Jacques Derenne/Massimo Merola (Eds.)

ECONOMIC ANALYSIS OF STATE AID RULES
– CONTRIBUTIONS AND LIMITS –

PROCEEDINGS OF THE THIRD ANNUAL CONFERENCE
OF THE
GLOBAL COMPETITION LAW CENTRE (GCLC),
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21 – 22 September 2006

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FOREWORD

Neelie Kroes*

Fifty years ago, the first European State aid rules were written into the Treaty of Rome. Half a century later, the rationale of State aid control remains just as valid. Effective State aid control maintains a level playing field for free and fair competition in the Single Market. In the European Union we control state subsidies because in general they distort the market, resulting in lower competitiveness for our businesses, less innovation, and higher prices for consumers. However, we also recognise that in some cases efficient and equitable state support can stimulate competition and helps oil the wheels of economic growth, to deliver better standards of living and more and better jobs for European citizens. The European Commission's State aid policy thus aims to enable targeted government interventions where they are necessary for a well-functioning and equitable economy, whilst ensuring they do not distort competition and intra-community trade.

State aid reform is one of the top priorities of my mandate as European Commissioner for Competition. Taking forward the European Council's call for "less and better targeted State aid", in June 2005 the European Commission adopted the State aid Action Plan (SAAP), an ambitious blueprint for the comprehensive reform of the State aid rules. The SAAP was designed to encourage Member States to contribute to the Lisbon Strategy by focussing more of their aid budgets on improving the competitiveness of EU industry and creating sustainable jobs (more aid for R & D, innovation and risk capital for small firms), ensuring social and regional cohesion, and improving public services. It also committed the Commission to rationalising and streamlining procedures, so that the rules are clearer, and to accelerate decision-making.

Introducing a more refined economic approach to State aid analysis is at the heart of this reform. Economic analysis has always been central to the Commission's analysis of the compatibility of State aid with the EC Treaty. Expanding and improving the economic tools at our disposal will improve the transparency and clarity of the Commission's decision-making process, and allow a more efficient assessment of the likely positive and negative effects of proposed aid, including through the setting of filters and thresholds to determine the cases most likely to distort competition. This should result in quicker approval of less distortive aid, so that the Commission can concentrate its resources on the cases liable to create more serious distortions of competition and trade. It should also help Member States better target their aid measures to fill those gaps in the market which really matter.

The Commission has put the refined economic approach into practice through adopting the new Framework for Research, Development and Innovation and the new Risk Capital Guidelines. Both texts implement the "balancing test", by explaining how the positive effects of the permitted aid measures can be weighed against any negative effects. They also justify the

* European Commissioner for Competition

conditions for compatibility with State aid rules, differentiating between cases requiring a lighter or deeper assessment, according to the risk of trade or competition distortion.

Developing and embedding this refined economic approach requires us to build upon experience of competition law and economic modelling, and innovate in our working practices and approaches. Definitions of key concepts must be agreed, as must the criteria against which compatibility of aid are assessed. I have always been clear that this will be best achieved through an open dialogue between policy-makers, economists, lawyers and academia. It was for this reason that I was delighted to contribute to the September 2006 conference organised by the Global Competition Law Centre which looked at the contribution and limits of the economic analysis of State aid rules. I am equally pleased that the presentations from that conference are being brought together in this publication, so that a wider public can get to grips with developments in State aid policy, and contribute to the debate.

This book makes an important contribution to the growing corpus of State aid economics. In assessing a wide span of State aid issues, including frameworks and justifications for economic analysis in State aid, and the work and policies of the European Commission, it provides a firm foundation for the growth of the discipline of State aid economics, and offers valuable food for thought on State aid, for students, practitioners and policy makers alike.

Preface

Massimo Merola and Jacques Derenne*

When we decided to launch a work on State aid within the framework of the *Global Competition Law Centre* (GCLC) of the College of Europe, we meant to achieve a number of aims: to provide an overview of the entire subject-matter (including the latest case-law developments) but also to make a substantial contribution to the ongoing debate on the reform of State aid and to pass on to the Commission – as per the tradition of the GCLC – a study formulating appropriate suggestions for the way forward in the field.

