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State Aid in the EU

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Contents

Abstract

The purpose of this paper is to examine the correlation between the economic theory and judicial rules governing state aid within the EU. Economic theory suggests that state aid give rise to a loss in efficiency, but might nevertheless but utilised to carry out countries industrial policies and to remedy market failures. The EU's rules are inspired by these economic considerations and therefore make use of a general prohibition against state aid. However, this is a general rule with many exceptions. The most important being the rules governing aid pursuing 'horizontal objectives', objectives meant to target a market failure. There is further a downward trend in total aid in relation to GDP in the EU during the last decade, as well as an increased proportion of horizontal aid in relation to total aid. A development meaning a more economic friendly approach towards aid, and the existence of fewer distortions within the common market.

Keywords: EU, State Aid, Competition

Abbreviations

CAP	Common Agricultural Policy
EC	European Communities
ECJ	European Court of Justice
ECSC	European Coal and Steal Community
EEC	European Economic Community
EU-25	25 MS before the expansion on January 1, 2007.
EU-15	15 MS before the expansion on May 1, 2004.
EU-10	10 new MS which joined on May 1, 2004
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
MS	Member States
OJ	Official Journal
SAAP	State Aid Action Plan
SME	Small- and Medium-sized Enterprise
RAG	Regional Aid Guidelines
R&D	Research & Development
R&D&I	Research & Development & Innovations
TEC	Treaty Establishing the European Community

1 Introduction

1.1 Issue

The European Union is a unique example of economic integration between a large number of countries in an effort to bring peace and prosperity to a continent, too long plagued by conflict and suffering. The first steps taken by six nations more than 50 years ago, have today grown into a Union comprised of 27 countries, a Union that has grown not only in members but also in areas in which the cooperation takes place. One of the key areas is undoubtedly the establishment of the four freedoms and the creation of a common European market, a market in which competition policy constitute a cornerstone.

The achievement of successful market integration is conditional upon an effective competition environment between the member states. As one of the main aspects of competition policy, state aid is an interesting area with large economic implications on the community level. Since its implementation and effectiveness is directly related to the functioning of the common market, and the competitiveness of the European economies.

The rationale behind state aid is laid out in economic theory and is later implemented in the highly regulated Community legal order. As often the case in commercial law, the question then arises; to what extent economic considerations are reflected in the legal instruments and in the development of the aid granted? How well is economic rational transformed in the implementation process? These are some of the questions this paper sets out to address.

1.2 Method, material and disposition

The chosen method for the paper is a literature study from both an economical and legal perspective. The economic background is based mostly on theoretical models explaining the fundamental economics of state aid, as well as its economic justification derived from the theories of political economy (*Chapter 2.*). The legal background then illustrates how these economic considerations are manifested in the substantial rules governing state aid (*Chapter 3.*). Due to the significant influence of case law developed by the ECJ in this area, an in depth look into ECJ jurisprudence is needed to fully grasp state aid as laid out in the TEC. The following part then examines the development of state aid during the last decade by making use of official EC statistics, adopted Community instruments, as well as examples of economic reasoning from state aid cases meant to illustrate how economic theory is reflected in aid decisions, and the continuous revision of state aid policy (*Chapter 4.*).

In an effort to avoid confusion concerning the use of EC vs. EU, it should be clarified that EU will be used throughout this paper when referring to the European cooperation as a whole, while EC refers to the areas concerning the first pillar of European Union law such as the common market and its competition policy.

2 Economic Theory of State Aid

The doctrine concerning the economic implications of state aid is extensive. This chapter will be limited to carry out a partial analysis with focus on the efficiency implications of aid and what separates state aid from other forms of market interventions. In addition, the most common economic arguments for the granting of aid will be handled together with some criticism of these theories.

The economical effects of state interventions are best explained by the traditional supply and demand curve, derived from the neo-classical school, where the crucial difference between state aid and other interventions, such as tariffs are easily exemplified.

2.1 Production subsidies

Even though state aid can be given for a number of reasons and in a number of ways[1], it is usually given as a subsidy to producing entities. It can therefore, in an economical sense, be interpreted as a *production subsidy*. Even if the recipient is not a manufacturing firm, the subsidy can be thought of as any measure conferring an economical advantage such as e.g. a preferential tax agreement for a company in the service sector. The model works regardless of the form of the subsidy as the important aspect is the sole fact that it does indeed lower the cost of production for the recipient.

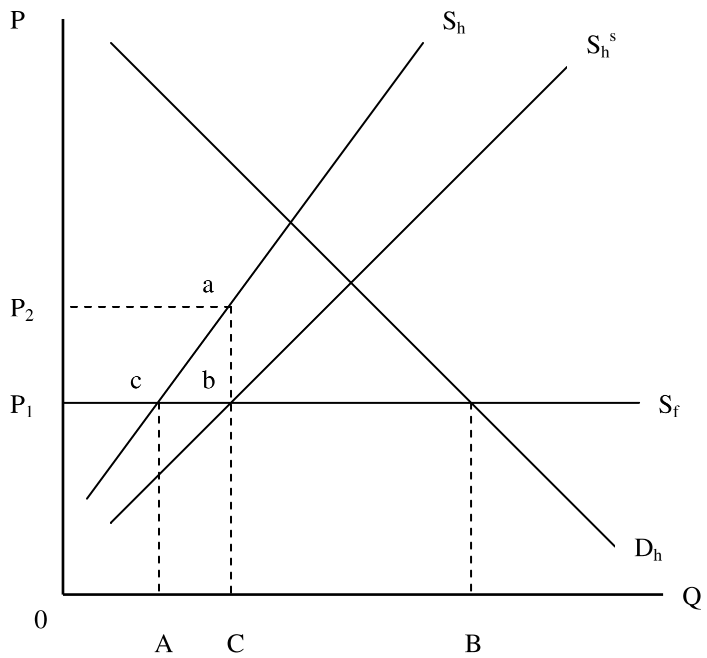
2.1.1 Efficiency-loss

In the initial stage where no distortions are present and where full competition is assumed the producer will be met by the free trade equilibrium (*Figure 1*). If the producer then would be given aid, seen as a

[1] Crocioni, p. 92

production subsidy, it would allow the company to supply the good at a lower cost, thus shifting the supply-curve downwards with the same amount as the aid given by the state. The producer supply will shift from S_h to $S^s{}_h$, and the price received by the producer will then exceed the amount paid by the consumers by the size of the subsidy at any output of the good. At market price P_1 producers will now be able to supply *OC* rather than *OA*, while consumers still pay OP_1 per unit supplied and the producers receive OP_2 (the price paid by the consumer plus the subsidy given). The subsidy is thus made up by *ab*, allowing the producers to increase its sales on the account of decreased imports with the amount *AC*.

