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Keywords
Wine and international trade; heterogeneous firms; perceived quality; quality incentives; collective reputation.

Research Question
The EU subsidizes policies to promote EU wine in foreign markets. Does it make sense? Who should benefit, established exporting firms or new ones? For rich markets or emerging ones?

Methods
We use a monopolistic competition model of international trade with heterogeneous firms. Utility comes also from perceived quality, which depends on individual firm’s and country aggregate’s quality (‘collective’ reputation).

Results
Preliminary results show that the optimal promotion policy depends on destination markets. In new markets, promotion policies should target more productive firms since the aggregate quality effect is more important.

Abstract
INTRODUCTION AND RESEARCH QUESTIONS
Recently, the European Courts of Auditors (ECA) has criticized the EU policy of subsidizing promotion activities aimed at increasing EU wine consumption in third countries. Member States spent euro 522 million in EU funds under the promotion measure between 2009 and 2013. For 2014-2018, there has been a large increase in funds (1.16 billion euro to the EU-27) (ECA, 2014). However, although wine exports to third countries have significantly increased in absolute terms, the audit revealed that EU wines have lost market shares in the main third countries targeted by promotion actions, with exports of EU wines not eligible for support increasing as well (ECA, 2012). Moreover, “…‘the promotion actions are often used for consolidating markets, rather than winning new markets’. Large wine companies have also benefited from funding, which was intended only for small-to-medium businesses…” (Mercer, 2014). It is thus not surprising that the Courts is concerned that, “given the difficulties experienced by the Member States in spending the 2009- 2013 budget initially earmarked for promotion actions, there is a risk that the 2014-2018 budget is set too high, endangering the application of sound financial management principles” (ECA, 2014).
Other commentators have taken a critical position as well. Robinson (2015), for instance, reports that wine producers outside Europe rightly complain that their EU counterparts have long been cosseted by subsidies. Since 2008, however, (promotion) funds should be spent on promoting European wine outside Europe, creating new markets and making it more competitive with the likes of New World producers. She also notices that France got a reduced budget over the period 2014 and 2017, probably due to the use of funds for buying “three VIP tickets for the tennis championships at Roland Garros which cannot be considered as a wine promotion action” and for promoting champagne, a name already world-famous.
The other two major recipients are Spain and Italy. For the former, she highlights how “the EU pointed out that far

too high a proportion of funds, 88 per cent, was given to six big companies that already had a presence in export markets. The whole point of this initiative is to make life easier for small and medium-sized companies." Regarding Italy, she notices that "there seems to be far more emphasis on the process than the results" of promotion activities (Robinson, 2015).

The case of Italy is interesting however also because there has been quite a controversy between major wine exporters and the Ministry of Agriculture. 'Italia del Vino Consorzio' and 'Istituto Grandi Marchi', representing 31 major wine producers with a turnover of 1.3 bn of euro and representing 15% of Italian wine export, argued against two features of the Italian regulation enacted to get access to the EU funds.

The first criticism is about markets. In the evaluation of proposals, projects aimed at markets in which beneficiaries have never implemented before any promotion activities with EU co-funding would have priority. This, they argue, would be against a basic strategic principle by which it is exactly in the foreign markets with more competition, which can also buy higher volumes, that have to be targeted with promotion activities, else competitors would gain bigger market shares (CdB, 2016). The second criticism is about beneficiaries: giving priority to firms that have never benefited from EU co-funding before would penalize those firms that in the past have successfully been trail-blazer for the whole Italian wine sector.

In this paper we address some of these questions. First of all, what is the economic rationale for promotion policies, if any? Second, if a promotion policy is to be implemented, how should it be designed? In particular, who should be the beneficiaries, only smaller-medium firms or should bigger firms receive subsidies as well? Last, which third-markets should be targeted, i.e., should promotion subsidies be focused to richer and established destination markets, or to new and emerging ones?

METHODS

We extend the model of monopolistic competition and heterogeneous firms (Melitz, 2003) into different directions. On the demand side, utility is quadratic in quantity (as in Ottaviano and Melitz, 2008) and linear in perceived quality. This specification enables to introduce variable markups to take into account, among other things, how market toughness (related to market size and the increase in competition that follows new entries in bigger markets) affects firm's behavior, such as the scope for quality differentiation (see, e.g., Antoniades, 2015).

Perceived quality depends on a convex combination of individual firm's quality and an aggregate (at the country level) function of qualities. The weight on the individual firm quality increases with the degree of awareness of the representative consumer of the destination market. If the consumer is relatively unaware, the aggregate quality (collective or 'national' reputation (Cagé and Rouzet, 2015)) has a bigger role in perceived quality. This may be true in new markets, where it may take time for buyers to gain familiarity with individual firms' quality.

On the supply side, firms are heterogeneous regarding marginal production (quantity) costs and all face a fixed cost for quality. In line with more standard models of heterogeneous firms, this implies that there is a sorting of firms into exporting, i.e., firms that export are those more productive/profitable.

RESULTS

In standard models of monopolistic competition with heterogeneous firms, an additional source of gains from trade is due to reallocation effects. Since only most productive firms self-select into exporting, trade liberalization increases the overall market share for more productive firms and increases industry average productivity, thus increasing economic welfare. An effect of subsidizing export – like for instance with a subsidy for promotion activities - is that it may increase the number of firms exporting (extensive margin).

In our model, results are more nuanced. Subsidized promotion activities – at least those similar to the EU ones that reduce the fixed cost of exporting - affect the selection into exporting, possibly enabling smaller firms to export. In addition, subsidies can also impact indirectly on firms' quality choices since they decrease their fixed costs of entry and there is more room to spend money on quality. Moreover, promotion policies affect quality choices also indirectly through their effect on aggregate quality (collective reputation).

Preliminary results show that the optimal promotion policy depends, ceteris paribus, on destination markets. In foreign countries where awareness (about individual firm brand) is relative low, i.e., new markets, promotion policies should target more productive, i.e., high quality, firms since the aggregate quality effect is relatively more important. On the other hand, in established markets, promotion policies may target smaller firms without dampening incentives for quality investments. Smaller firms may have higher costs, but returns from quality would be higher since individual quality recognition by consumers is higher and because, before smaller firms, the bigger/better quality firms were exporting and hence aggregate perceived quality higher.

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