We attempted to do so by focusing on one of the pillars of the Reform, as expressed in the Action Plan, *i.e.* a refined economic approach in the application of State aid rules as the key instrument to target most State aid towards the Lisbon objectives. We did so because we realized that economic analysis was the perfect perspective from which to look at the main unresolved or controversial issues in State aid enforcement and seek new guidance for a way forward.

In fact, it seemed clear to us that a refined economic approach could impact on State aid at three different levels:

– at the law-making level (*de jure condendo*), as it can guide the Commission in the definition of the priorities and guidelines of State aid policy;
– for the purpose of identifying the appropriate tools (group exemptions, horizontal guidelines, *etc*., and elaborate methods of analysis and appropriate assessment criteria) to pursue the objectives that have been set for the State aid policy;
– finally, at the enforcement level, as an economic approach can help to apply the rules in a more objective and refined manner, thus contributing to the improvement of the quality and efficiency of the Commission's enforcement.

The articles published in this book are the result of quite a long reflection process aimed at providing a deep analysis of the potential contribution that an economic approach can bring in practice to these three levels of State aid control. The main contributors to this process have definitely been the numerous fine economists and lawyers who accepted to jointly undertake such analysis, within the framework of a number of working groups that were set up for this purpose. These groups regularly convened between September 2005 and June 2006 in order to produce papers on various issues, which were the starting point of the Third Annual Conference of the GCLC of the College of Europe on 21 and 22 September 2006.

Judging from this book – which represents the end result of this joint effort – it has been a very fruitful cooperation, although not always smooth. Economists may have some delay in the

* Massimo Merola, Partner, Bonelli Erede Pappalardo, Brussels. Professor, College of Europe. Jacques Derenne, Partner, Lovells LLP, Brussels. Chargé de cours adjoint, University of Liège.

field of State aid but the ones who got involved in this work were certainly keen on catching up quickly and put forward so many interesting ideas; the lawyers, on the other hand, made their best to set aside their natural fear towards the emphasis given to the economic models, but stressed the need that the qualification phase of the analysis remains mainly a legal exercise as it implies the qualification of facts and interpretation of law in view of the permanently changing circumstances.

At the end of the day, both economists and lawyers have appeared to agree that economic analysis can bring a lot of added value to State aid control, particularly where the definition of the correct parameters and methodologies for the assessment of State aid is concerned, while their application will require at least a proper cooperation between economists and lawyers. This is partly reflected in the title of this work ("*Economic Analysis of State aid rules – Contributions and Limits*") and can be seen as the *leitmotiv* of most articles in this book: economic analysis should contribute to a proper enforcement of State aid rules but this contribution has some limits set up by certain legal principles enshrined in the EC Treaty, notably as far as the qualification of State aid is concerned.

The first set of articles in this book focuses on the definition of the objectives of State aid control (should the traditional definition be adapted or does it still serve the basic goals of the Treaty and is it still consistent with the overall reform of competition policy?) and discuss the most suitable tools as previously defined. The second set goes through the various steps of the analysis and tries to understand what the role of a refined economic approach can be in enforcement practice, in other words, what is the added value that economic analysis could bring to every single aspect of State aid policy.

Of course the European Commission could not be left out in such an important debate and indeed a number of distinguished representatives of the Institution gave an outstanding contribution thereto, particularly by putting forward their own views on the various topics analyzed by economists and lawyers on the occasion of the 2006 Conference. These contributions, for which we are most grateful to the European Commission and express, once again, our deepest gratitude, are also published in this book as a further step forward in the analysis.

Special thanks go to Commissioner Kroes, who supported from the outset the idea of the Conference and honored us with her presence and contribution, but more generally shows continuous support for the activities and various initiatives of the College of Europe and the GCLC.

Keynote speech

Neelie Kroes*

The refined economic approach in State aid law: A policy perspective

Ladies and Gentlemen, dear friends and colleagues,

Thank you for your kind welcome. This third annual conference of the Global Competition Law Centre is tackling a most pertinent theme: the economic analysis of State aid. I'm delighted that you, and notably Massimo Merola and Jacques Derenne, have ventured into this field and have brought together such a fine audience today.