Figure 1



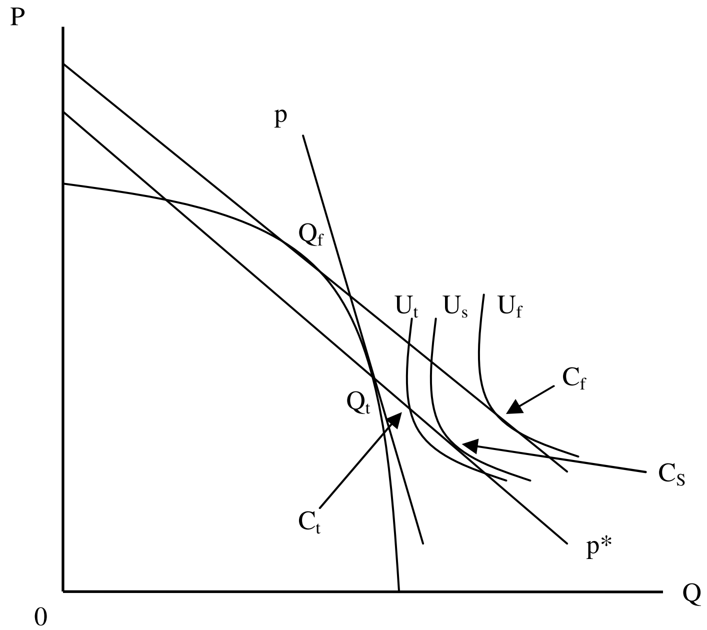
Source: Greenaway (1983) p.144

The remaining effect of the production subsidy is the fall in imports of the subsidised good. Unlike the use of a tariff, the production subsidy only affects the supply-curve, leaving the demand-curve unchanged. In welfare terms, this means that the only loss is the one of production equivalent to the area, *abc*, while no consumption dead-weight loss is present. The production subsidy then creates less distortions then a tariff that also distorts consumption.[2]

Another major difference is also that while the use of tariffs creates an income for the state, the production subsidy constitutes a cost. The subsidy means that a distribution of income from the state to the receiving producer, equivalent to P_1baP_2.

The difference in welfare-loss between a production subsidy and a tariff can also be illustrated in the same model (*Figure 2)*.

Figure 2



Source: Markussen (1995) p.252

Since the subsidy does not distort consumer prices, consumers will still be able to consume at market prices, with consumption at, C_s, facing the utility level of U_s. Whereas the imposition of a tariff change the prices facing the consumer, leaving consumption in C_t, and the utility level at U_t. The distorted quantity, Q_t, will still be the same, but the subsidy allows consumption at a higher utility level since it does not distort the gains from trade. The distortion caused by the tariff distorts both consumer and producer prices, thus diminishing both the *gains from trade and*

[2] Greenaway, p. 144

specialization. While the undistorted consumer prices in the case of the subsidy, leaves the *gains from trade* unaffected and only causes a loss to the *gains from specialization.*[3]

2.1.2 Non-competitive markets

When dealing with state aid from an efficiency approach it is important to recall the underlying assumptions of perfect competition that it is based on. When assuming perfect competition conditions there will not be any incentives for the use of production subsidies since they, as shown above, reduces welfare. However, if one relaxes this assumption of perfect competition one might come closer to the reality. Since arguments have been made that most markets are not perfect competitive, but in fact share the characteristics of a Cournot oligopoly.[4] How does this change the justification for prohibiting state aid?

In oligopolistic markets within a customs union, the member countries get an incentive to give production subsidies to firms since it may yield higher profits. This could be the case when the characteristics of imperfect competition are combined with discretionary taxation.[5] If member countries are allowed to give discretionary subsidies, they may continue to do so in a *Nash equilibrium* where the situation of a prisoner's dilemma may be obtained. In such a situation, the individual member country may be gaining by giving subsidies, since the increased export of the subsidies product outweighs the cost of granting the subsidy. This does however cause a loss to other countries, which productions suffer from the competition of the subsidizing country. This loss is however greater than the overall gain for the country using the subsidy, making the best solution a multilateral reduction of subsidy level, which would increase welfare of all member

[3] Markussen, p. 253
[4] Brander, p. 83 ff.
[5] Collie (2000), p. 869 ff.

countries.[6] This does then provide the economical justification for supra-governmental control of state aid in a customs union, such as the EU. It also means that even if the assumptions concerning perfect competition are not fulfilled there are economical justifications for a negative approach against production subsidies, and for a regulation of state aid on a community level.
The same authors that reached this conclusion have later modified their conclusion in a new analysis, where they examined subsidies in a Cournot and Bertrand oligopoly where the products, unlike the first analysis, are considered to be nationally differentiated. With *heterogeneous* products, the negative effects on foreign producers caused by the subsidy might be outweighed by the positive effect on foreign consumers due to cheaper imports. [7] In theory, this might be a true assumption but when *plausible values* are given to the opportunity costs of production subsidies, the subsidies will probably not be used in a Bertrand oligopoly, and should be prohibited in a Cournot one, since it would increase the combined welfare of all countries, a conclusion in line with the first study.[8]

Production subsidies does then create less distortions than other market interventions, therefore making them the 'best' market intervention in an economic sense, even if the conditions of perfect competition is not fulfilled. This is of special interest for an organisation such as the European Union, which has as a main objective to achieve increased economical integration and intra-community trade. By keeping obstacles to trade to a minimum, more trade is likely to emerge and thus increasing the scope and depth of the European integration.

Since production subsidies do in fact constitute an efficiency loss, why are they still allowed? Should not the same laissez-faire approach that is responsible for the negative attitude towards tariffs also have affected state aid?

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[6] Ibid. p 881.
[7] Collie (2002), p. 220 ff.
[8] Ibid. p. 230

The answer and rationale for that this is not the case can partly be found in the doctrine of industrial policy and the economics of integration. In line with this view, state intervention is a useful tool that may be used to increase national welfare.

2.2 Industrial policy

The rational for giving state aid through productions subsidies or in other forms, usually takes its starting point in the theories of industrial policies. There is no general definition of industrial policy, but one used is:

'…*a set of measures used by governments to influence the investment decisions of individual enterprises-public and private- so as to promote such objectives as lower employment, a healthier balance of payments and a generally more efficient industrial economy*'.[9]

According to this definition, the relationship with state aid is clear, as state aid through production subsidies becomes a way for the State to implement its industrial policy. Derived from the industrial policy, also comes the notion of '*Strategic trade policy'* meaning ways for the government to promote economic growth by using inventions such as subsidies, tariffs and non-tariff barriers.[10] In this theory the EU finds support for the interventionistic regime of state aid, as a measure to increase both consumer and producer surplus[11]

Since Art. 3 TEC prohibits intra-community tariffs, as a necessary requisite to create the EEC[12], subsidies has been an important tool for member states and the community itself to employ their industrial policy. Even though regulated in the TEC, an absolute prohibition of state aid does not exist, still allowing industrial policy decision by means of state aid to be carried out within the framework of the TEC.

