 1, Measure 1 -

would have to be frozen until DG Comp had approved the Operating Aid. This applies to all forms of State Aid which have to be approved by DG Comp, not just Operating Aid. In discussions between the UK and the Commission it was agreed earlier this year that each of the Single Programming Documents for the United Kingdom's Objective 1 areas, including that for West Wales and the Valleys, would contain text allowing providing for flexible arrangements for new forms of State Aid to be applied without the need for formal Decisions modifying the SPDs.

16. In competitiveness terms, the way any business rate reduction might be targeted would depend on what market failure the reduction is aiming to address. DG Comp insists that each proposed Operating Aid be justified by a specific market failure, and that the Aid addresses that failure tightly. However, the identification of a market failure is not sufficient to justify public intervention. Intervention should be aimed at removing the market failure by securing a sustainable adjustment in the market

COMMUNITY INVESTMENT TAX CREDIT

17. This is a proposal by Treasury, arising out of the Chancellor's recent Pre-Budget Report. National Assembly officials are contributing to Treasury consideration of options. These are not, at present, for publication.

18. The basic principle of the scheme, as set out in the Chancellor's report and the report of the Social Investment Task Force, is to provide a tax credit to firms investing in community finance schemes in deprived areas. These community finance schemes may include support for small firms, or more traditional forms of community regeneration activities, including community enterprises.

19. The thrust of the scheme seems similar, in State Aid terms, to that of the Subordinated Equity Fund discussed above. The benefit, in the form of a Tax Credit rather than a guarantee of return, goes to the financial institutions investing in community finance organisations in order to get those institutions to invest in unpromising areas. The Italian Government is expected to propose to DG Comp a similar scheme for the southern regions of Italy. DG Comp, although aware of the proposal, has not commented on whether this would be Operating Aid or on its acceptability.

RESEARCH & DEVELOPMENT TAX CREDIT ENHANCEMENT FOR OBJECTIVE 1 AREAS

20. To date, this proposal has not been supported by Treasury, mainly on the basis of the potential for leakage, such that firms could be able to qualify for the credit without actually doing any Research and Development in the Objective 1 areas. Treasury take the view that it

would be impossible to prevent this leakage without imposing onerous compliance costs on Government and business alike.

21. Our general view of this proposal is that it addresses one of Wales' most significant industrial problems very closely. It is difficult to argue that the concentration of R&D activity in the South East is a market failure, because R&D is generally concentrated among very large firms. However, it is generally agreed that small firms could do more R&D and that this would be an important source of development in the knowledge economy. We are therefore seeking to revise the proposal in such a way as to minimise leakage without the imposition of heavy compliance costs. Accordingly, we have discussed the issues with a tax expert. One outcome of these discussions is the need to obtain detailed advice on how a broadly comparable measures might operate in Ireland. Any scheme would need the express approval of Treasury.

FEEDBACK FROM BRUSSELS

22. Following a highly helpful and informative meeting with the Director of State Aid in DG Competition the following points emerged:

23. It is far from too late to submit either operating aid or other fiscal measures to the Commission for their consideration.

24. Operating Aids are not popular with commission and are only tolerated in Article 87(3)a regions where there is ample justification. Operating Aids have to be closely targeted and justified in terms of regional handicaps of the potential beneficiary region and must be "proportionate" to the problems they seeks to solve. This is a highly subjective area where a robust case is essential.

25. Fiscal variations can be provided through investment aid as well as through operating aids. The Commission clearly favour investment aids linked to a positive act of either increasing investment or employment in the beneficiary region.

26. Sectoral measures such as the Tax credit for R&D can include increases for Article 87(3)a regions and regions eligible under Article 87(3)c.

27. Business rate reductions for small firms would not have to notified if they were "de minimis"- i.e. less than 100,000 euros over 3 years to a beneficary. Care would have to be taken on the cumulative affect of any such scheme with other de minimis schemes.

28. The approval of venture capital funds and other funds such as those already in the Finance Wales proposals are actually perceived by the Commission to be more complicated than fiscal variations.

CONSULTATION WITH IRISH TAX AUTHORITIES

29. The Irish tax authorities have also been approached and evinced a willingness to assist in providing general guidance on the extent to which tax measures may be helpful in regenerating West Wales & the Valleys. However, they asked us to postpone the visit until after their budget, on 6 December. A visit is being arranged for early January 2001.

30. As noted above, one of the items on the agenda will be the possibility of amending the R&D Tax Credit enhancement so as to minimise leakage. Other possibilities will also be explored.

CONCLUSION

31. It is clear that there are a number of opportunities for Wales to develop and expand the range of fiscal variations and other incentives to complement Structural Fund Programmes. These opportunities arise from:

The proposals included in the Chancellor’s pre-Budget statement,

The Green Paper on Local Government Finance

From the feedback received from Brussels on both operating aid and investment aid and the potential to fully exploit new regional State Aid scheme in Wales.

32. Because of the sensitive and technical nature of this work and its potential benefit to the Welsh economy, specialist advice may be needed early in the New Year. If this is the case, we shall arrange for a fast track procurement of such advice. It will be necessary for the Assembly to employ consultants to help it identify the key regional handicaps and structural weaknesses of the economy in West Wales and the Valleys and the most effective and realistic ways of addressing them, through appropriate fiscal variations, be they operating or investment aids or other methods. This work will have to address Whitehall and Commission concerns, limitations and opportunities.