I can see from the programme that you have ambitious objectives. In fact, you will cover practically the entire spectrum of State aid analysis. I'd like to focus my own small contribution to this important debate on the reasons why we need economic analysis in State aid law, and how the Commission is going about it.

Competition drives competitiveness – but there are cases where markets fail

My starting point will come as no surprise to you! As we all know, it is competition, and not State intervention or public funding, that drives competitiveness. It is competition that gets companies to invest in knowledge and innovation and forces them to stay fit, efficient and effective. This is why State aid is in principle prohibited by our European treaties. Unless, of course, it is well targeted to genuine common interest objectives in areas where markets alone would fail to deliver.

I spend a lot of time repeating this simple message. But just look at all the neo-nationalist reflexes, neo-protectionist temptations and neo-interventionist rhetoric we are confronted with these days! It sometimes feels like this basic wisdom needs re-inventing, or at least re-iterating, every single day.

So first and foremost we need to trust in the market. Of course, the story does not end here – I'm enough of a politician to know that governments have an important role too. Not in picking what may – or may not – be winners. But instead in creating the right conditions for markets to deliver the growth and jobs we all need.

In fact, as the Aho report demonstrated, for example as regards lead-markets, much of what governments can and indeed should do, is not about throwing money at companies. Instead, they should look to smart regulation and standard-setting, including less regulation wherever possible. They should look to smart procurement and investment in general infrastructure or

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* European Commissioner for Competition

education. To smart measures which will go much further to create the right conditions for business to flourish than any amount of State aid ever can.

But economic reality is what it is – and it cannot be denied that markets sometimes fail. This is where State aid has its proper place in the wider policy agenda, as one of the tools – but by far not the most important – that governments have to stimulate competitiveness.

So, State aid policy is all about markets, actors on markets and State intervention in markets. This is why we need economic analysis in State aid – and this is our starting point for State aid reform.

The State aid Action Plan: using refined economic analysis to reform State aid policy

Last year's State aid Action Plan began the most ambitious review of State aid instruments and policy the EU has ever seen. The talk has been of "less and better aid" for quite too long – and with the Action Plan we aim to move from "talking the talk" to "walking the walk". One of our key messages is a new focus on a refined economic approach to improve our policy.

Not a revolution

I emphasise the word "refinement" because State aid policy has not suddenly discovered economics like some hitherto unknown parallel universe! Of course not! State aid is as intrinsically linked with economic reasoning as any other area of competition law. Economics has always underpinned our traditional analysis of whether or not a measure is State aid, and if it is compatible.

In the US, they say that economists keep the lawyers honest and vice versa. I see no tension between the legal and the economic approach. Our objective is always the same: take the right decision, as close as possible to reality, and with the best possible factual underpinning! The State aid Action Plan did not need to 'revolutionise' the legal framework, nor upset existing jurisprudence. In fact, it only aims at making the Commission's practice more explicit – and yes, a bit more professional and a bit more up to date.

Introduce more and better economic tools

This is why the State aid Action Plan announced that economic analysis should be refined, and that it should be used as a tool for reform. Just as was done in antitrust and mergers, we want now to develop and enhance the economic tools that we in the Commission use to analyse State aid cases.

And outside the Commission too, I'm delighted that State aid has now found its rightful place on the map of academic economists. Professor Roeller, who recently stepped down as our Chief Economist, told me that he considered this a major achievement of his tenure. I take this opportunity to thank him for all his excellent work with the Commission! Let me also welcome Professor Damien Neven as his successor. He and his team will have a crucial role to play in implementing our policy.

The ball is well and truly rolling now. A series of studies and articles have recently been published. More academic research is under way. Today's conference will generate further interest in State aid economics – and I have even been told you are planning to edit a book. Let's hope it becomes a best-seller! All this is very welcome, and it will help us to further refine the economic tools we need for our policy.

Better targeting

What then do we need 'refined economics' for? First and foremost, to support our wider policy objectives. The State aid Action Plan argued that subsidies could be used pro-actively to support growth and jobs, by better targeting aid at the market failures to be corrected, through horizontal instruments like R&D and Innovation aid, Risk Capital aid, or targeted support for SMEs. A refined economic analysis can help in identifying real market failures and then in assessing the actual effects of a measure, both in terms of its positive impact, but also as concerns its negative effects on competition and trade.