[9] Sauter, p.59
[10] Goldstein & McCuire, p. 547
[11] Beasley & Seabright, p. 21
[12] Senior Nello, p. 3ff

2.2.1 Market failure

The use of state aid as a strategic trade policy is usually justified with reference to, that it is a remedy for market failure caused by such phenomena as[13]:

- externalities
- information asymmetries
- coordination problems
- market power

Market failures means that the market fails to allocate resources efficiently, wherefore market interventions are needed to remedy this deficiency. The theory deviates from the notion that free competition provides the most efficient allocation of resources. It is therefore the theories of market failures that give support for the need of an overall competition policy, since firms otherwise might exploit market conditions, causing a negative effect on overall welfare. Even though all above-mentioned types of market failure could be remedied by an active strategic trade policy, this paper will limit itself to the most commonly referred to of the market failure phenomenon, externalities. [14]

2.2.1.1 Externalities

In its simplest definition, an externality means that one's actions or choices unintentionally affect a third party's well being.[15] This causes a divergence between social and private marginal costs that is not reflected in market prices, as with the classical example of pollution as an externality.[16] The

[13] Friederiszick et others, p. 14
[14] Crocione, p.91

[15] LeClair & Franceschi, p. 464
[16] Nicholson, p.368

externality might also be a positive one, as in the other classical example of bees' pollination of crops. The most relevant positive externality is however, the spill over effect from R&D.[17] Here the social return gained by investments in R&D is higher than the private return, which then would justify state aid to the R&D sector.

The use of state aid to remedy externalities can nevertheless be criticised according to the first best policy. Since the practice of tackling market failure with state aid is indirect and thus ineffective.[18] A view shared by the Commission in the SAAP*:*

" it is not enough for state aid to target a market failure. Before resorting to State aid, which is in general only the 'second best' option to achieve optimal allocation of resources, it should be verified whether other less distortive measures could remedy the market failure."[19]

The introduction of state aid may then in effect lead to a worse distortion then the one created by the externality, and cause an even greater efficiency loss.[20] Even if the purpose of granting aid is not pursuing an economic objective, but rather one of a social character, it might not be an economic efficient approach to use state aid (e.g. when distributing a universal service it might be better to grant the aid directly to the consumer than giving state aid to a firm which in turn supply the consumers).[21]
Misplaced subsidies may then be detrimental to market integration, where such aid risk promoting certain undertakings in an unfair manner, thus contributing to an oligopolistic situation rather than one with perfect competition. This will especially constitute a risk when dealing with larger companies, with greater market shares that are active on a larger geographic market, where they risk distorting competition to a larger extent and thus disrupting the trade between member states. Rightly targeted aid can on the

[17] Sauter, p. 66ff & Senior Nello, p. 323
[18] Nicolaides & Bilal, p.104
[19] SAAP, p.7
[20] Senior-Nello, p.81
[21] Crocioni, p. 92

contrary contribute to greater market integration and act as a catalyst for trade creation. Promotion of development in R&D can have positive spillover effect on other sectors of the industry and by giving a helping hand to less development regions of the EU with regional development aid; a more competitive environment can be obtained. Government subsidies thus have a large effect on trade within a cooperation like the EU, where large aid levels most certainly will have an effect on competition and thus on the integrated market of intra-community trade. Since the receiving of a subsidy by definition puts the recipient in an advantaged position, and since the freedom of movement should be present within the EU, trade will always be affected by the granting of state aid. It is therefore of extra importance from an integration perspective to ensure that aid is properly targeted in order not to reinforce market imperfections.

Even though state aid has a negative effect in regards to efficiency-loss, it is nevertheless not enough for the EU to refrain from utilising it in some areas where it is considered as a crucial tool for the EC's industrial policy. An approach that is reflected in the EU's substantial framework of rules concerning state aid.

3 EC Regulation on State Aid

3.1 Origin of the EC rules

The origin of the Community rules on state aid can be found in the GATT, where the term subsidies are used.[22] The approach of the GATT has been to separate subsidies depending on their purposes. The general subsidy has a negative impact on trade, but if it is pursuing socioeconomic development, R&D or granted without favouring specific firms/industries, it should be allowed.[23]

These rules later inspired the rules on 'subsidies and aids granted by States' in Art. 4(c) of the Treaty of Paris, which established the ECSC.[24] This provision was established to achieve equal competition conditions in the newly founded European cooperation. This provision was closely linked to the formation of the customs union, and the freedom of movement it created. The notion of 'undistorted competition' was also introduced in the article which shows that not only state measures that creates obstacles to the freedom of movement, but also distorts competition between undertakings in the internal market, where targeted.[25]
The aim of the EC regulation has later been clarified by the ECJ, stating that the aim of the common competition policy is twofold[26]:

- Effective integration of the member states' markets into a common community market.
- The protection of a competitive business environment within the common community market.

[22] Art. 16 General Agreement on Tariffs and Trade[1947]
[23] Markusen et other, p. 361
[24] Plender, p. 6
[25] Biondi & Eeckhout, p. 107ff
[26] Collins, p. 381

Hence, the ECJ link the common competition policy both with the economics of *efficiency* and *integration*.

3.2 Current EC rules

The main community rules regulating state aid are outlined in Articles 87-88 TEC, (*Annex*) which covers 'aid granted by states'. In addition to the TEC, state aid is an area in which the community institutions, through the years, have developed a number of other instruments for the regulation of state aid, such as: guidelines, notions, policy frameworks and case law.[27]

3.2.1 Art 87(1) TEC

The natural starting point for state aid is in article 87(1) TEC, which states:

"*Save as otherwise provided in this Treaty, 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 common market*."

This paragraph raise several issues of interpretation, which has been settled by the ECJ in numerous case-law. Article 87(1) has five main requisites (*aid*, *state resources*, *effect on competition*, *selectivity* and *effect of trade between MS*) which must be defined to effectively understand the state aid regulation

(i) Aid

Which measures that are covered by '*aid*' are not defined by the TEC itself and this notion has instead been interpreted through the case law of the ECJ.

[27] Winters, p. 475

The rational for this, is that it is substance, not form, which is the main criteria for defining aid.[28] The ECJ has acknowledged this position on several occasions, stating that aid is 'defined in regards to its effect, and not its aim or form'.[29]

'Aid' has therefore been considered to include such varying measures as: direct subsidies, preferential interest rates, favourable loan guarantees, the provision of land or buildings on special terms, a reduction in social security contributions or tax exceptions.[30]

To create some order regarding the different types of aid, the Commission has divided aid into four basic categories[31]:

- Group A – aid made up direct transfers to firms, including grants and interest
- Group B – aid such as equity participation and all forms of debt conversion
- Group C – aid from saved interest, e.g. tax deferrals
- Group D – aid in form of guarantees.

A more general definition of aid may also be; any capital contribution made by a Member State on conditions that do not correspond with normal market conditions, i.e. an interest in profitability in the long term. A lack of such interest will then lead to the transaction being regarded as aid,[32] also known as the *market investor principle* or *market economy investor principle*.[33]

(ii) State Resources

The requisite that aid should be granted by a '*member State or through State resources*' has also been given as wide interpretation, and is meant to cover

[28] Craig & deBurca, p. 1141
[29] C-173/73, para 27; C-61/79, para 31; C-290/83, para 20;
C-44/93, para 66; C-75/97, para 25
[30] Craig & deBurca, p. 1141
[31] Besley & Seabright, p. 17
[32] Craig & deBurca, p. 1144
[33] Plender, p. 8 ; Oswell, p. 756

aid granted by both regional or/and central governments. [34] It may also include advantages given by both public and private bodies, if they are designed or established by the state.[35] It can also be noted that aid granted by Community institutions are not included by the notion, even though member states resources indirectly fund these measures.[36]

(iii) Effect of competition

The third requirement if that the aid should '*distort or threaten to distort competition*'. As shown in the economical analysis, the granting of aid does in itself constitute an advantage for the recipient and will therefore distort competition. This approach has also been adopted by the ECJ and in practice; it has been rather unproblematic to prove the fulfilment of this, the third requirement.[37] As long as 'aid' is given to certain recipients they will automatically be placed in a more advantageous position then its competitors, and thereby distort competition.