Focus on important cases

Second, and as a consequence, a refined economic analysis can help us draw the line between a priori problematic cases and those which give less reason for concern. We should avoid unneeded bureaucracy by not requiring that insignificant cases, like local swimming pools or zoos, are notified. Economic analysis will therefore also guide us in drawing up the future General Block Exemption.

Implementing the refined economic approach

So that's our rationale for using refined economics in State aid. Stakeholder reactions have been enormously supportive, although there's also been a bit of the healthy scepticism we experienced when we made the same step in antitrust and mergers. But as they say, the proof of the pudding is in the eating. Let me therefore turn to how we are implementing our refined economic approach.

In the rules

Over the last year, the Commission has produced a number of documents which put more flesh on the bones of refined economics. Our Communication of September 2005 clarified what we call the 'balancing test' in the new area of State aid to Innovation. The resulting rules have been enshrined in our draft Framework on Research, Development and Innovation, which has just been launched into second stakeholder consultation.

Along with the recently adopted Guidelines for State aid to Risk Capital for SMEs, this constitutes a package to increase economic efficiency in support of the Lisbon agenda. The texts demonstrate how analysis of market failures can be used to design better rules, by identifying State aid measures that can be considered a priori compatible, even in completely novel areas like innovation – thereby keeping State aid law abreast with economic progress and needs.

Both texts are clearly based on the refined economic approach:

- First, they implement the balancing test. They explain how the positive effects of risk capital measures or aid to research and innovation can be weighed against potential crowding-out or other negative effects on competition and trade;
- Second, they clearly spell out that it is market failures, like imperfect or asymmetric information, positive externalities or public goods which prevent the market from optimising the levels of risk capital or of research and innovation 'produced' by private companies;
- Third, they justify the conditions for compatibility. In so doing, they distinguish between a lighter and a more detailed assessment, depending on the risks of distortion of competition and trade. The rules clearly explain in which limited number of cases a detailed assessment will take place, and which criteria the Commission will use. Let me re-assure you here, if need be: This will not impose an excessive burden on Member States and companies! The information we intend to request is just what any self-respecting company will itself gather and analyse when deciding whether to invest a large amount of money in research or innovation.

All in all, the refined economic approach brings more clarity to our rules, better explains the Commission's reasoning, and thereby gives better guidance to stakeholders. We will use the same approach when reviewing other sets of rules under the State aid Action Plan, and our next concrete target is State aid for Environmental Protection.

... and case by case

So we're adapting the rulebook. But what about our practice in individual cases? Well, here too the refined economic approach has become a standard feature. We have had extensive brainstorming and internal debate on how the balancing test should be used, whether it would change our practice and make it more lenient or more restrictive, whether we need more tools to do the job properly and so on. We have even revisited some of our old cases, to see whether they would be decided differently. And we have benefited from a number of recent studies, by the Commission's Group of European Policy Advisors, the UK's Office of Fair Trading, and others.

On this basis, my Directorate General has developed an internal methodology to support the work of case handlers. Internal training is helping embed the refined economic approach in the reality of daily practice. You can see the first results in our recent decisions – for example, in the area of broadband (be it Appingedam or the Irish Metropolitan Area Network), or digital television in Berlin-Brandenburg, or even training aid to large motor companies.

We are committed to applying a refined economic approach consistently and across the board. So when some Member States' call for State aid rules which reflect the so-called external aspects of competitiveness, my response is again based on economics rather than on politics.

I'm not willing to take it for granted that more State aid – matching aid, or 'globalization aid' – is the solution. When you actually look at the economic impact of State aid on investment decisions, you are forced to conclude that aid is at best the Number 5 or 6 criterion on any investor's list: Business is much more interested in skilled labour, stable framework conditions, good infrastructure and efficient administration (no red tape!). State aid can never compensate for structural deficiencies – but perhaps it is sometimes easier for politicians to throw money at lame duck companies than to accept responsibility for addressing the real problems.

Ladies and Gentlemen,

A renewed focus on economics is driving the development of tools which are crucial to the success of State aid reform. The Commission has started to use these tools, and considerable work has already been done.

Of course, economic refinement is an on-going process. Our primary concern is therefore to constantly improve our practice. In that, we rely on stakeholders outside the Brussels ring-road to tell us what is going right, and where we can get better.

That is why it really has been my pleasure to be here to open today's conference. And that is why I would encourage you to continue the discussions long after today and to stay in touch with my Directorate General. Please help us deliver the modern, professional approach to State aid analysis which has such an important part to play in the delivery of economic growth and jobs in Europe.

Thank you for your attention!

The economic analysis of State aid control

David Spector*

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I. Introduction

Compared with the other branches of competition policy, State aid control has been the focus of little economic research until recently.[1] Part of the explanation probably lies with the lack of interest for this question in the United States, where State aid control does not exist. But a more fundamental reason is probably at play: an economic assessment of State aid control does not involve a small number of well-defined questions (like unilateral and coordinated effects in the case of merger analysis, or exclusionary strategies in the case of most abuses of a dominant position), but rather a broad array of fields of economic theory.

First, there are many different mechanisms by which aid can be beneficial or harmful: the possible benefits are related to the need to correct some form of market failure which may result from informational asymmetries, positive externalities, or market power; as to the possible harm, it may be related to the risk of creating static inefficiencies in production (by encouraging production by inefficient firms), dynamic inefficiencies (by changing firms' expectations and thus their behaviour), or to the risk of making market structures less competitive. The overall weighing of all these effects also depends on the cost of public funds, itself a complex issue and the focus of a vast literature in the field of public finance.

Second, the assessment is made more complex by the fact that the economic analysis of State aid control is not the same thing as the analysis of State aid. State aid control is after all a control over the decisions of national governments, and an economic analysis must therefore address the determinants of national aid policies. Justifying State aid control by the possibly inefficient character of State aid is indeed not convincing. National governments can and sometimes do make inefficient choices in all branches of policy, but this obvious fact is not usually viewed as sufficient to warrant control at the Community level. In general, one may consider that the mere fact that a given policy is inefficient should deter a national government from following it; and even when this is not the case, there is no reason to assume that the European Commission would necessarily be better inspired than national governments. An economic analysis of European State aid control must therefore not only provide guidance as to the identification of the beneficial and harmful effects of State aid, but also identify in which circumstances national governments are likely to grant State aid which should in fact not be granted. In other words, while the analysis of State aid tends to emphasise market failures, the analysis of State aid control must also account for the possibility of government failure.

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1 This has changed lately. Major recent contributions on the theoretical side include D. Collie, State aid in the European Union: The prohibition of subsidies in an integrated market, *International Journal of Industrial Organization*, vol.18, 1998; D. Collie, Prohibiting State aid in an Integrated Market, *Journal of Industry, Competition and Trade*, vol. 2 (3), 2002; D. Collie, State aid to Investment and R&D, European Economy, *Economic Papers*, vol. 231, 2005; M. Dewatripont et P. Seabright, "Wasteful" Public Spending and State aid Control, *Journal of the European Economic Association*, 2006. For an empirical assessment, see D. Neven and L.-H. Röller, eds.: The Political Economy of State aids: Econometric Evidence for the Member States, in *The Political Economy of Industrial Policy: Does Europe have an Industrial Policy?*, Edition Sigma, Berlin, 2000. For broad surveys, discussing theory, empirics, and policy, see, e.g., T. Besley et P. Seabright, The Effects and Policy Implications of State aids to Industry: an Economic Analysis, *Economic Policy*, 1999; and H. Friederiszick, L.-H. Röller and V. Verouden, European State aids Control: an economic framework, in *Advances in the Economics of Competition Law*, Paolo Buccirossi (ed.), MIT, Press 2006.

II. Why should state aid be prohibited?

1. State aid control cannot be justified only by the inefficiency of State aid

Even though the subsidiarity principle is not legally applicable to State aid control, the very existence of a Community control is sometimes justified on the grounds that the granting of aid entails significant negative cross-country externalities, which can be internalized only at a supranational level.[2] It can thus be helpful to distinguish, among the factors likely to induce governments to make inefficient decisions about the granting of State aid, between those resulting from cross-country externalities and those induced by purely internal effects. This distinction matters because the necessity of State aid control at the Community level is more obvious when the inefficiencies result from cross-country externalities than when they do not – even though, even in the latter case, some convincing justifications for Community control exist (see infra).