(iv) Selectivity

The favouring of certain undertakings means that the transfer affects the balance between the undertaking and its competitors. This *selectivity* criterion also mean that general measures undertaken by the state such as taxation does not fall under state aid since it does apply generally and isn't aimed at certain recipients.[38]

(v) Affecting trade between MS

The fifth requirement of '*affecting trade between Member States*' comes as an effect of the distorted competition, as it leaves the recipient in a stronger position compared to non-recipient competitors within the community. Case law has stated that it is not necessary to prove that trade has been affected, but the mere possibility that trade may be affected is sufficient.[39] As well as

[34] von Quitzow, p. 140
[35] Craig & deBurca, p. 1144
[36] C-213-215/81
[37] Craig & deBurca, p.1146
[38] Vademecum Community Rules on State Aid (2007), p. 3
[39] C-173/73

that, even small amounts of aid or small recipients may affect intra-community trade.[40] The relative ease by which this requirement is usually fulfilled shows the negative position taken by the policymakers towards any regime that may threaten to distort intra-community trade and thereby undermine European market integration.

3.2.2 Art. 87(2-3) TEC

In spite of the general prohibition of state aid, exceptions are nevertheless allowed if they fall under the measures, listed in Art. 87(2-3) TEC. The rational for the existence of these exceptions is that they are deemed to have some beneficial impact on the community as a whole, which outweighs their negative effects. A trade-off is made between the need to address market failures by state intervention and the efficiency loss caused by the granting of the aid. It is thus under these provisions that measures of the industrial policy can be implemented. The exceptions in 87(2) list three types of state aid that *is compatible* with the common market, state aid;

- With a social character granted to individuals
- For natural disasters or exceptional occurrences
- For the special position of Germany, caused by its division

While the exceptions in 87(3) *may be compatible* with the common market, regarding state aid:

- For regional development
- To promote an important project of common EU interest
- To develop certain economic activities of certain areas
- To promote cultural and heritage conservation.
- Other categories of aid to be specified by the Commission and the Council

[40] C-142/97, para. 43

This means that the Commission has a wide discretion when determining which aid that may be compatible. It is also not sufficient that the aid fall under 87(3) but it must also, in the eyes of the Commission, be deemed necessary and proportionate in relation its intended result.[41]

3.2.3 Other Community instruments

In addition to the rules laid down in the TEC, the Commission plays an active role in the regulation of the state aid through both formal and informal instruments. Formal ones could be decisions and regulations, while informal includes notions, policy frameworks and guidelines.[42] These instruments are especially important when making decisions concerning aid under Art. 87(3) since this fall under the discretion of the Commission.

3.2.3.1 "Horizontal objectives"

The Commission has worked out a special category of cross-industry aid or horizontal aid, that is not exclusive to a specific industry or sector but rather meant to address problems, such as the ones listed below, that may arise in any industry or region.
By combining formal and informal instrument, criteria have been set out to regulate aid in areas that fall under the exceptions in Art. 87(3). Examples include aid for:[43]

- Research and development and innovation(R&D&I)
- Rescue and Restructuring of firms in difficulty
- Environmental protection

An example of the first category are the Community Framework for State Aid for R&D,[44] which describes in what way state aid can be used for R&D

[41] Quigley & Collins, p.76
[42] Winters, p. 475
[43] Vademecum Community Rules on State Aid(2007) p. 5

while limiting distortion to a minimum. Other instruments of a similar character include frameworks and guidelines for state aid in regards to restructuring aid and the environment.[45]

Even if an aid is targeted towards a horizontal objective, it does not give the member state 'carte-blanche' to distribute it. Since the potential effects and distortions created obviously differ from case-to-case, the Commission has decided that larger cases require a notification of the granting of aid. While some cases like aid to SME have been exempted form the notification requirement since they are less probable of creating significant effects or distortions due their predefined small scale.[46]
Certain areas are also exempted from the state aid rules described in this chapter. Such areas include agriculture, forestry, fisheries and aquaculture. Due to their special nature and because of political compromises they are instead guided by specific guidelines.[47]

The Commission carries out its monitoring duties, as stated in Art. 88 TEC, by releasing a yearly *Scoreboard* describing the use of state aid within the EU. This then constitute an essential tool when examining the development of state aid in the EU.

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44 2006//C323/01
45 2001/C37/03 & 2004/C244/02
46 Sinnaeve, p. 1483
47 2006/C319/01 & 2004/C229/03

4 Economic Development of State Aid

To examine the development and progress of state aid in the EU, the Commission publish extensive material on state on a yearly basis. The last available numbers are from 2004, and with a perspective taken ten years back in time, the development of state aid since the adhesion of Sweden to the EU can be exemplified.

4.1 Overall Aid levels

A look at aid as a percentage of GDP shows a decrease the latest ten years all over the member states. The data are based on aid excluding aid to agriculture, fishery and transports, since these are all sectors that are highly regulated in regards to quotas and subsidies, and their policies are formulated upon political compromises rather than economic theory.