2. Paternalistic justifications for State aid control

Irrespective of any cross-country effects, governments can decide to grant inefficient State aid for a variety of reasons. The most obvious one is incompetence. But the possible (and, in some cases, no doubt very real!) incompetence of national governments falls short of justifying State aid control at the Community level, for two reasons. First, with all due respect, there is no reason to assume a priori that officials are systematically more competent at the European Commission than in national governments. Second, even if they were, this superior competence could in theory be applied to many fields of policy. It does not imply that State aid should be subjected to the control of the European Commission, while other branches of economic policy would remain entirely in the hands of possibly incompetent national governments.

Two other sources of inefficiencies make for a more convincing justification for State aid control.

a) State aid control as a tool to help governments resist interest groups

The ability of private interest groups to distort economic policy in their favour has been amply documented.[3] For example, empirical studies in the United States have shown the degree of tariff protection enjoyed by various industries to be directly correlated to the level of donations to political parties.[4] As for aid to private firms (which is not prohibited in the United States),

2 T. Besley and P. Seabright (see supra n 1); J. Fingleton, F. Ruane, and V. Ryan, Market Definition and State aid Control, *European Economy*, vol. 3, 1999.

3 Cf. T. Persson and G. Tabellini, *Political Economics: Explaining Economic Policy*, MIT Press, 2000.

4 P. Goldberg et G. Maggi, Protection for Sale: An Empirical Investigation, *American Economic Review*, vol. 89 (5), 1999.

their costs appear to be disproportionately large when assessed against their alleged benefits, especially if the latter are measured according to the number of jobs created. For instance, the aid granted in the 1990s by the State of Michigan to various firms on job-creation grounds cost more than 2 million dollars per job ; the aid granted by the State of Alabama to Daimler-Benz amounted 168,000 dollars per job.[5] In particular, sector- or firm-specific public policy seems to be often tilted in favour of declining industries, in the United States at least.[6]

There is little doubt that similar inefficiencies can be found in European countries, for example regarding trade policy. In the case of State aid, recent research has shown that the allocation of aid is largely determined by political rather than economic factors.[7] Whether such inefficiencies, which reflect the imperfections of national political institutions, are enough to justify a control at the Community level is a moot point. One could argue that the Commission's role is not to prevent a government from engaging into wasteful public spending: the citizens of a democratic country should be left free to have their government spend public funds inefficiently if this pleases them, as long as there is no harm to other countries. Beyond this cynical view, one could also claim that countries willing to limit the power of interest groups can do so by using, for example, constitutional clauses constraining the ability of their governments or parliamentary majorities to favour arbitrarily selected private firms. After all, such clauses could be seen as an extension of the general anti-discrimination and equality clauses present in many constitutions.

If all State aid were inefficient, a constitutional prohibition in each country would be sufficient and there would be no need for supranational control. But this solution may be unsatisfactory because, in the real world, some State aid may be desirable. The best solution may thus be an institutional setup combining flexibility – i.e., the possibility to grant State aid in some circumstances – with sufficient insulation from the pressures of domestic politics. European State aid control bears a striking similarity to this theoretical solution.[8]

A recent event, outside of the realm of State aid, casts light on the merits and limits of this justification. It regards the discussions between European countries about whether each country should be free to set VAT rates in the restaurant sector at the level of its choosing. In the name of the subsidiarity principle, France asked to have the right to lower its rate, claiming that, since restaurant meals are an immobile good, their taxation involves no cross-country externalities and should be left in the hands of national governments. The European Commission broadly agreed with this view. It claimed that, though the lowering of VAT rates on restaurants is not a good policy in its view, it had no problem in leaving the decision to national governments, and that European coordination should focus on mobile goods, for which cross-country tax externalities may be present. But several European countries successfully opposed

5 See R. Tannenwald, Are State and Local Revenue Systems becoming Obsolete?, *National Tax Journal*, vol. 55 (2), 2002.

6 G. Hufbauer and H. Rosen, *Trade Policy for Troubled Industries*, Policy Analyses in International Economics 15, Institute for International Economics Washington, D.C., 1986; G. Hufbauer, Gary, D. Berliner and K. Elliot. Trade Protection in the United States: 31 Case Studies, Institute for International Economics, Washington, D.C., 1986.