Figure 3. **Overall EU State Aid (1994-2005)**

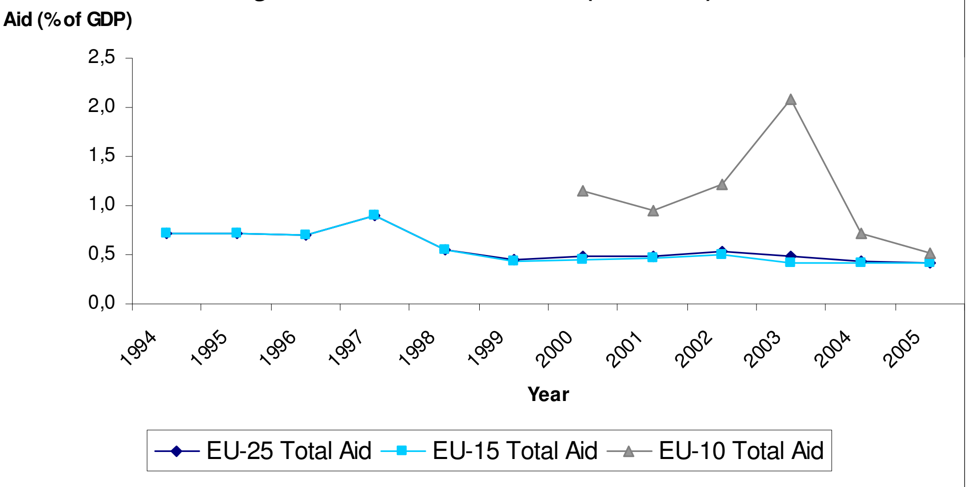
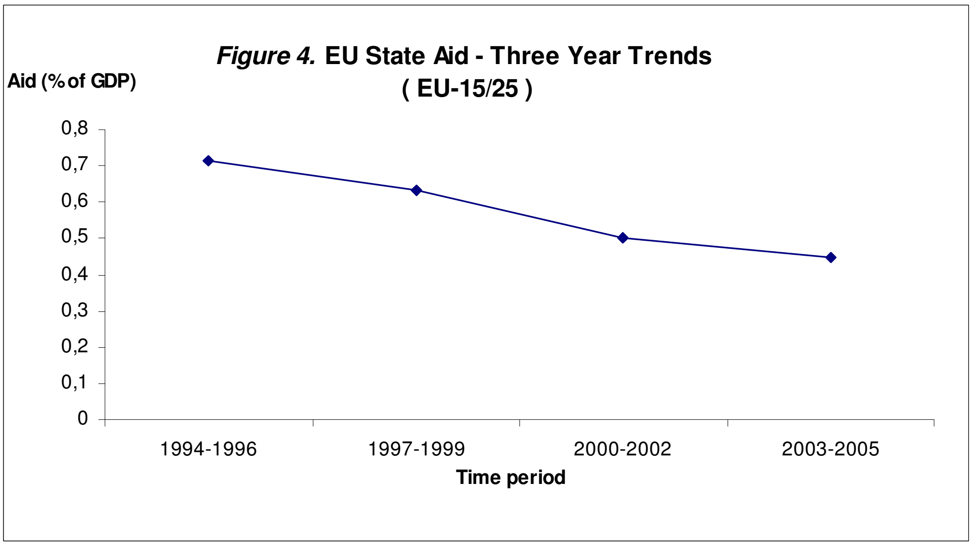


Figure 3 shows that the decrease in aid levels in relation to GDP has been significant during the last decade with more than a 40 percent decline in relative terms.[48] Where state aid measured as percentage of GDP was about 1 per cent for the EU-15 in 1994, and about 0,6 per cent for the EU-25 in 2005.

One can also notice the slightly higher aid levels in the EU-10 group, which however has declined since their accession and their number seem to be converging to the overall levels of the EU-15 countries.

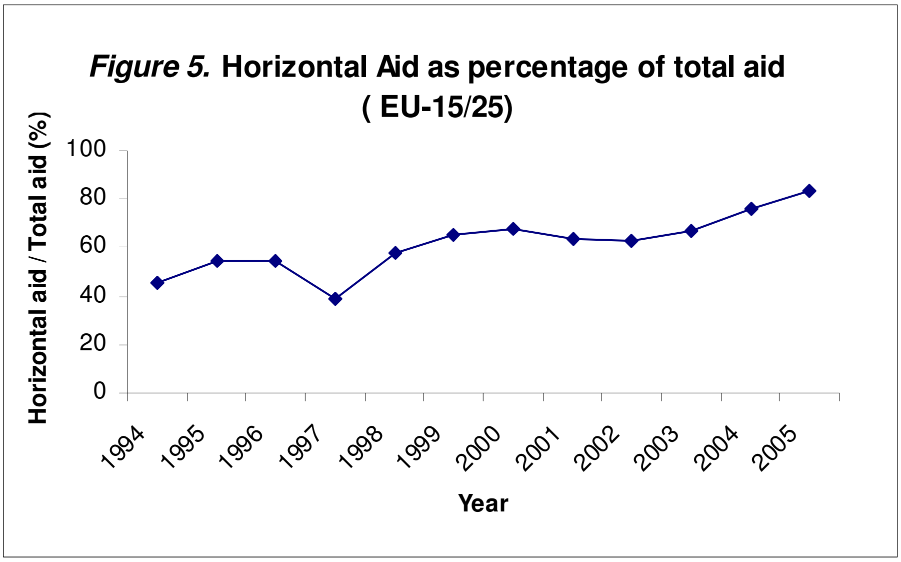


Examining the period divided into three year periods for the Union as a whole (*Figure 4)* show that the decline seem to be somewhat losing moment in the latest timeframe. The figure show all MS (*EU-15 and after the enlargement, EU-25*) and the relative decrease was only about 0,04 percent during the last time period whereas the earlier periods has had a relative decrease of 0,13 and 0,17 percent. This trend can then partly be attributed to the inclusion of the EU-10 numbers. [49]

[48] European Commission – *Total State aid by Member State as a percentage of GDP*
[49] Ibid.

4.2 Horizontal Aid levels

A more interesting perspective from the economical justification perspective is that of the horizontal aid (*Figure 5).* [50] Since it is deemed more economic friendly and perceived to target market failures, it should then ideally account for an increasing amount of the total state aid.[51]



From only making up about 45 percent of all aid in 1994, to 84 percent in 2005 the aid following horizontal objectives has increased substantially.

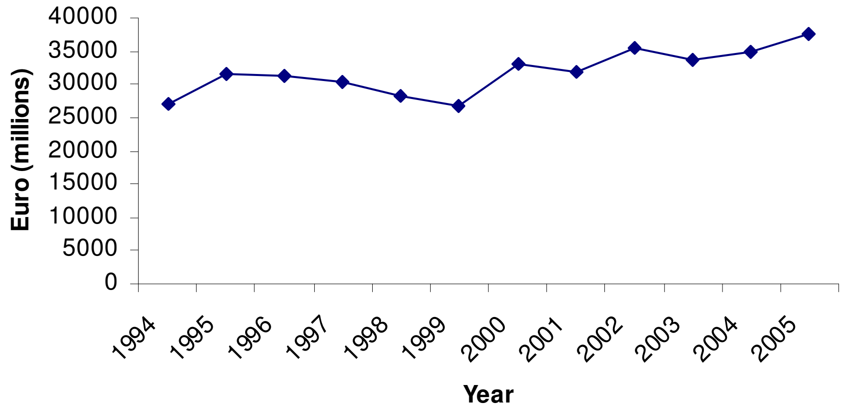
The amount of aid during the same time can also be exemplified (*Figure 6*).[52]

The figure shows that during the period there has been an increase in absolute horizontal aid from *26929 millions* in 1994, to *37709 millions* in 2005.

[50] European Commission - *Share of State aid to horizontal objectives as a percentage of total aid*
[51] All figures (Fig. 5-6) on the development of horizontal aid are based on the EU-15 numbers, and after the enlargement the EU-25 numbers.
[52] European Commission - *Share of State aid to horizontal objectives as a percentage of total aid*

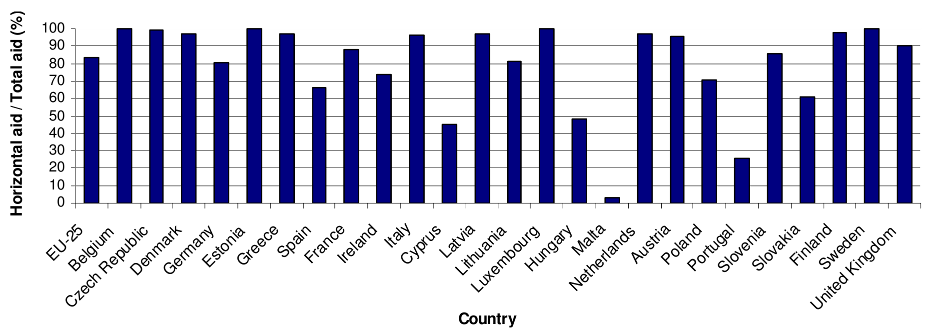
The development thus clearly shows an increase of horizontal aid and a decrease in the share of non-horizontal aid as percentage of the total aid. It does however not address the internal differences within the union.