7 D. Neven and L.-H. Röller (supra n 1).

8 For a related argument, see M. Dewatripont and P. Seabright, supra n 1.

this. In particular, the German minister of finances stressed that, if he were left free to set the rate of VAT, he would not be able to resist the lobbying of restaurant owners and would be forced to lower VAT, even though he viewed such a lowering as economically inefficient. In other words, he asked the European Commission to tie his hands in order to insulate a purely German economic policy decision from the pressures of German interest group politics. The logic of this position is very similar to that justifying a European State aid control policy by the necessity to protect national governments from themselves, or at least from powerful domestic interest groups. Interestingly, as is revealed by its stance on the VAT front, the Commission seems to be reluctant to play such a role, presumably because it does not enjoy being scapegoated by national governments which happily shift the blame to "Europe" in order to justify unpopular decisions. This very understandable reluctance means that State aid control cannot be primarily justified by the need to overcome the imperfections of national politics.

b) State aid control as a commitment device for national governments

Another possible justification for State aid control, unrelated to any cross-country externalities, is the existence of a commitment problem facing national governments. The problem is that if governments were free to grant aid as they pleased, the expectation of this possibility would affect firm behaviour even before any aid being effectively granted. For example, if it is expected that failing firms will be rescued by governments with some probability, companies may be encouraged to undertake overly risky investments, or to adopt lax management practices. More generally, a firm's incentives to become more efficient so as to cut costs, raise quality or innovate are likely to be dampened if it expects that the resulting competitive advantage will be offset by the granting of aid to its lazier rivals. This idea has been formulated by the Economist Janos Kornai when analysing attempts by the Hungarian government to partly liberalise the economy : "*Although state-owned enterprises were vested with a moral and financial interest in maximizing their profits, the chronic loss-makers among them were not allowed to fail. They were always bailed out with financial subsidies or other instruments. Firms could count on surviving even after chronic losses, and this expectation left its mark on their behaviour*"[9]

State aid thus has a diffuse and indirect cost, beyond the sector to which aid recipients belong. Every time an aid is granted, this confirms agents' belief that they live in an economy in which aid may be granted in the future. Irrespective of the criteria for receiving aid, this is likely to distort firm behaviour. If aid is granted in priority to failing firms, this is likely to decrease incentives to innovate; if it is channelled mostly to support R&D, this may lower incentives to undertake R&D out of private funds; more generally, the possibility of State aid encourages firms to divert resources away from productive uses into lobbying.

9 J. Kornai, E. Maskin and G. Roland, Understanding the Soft Budget Constraint, *Journal of Economic Literature*, vol. 41 (4), 2003. See also J. Kornai, The Soft Budget Constraint, *Kyklos*, vol. 39 (1), 1986.

Since national governments typically have short horizons (i.e. until the next election), they may be tempted to forego the benefits of not granting aid (i.e., contributing to slowly changing firms' expectations and behaviour) in order to enjoy the short-term benefits of aid.

This type of problem is by no means limited to State aid. In the same spirit, governments approaching an election are often tempted to follow lax budget policies toward the end of their terms, because the benefits from a budgetary expansion are immediate, while the costs fall on future generations which will have to repay government debts – or, at the very least, to next year's taxpayers.[10]

In some American states, the constitution imposes a balanced-budget clause, precisely in order to prevent governments from succumbing to the temptation just before elections. Could the same be done about State aid, through a simple prohibition at the national level? The problem with this solution is, again, that some flexibility may be desirable if State aid is considered an efficient instrument in some circumstances. In this case, Community control may constitute a good compromise between insulation from domestic political cycles and the need for flexibility.

c) The cost of rent-seeking

Firms' expectations that they could possibly benefit from State aid induces them to divert resources away from productive activities to unproductive rent-seeking ones.[11] According to various estimates, the cost of these rent-seeking activities is very high. In the United States, total expenditures on transfer activity have been estimated at 25% of GDP.[12] Other estimates, based on regressions of gross national output on the relative number of lawyers (supposed to be a proxy for the magnitude of rent-seeking activities) and physicians or engineers (supposed to be a proxy for the magnitude of productive activity) point to similar or even higher costs of rent-seeking.[13] Of course, lobbying to be granted State aid is but one of many forms of rent-seeking activities, and the above figures do not refer specifically to State aid. But they are sufficiently impressive to make one consider the costs of the induced rent-seeking activities as an important adverse effect of State aid.