Figure 6. **State aid to horizontal objectives (EU-15/25)**



The horizontal aid given in 2005 (*Figure 7)* shows that in some countries, like Sweden and Estonia, horizontal aid make up all of the given aid, whereas in a countries like Portugal and Malta horizontal aid barely makes up 20 and 5 percent respectively.[53]

Figure 7. **Horizontal aid as percentage of total aid (2005) (EU-25)**



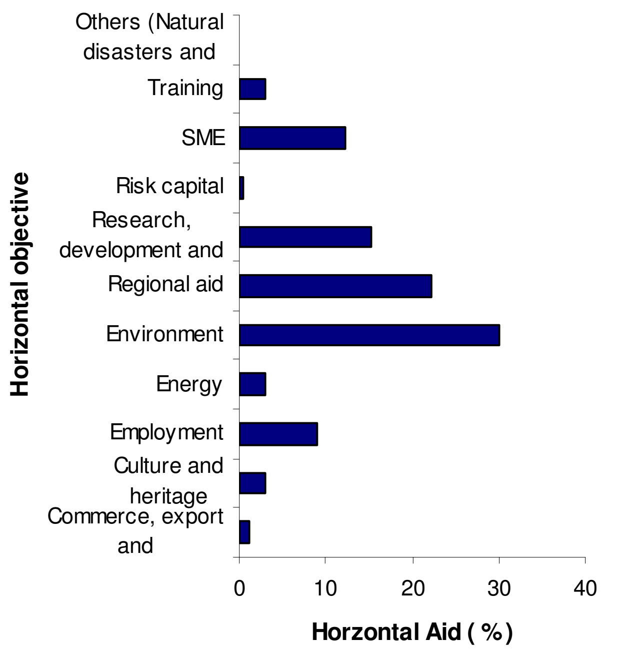
Even though horizontal objectives only account for a minor part of aid in many countries, horizontal objectives account for between 70-90 percent of

53 Ibid.

all aid in major economies like France and Germany wherefore the EU average remains high.

The different objectives targeted by the horizontal aid can be exemplified by the different receiving sectors (*Figure 8*):

***Figure 8.* Horizontal aid after objective (2005) (EU-25)**



The aid aimed at horizontal objectives for 2005 are dispersed among a number of subgroups, where the biggest recipient is targeted at *environment aid* (30 per cent) followed by *regional aid* (22 per cent) and *R&D&I* (15 per cent).[54] Also within this indicator there are clear country differences e.g. environmental aid that account for a large part in countries like Sweden, 81 percent, and Germany, 58 percent, whereas aid to SME form an important objective in some countries like Belgium, 39 per cent, and Austria, 31 per cent.[55]

[54] European Commission - *State aid to horizontal objectives by objective in million euros*
[55] European Commission - *State aid to horizontal objectives by objective in million euros*

To fully grasp the current state of state aid in the EU, only an economic perspective is not sufficient but one must also take the development of legal instruments into account.

5 Legal Development of State Aid

There has been substantial development of the legal sphere of EU state aid during the last decade, regarding both the instruments adopted by the Commission as well as regarding case law decided by the ECJ. The following chapter limits itself to the legal development concerning the economic aspects of state aid, and the process in which theses economic consideration should be analysed.

5.1 State Aid Action Plan

An important part of the recent development occurred in June 2005 when the Commission launched its *State Aid Action Plan*, with many interesting aspects from an economical perspective. The SAAP addressed the need for a comprehensive reform of the state aid policy and among other focal points was the 'refined economic approach' towards state aid.[56] By more clearly taking its theoretical justification from the economic theories of market failure, the Commission hope to better fulfil the aims set out in the Lisbon Strategy.[57] State aid should therefore only be granted to combat a well-defined market failure, and the Member State has to show that the granted aid change the behaviour of the recipient company, so that it, in fact, address the market failure. It is therefore needed to conduct an *ex post* monitoring of the recipient to analyse the effect of the aid.[58]

By taking a more economical approach to distortions caused by aid, the commission hopes to make the community industry more vital and effective. In their approach, the Commission focus on market failures such as

[56] SAAP, p.5

[57] Strategy adopted at the Lisbon Council in Mars 2000: "aimed at making the EU the most competitive economy in the world and achieving full employment by 2010."

[58] Roeller & Stehmann, p. 290

externalities, imperfect information and public goods and that state aid often is the ‘second best’ option when addressing such problems. Its use should therefore be kept at a minimum and preferably focusing at certain key areas that are important for the future competitiveness of the community.

This approach does however not extend to all the rules governing state aid due to some areas’ specific nature. The laissez-faire and efficiency approach just would not work well with the protectionist agenda in the CAP or the hardly-governed quotas in the Fishing Policy.
Other horizontal objectives such as R&D, regional development and investing in human capital do nevertheless form an integral part of the SAAP, areas which importance also are envisaged in the Lisbon Strategy for the future competitiveness of the region.[59]

5.1.1 Spring update 2007

In its latest update to the SAAP, released on June 28 2007, the Commission continued to emphasise the economisation of state aid and its importance for the Lisbon Strategy. Where it quoted the Council recalling member states:

"…to continue working towards a reduction in the general level of state aid, while making allowance for any market failures. This movement must be accompanied by a redeployment of aid in favour of support for certain horizontal objectives such as research and innovation and the optimisation of human capital. The reform of regional aid should also foster a high level of investment and ensure a reduction in disparities in accordance with the Lisbon objectives".[60]

In addition to the SAAP, the Commission has also adopted other instruments that reflect this new approach, such as the Guidelines relating to specific horizontal objectives.

[59] SAAP, p.8 ff.
[60] European Commission, *State Aid Scoreboard Spring 2007 Update*, p. 10

5.2 Development of Horizontal objectives

In key areas falling under horizontal objectives, new policy instruments have been adopted following the SAAP. To exemplify the interaction between state aid and the Lisbon strategy, the recent development within R&D&I and Regional aid will be handled.

5.2.1 Framework for State Aid for Research and Development and Innovations

As part of this economic approach strategy, a new *Framework for State Aid for Research and Development and Innovation* has been adapted.[61] R&D&I are seen as a key area due to its positive externalities in forms of knowledge spillover in other sectors of the economy.[62] These effects encompass the creation of new markets and technologies, but are not confined to the industry directly targeted by the aid. Such aid holds a wider importance to the Community economy in up- and downstream markets, as well as alternative use in other sectors.

The Framework lays out a "balancing test" for the approval of state aid, where the aid must be:[63]

(i) targeting a well defined market failure
(ii) the appropriate policy instrument
(iii) have an incentive effect(i.e. change the behaviour of the firm)
(iv) proportional to its pursued objective
(v) creating only a limited distortion on competition

The purpose of the test is to promote a better targeting of state aid to R&D that is beneficial for the society. The beneficiary effects are also, what create

[61] 2006/C323/01
[62] Ibid. p.6
[63] Ibid. p. 5

its legal basis in Art. 87(3) (c) and possibly Art. 87(3)(b) TEC.[64] When carrying out the test certain thresholds are used depending on the type of research that is undertaken, and the aid may only be allowed if these quotas are obeyed.

Market failure does not always lead to insufficient R&D, but the R&D is sometimes not properly targeted to benefit the society as a whole, (e.g. needless duplication undertaken to push out competitors from the market) wherefore the area is considered to be in need of regulation.[65]

5.2.2 Guidelines on national Regional Aid for 2007-2013

Of special interest to promote economical integration and equal opportunities of competition are also the rules governing aid for regional development, found in *Guidelines on national Regional Aid for 2007-2013* (*RAG*).[66] The legal bases for these rules are found in Art. 87(3) (a) (c) TEC and they state that a region is entitled to aid if its GDP/cap. (PPS) is lower than 75 per cent of the EU-25 average, and until 2010 also for regions with 75 per cent of the EU-15 average. These targeted regions were identified in 18 different Member States, and the scope of the aid was determined.[67]

The RAG does not contain the same balancing test as the framework for R&D&I, it does however contain provisions on the 'incentive effect'. The regional aid must produce an incentive effect to carry out investments in the targeted region, which would not occur otherwise.[68] It also states that the aid cannot cause a distortion to trade and competition to an extent, which is contrary to the common interest.[69] This means that the RAG also carries out its own 'balancing test' even though not stated as clearly as in the R&D&I Framework. The RAG tries to attempt the reduction of state aid that the

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[64] Ibid. p.12
[65] Roeller & Stehmann, p. 291
[66] 2006/C54/08
[67] C(2007) 358 Final p. 15
[68] 2006/C54/08 p. 8
[69] Ibid. p. 6

SAAP envisaged, with the goals of increased economical and social equality set out in the Lisbon strategy. Rather than keeping inefficient firm running through aid and in the meantime distorting competition, the regional aid framework is meant to allow a strategic industrial policy being carried out to reduce disparities and increase growth in the community as a whole.[70]

5.3 State-Aid Cases

Since the adoption of the Commissions 'new' approach, there has been a significant increase in the number of cases before the Commission.[71] The number of new registered cases in 2006 reached 921(36 per cent increase compared to 2005) and the Commission made 710 final decisions (12 per cent increase compared to 2005). The Commission deemed the aid compatible in 91 per cent of the cases, not falling under state aid in 4 percent, and 5 per cent of the cases were considered to require further investigation. The investigation gave that 3 per cent out of the 5 per cent did not infringe state aid, whereas 2 per cent constituted an infringement

In order to examine how the Commission's new approach manifests itself in practice one need to look into some of the recent cases concerning state-aid. I have chosen three different cases within three different policy areas (R&D aid, regional aid and sectoral aid) to exemplify the Commissions reasoning. They do all regard aid following horizontal objectives and are thus meant to correct for market failures. These cases are not intended to give a full picture of the Commissions evolution regarding state aid evaluation, but merely to exemplify the economic reasoning undertaken.

[70] Senior Nello, p. 320
[71] C(2007) 358 Final p. 16

5.3.1 R&D aid to Rolls-Royce

An example of the application of the envisaged 'balancing test' is found in the recent case of R&D aid given to Rolls-Royce for the development of an environmental friendly aircraft engine.[72]

The Commission utilise the test as described in Point 7 of the R&D&I Framework, paying special regard to the condition of 'incentive effect'. The Commission acknowledged the need for government funding since the project:[73]

- Involves both public universities and industry partners.
- Otherwise would risk being delayed, and aircraft industry then missing important development deadlines.
- Involves potential technological spillover effects, with positive effects for research objectives on the European level.

These reasons convinced the Commission that that the aid has an incentive effect, and they further deemed the distortion to competition to be limited, since the project remains on the industrial research level. Completing the test, the aid was allowed under Art. 87(3) (c) of the TEC.

5.3.2 Slovak regional development aid

The case concern aid granted to the Slovak shipbuilding company, *Slovenské lodenice Kornárno,* in a region eligible for aid under article 87(3) (a).[74] Since the case involved regional aid, the RAG's aid threshold applies which was not violated by the intensity of the aid. The Commission did not explicitly evaluate the 'incentive' criteria, but stated that the positive effect, which the aid would have for local development conditions and

[72] C(2006) 3215 Final
[73] Ibid. Point 3.3.3
[74] C(2007) 1182 Final

employment, was a crucial factor for granting the aid.[75] The Commission also deemed the aid likely to improve the firm's competitive position on the market and by doing so, they also hinted towards the fulfilments of the Lisbon objectives. Unlike the R&D&I's 'balancing test', they did not however go into the severity of the possible distortion of competition, a question that the threshold in the RAG is supposed to cover. The conclusion thus held the aid to be compatible with the RAG, and it was thereby allowed.

5.3.3 Italian subsidizing of digital decoders

The case concerned aid granted to the purchase or rental of digital decoders in Italy.[76] In reaching its decision that the aid was *not* compatible with the common market, the Commission utilised comprehensive economic reasoning. They made use of the exact same 'balancing test' as prescribed in the R&D&I Framework and concluded that in the case of a shift towards digital broadcasting there might be externalities caused by the switchover and cohesion problems that justify the aid as a remedy for market failure.[77] The balance nevertheless tipped over towards incompatible due to the effects on competition. The measure would favour some television broadcasters in an unnecessary and unproportional way, on a market characterised by a strict oligopoly where competition is very limited.[78] Even if one could disagree with the factual assessment made by the Commission it is surely comforting to see the extent of the economic reasoning underlying the decision in this case.

[75] Ibid. p 12
[76] C(2006) 6634
[77] Ibid. p. 44
[78] Ibid. p. 48

5.4 Extending the use of the balancing test

These brief examples of the Commissions assessments, illustrate the economic reasoning utilised in the decision process. The use of a balancing reasoning between the negative effects of aid on competition and the positive effect in terms of common interest was set out in the SAAP.[79] The use of the balancing test described in the R&D&I Framework is however, easily extended to most areas of state aid, a development advocated in the literature.[80]

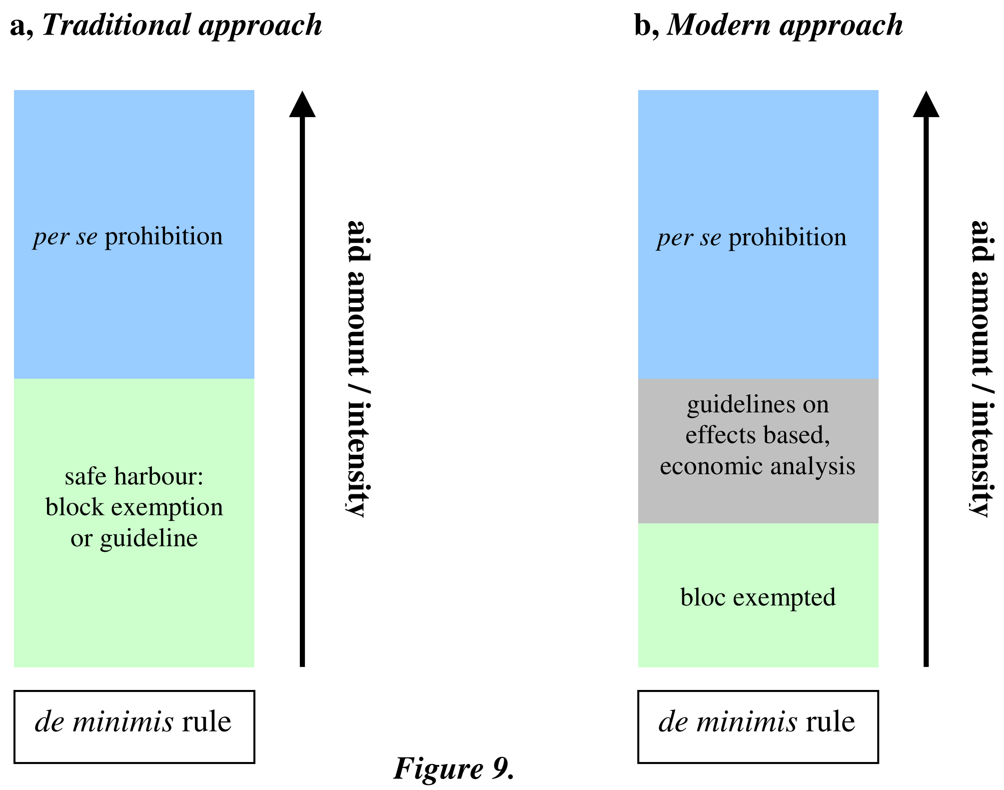

Figure 9.

By more frequently using a cost-benefit analysis, and making sure that the aid is actually targeted towards remedying a market failure, there is great efficiency gains to be made. It is otherwise to easy for states to utilise the exceptions under the TEC to disguise their aid as compatible with the

[79] SAAP, p. 4
[80] Friederiszick et al, p. 37

common market even though merely following objectives in a protectionist agenda. The use of the test creates a more flexible approach(*Figure 9*)[81], whereas the *traditional approach* has been that small amount of aid fall under *de minimise* rule, slightly larger aid were guided by block exemptions and guidelines, and exceeding aid were *per se* prohibited. The use of a balancing test would instead constitute a *modern approach* were the economic test on a case-to-case basis decide if the aid should be allowed. The *per se* prohibition for large aid amounts still remains the same, but the middle-sized aid will be allowed based on the conclusion reached by utilising the balancing test. This would mean an increased economisation of the stat aid regime, a development, very much welcomed.

[81] Ibid. p. 50-52

6 Summary & Conclusion

The purpose of the paper was to outline the economic and judicial background of state aid in the European Union, and to see how the development of state aid has been in the last decade. By doing so, I wanted to examine how strong the relationships were between economical theory, laws and regulation, and the development of state aid levels. The basic assumptions about state aid are that it distorts competition, inflicts an efficiency loss and thereby reduce welfare. This is the notion that has lead to the basic prohibition of state aid, and the need for supranational regulation. However, the economic theory also provided situations when state aid might be used as a tool for remedying market failures that occur in the common market, a rationale that has lead to the exceptions from the general prohibition. These situations are meant to be covered by the rules on ‘horizontal aid’, meaning aid that does not favour a certain industry sector but is granted to target a specific area where a market failure is present.

The development of state aid is showing a less distorting trend, where aid levels in relation to GDP has decreased with more than 40 per cent over the last decade. The percentage of horizontal aid has during the same time increased substantially from 45 to 84 per cent of the total aid, and the absolute horizontal aid has during the period also increased significantly. The methods of evaluating aid has in the same time become more influenced by economic theory, more clearly stating that aid should be granted to remedy an existing market failure. The risk of member states succeeding in disguising mercantilist aid too domestic firms as following horizontal objectives has thus become harder.

The balancing of pros and cons when assessing the comparability of state aid is not a new approach in itself, but the formalisation of the process and the clear stating of on which criteria the assessment are conducted, are. It does however not show in detail how each step is examined. The

Commission might conclude that a measure has a limited effect on competition but does not extensively state on which fact they have reached this conclusion. In other areas in competition law such as abuse of dominant position and merger control, economic theory has been employed in criteria's such as market and product substitutability that can be measured by empirical examinations. By utilising more economic considerations not only in stating its balancing test, but also in the actual assessment of the test, a more efficient outcome is likely to emerge. The balancing test adopts a case-to-case approach that is welcomed, since no granting of aid is exactly like the other, and neither is its effect on the market. In order to facilitate the process and the workload of the Commission one might agree to the need for the threshold approach adopted in the case of e.g. granting of regional aid. However, the mere fact that an aid is pursuing horizontal objectives, and is perceived to be more economic friendly, does not mean that it is always the case. Aid for R&D does not always lead to positive spill over, and regional aid does not always lead to increased economic prosperity in the targeted region. It is therefore important to not asses state aid just from an *ex ante* perspective, but also to follow up on aid given and examined how well it corresponded with the stated objectives it set out to correct. By adopting a mandatory *ex post* examination, the Community might be able to learn from the past and further improve the economisation of state aid.

An area for further studies could thus be to examine the specific data used by the Commission when applying the balancing test, even if the current transparency status in the community institutions might make such an examination somewhat difficult. Another interesting approach might then be to investigate the consistency of applying the balancing test by a substantive case-to-case assessment. It will also be interesting to follow up on how the development will continue over the next decade to see if the present trend continues or if its pace might decline.

Annex – EC Treaty Art. 87-88

Aids granted by States

Article 87

1. Save as otherwise provided in this Treaty, 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 common market.

2. The following shall be compatible with the common market:

(a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;

(b) aid to make good the damage caused by natural disasters or exceptional occurrences;

(c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.

3. The following may be considered to be compatible with the common market:

(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;

(b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;

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

(d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;
(e) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.

Article 88

1. The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the common market.
2. If, after giving notice to the parties concerned to submit their comments, the Commission finds that aid granted by a State or through State resources is not compatible with the common market having regard to Article 87, or that such aid is being misused, it shall decide that the State concerned shall abolish or alter such aid within a period of time to be determined by the Commission.

If the State concerned does not comply with this decision within the prescribed time, the Commission or any other interested State may, in derogation from the provisions of Articles 226 and 227, refer the matter to the Court of Justice direct.

On application by a Member State, the Council may, acting unanimously, decide that aid which that State is granting or intends to grant shall be considered to be compatible with the common market, in derogation from the provisions of Article 87 or from the regulations provided for in Article 89, if such a decision is justified by exceptional circumstances. If, as regards the aid in question, the Commission has already initiated the procedure provided for in the first subparagraph of this paragraph, the fact that the State concerned has made its application to the Council shall have the effect of suspending that procedure until the Council has made its attitude known.

If, however, the Council has not made its attitude known within three months of the said application being made, the Commission shall give its decision on the case.

3. The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the common market having regard to Article 87, it shall without delay initiate the procedure provided for in paragraph 2. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.

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