Does this warrant supranational State aid control? The answer is quite similar to that in the previous section. On the one hand, the mechanism at play is purely national, in that if a country develops a reputation for granting State aid while its neighbours do not, the rent-seeking activities will take place in that country, and the corresponding costs will not be incurred abroad.

10 See T. Persson and G. Tabellini (supra n 3) for an analysis of the impact of electoral cycles on economic policy.

11 For an introduction to the concept of rent-seeking, see G. Tullock, Rent seeking, in *The New Palgrave: A Dictionary of Economics*. Palgrave Macmillan, vol. 4, 1987.

12 D. Laband and J. Sophocleus, An Estimate of Expenditures on Transfer Activity in the United States, *Quarterly Journal of Economics*, vol. 107(3), 1992.

13 S. Magee, W. Brock and L. Young, *Black Hole Tariffs and Endogenous Policy Theory: Political Economy in General Equilibrium*. Cambridge: Cambridge University Press, 1989; K. Murphy, A. Shleifer and R. Vishny, The Allocation of Talent: Implications for Growth, *Quarterly Journal of Economics*, vol. 106(2), 1991.

This precise mechanism thus does not generate any cross-country externality. On the other hand, since it relies on a reputation effect unfolding over the long-run, short-sighted national governments may lack the proper incentives, and supranational control may represent a substitute for a constitutional ban – maybe a slightly better one, given the flexibility it affords.

3. Non-paternalistic justifications: internalising cross-country externalities

While purely domestic problems could, in theory at least, be dealt with at the national level, a pan-European policy is the only possible way of internalising externalities. Accordingly, several economists have claimed that State aid control should focus on aid inducing negative cross-country externalities, i.e. on aid which has negative effects on the countries other than the one granting it.[14] This view is also sometimes held by Commission officials.[15] It is thus particularly important to identify in detail the mechanisms giving rise to negative cross-country externalities. Two of them can be singled out: wasteful subsidy races, and cross-country rent-shifting in oligopolistic markets. Interestingly, the notion of "distortion of competition", which is so prominent in the law of State aid control and appears to be staging a comeback after years of oblivion, pertains only to the latter (see infra).

a) State aid, local externalities and inefficient subsidy races

aa) The nature of the externality

A firm's decision to set up, expand or maintain a plant in a country often generates sizable benefits for the host country: tax revenues (levied directly on the firm or indirectly, on employees' salaries), possibly a decrease in unemployment and in the associated costs, increased demand for the output of local suppliers, etc. It may also result into a transfer of skills to the local workforce, which can then benefit the economy more broadly as workers change firms. Each national government thus may have an interest in granting aid in order to lure firms into its territory. Absent State aid control, competition across governments wanting to attract the same firms might result into large volumes of aid, shifting the location of firms' activities rather than creating new ones.

If public funds had no "deadweight cost", i.e. if a transfer of 100 euros to a firm cost only 100 euros to the country granting the aid, State aid would raise distributional issues, but it would be neutral from an efficiency viewpoint. However, in reality, raising tax revenues is costly; because taxes distort economic agents' incentives and decrease total wealth. According to some empirical estimates, raising 100 euros for the government entails a deadweight cost

14 T. Besley and P. Seabright (supra n 1); J. Fingleton, F. Ruane, and V. Ryan (supra n 2).

15 T. Kleiner and A. Alexis, Politique communautaire des aides d'État : une analyse économique plus fine au service de l'intérêt commun, *Concurrences*, vol. 4-2005.

between 18 and 24 euros: when the government raises 100 euros, other economics agents lose not 100 euros, but between 118 and 124 euros.[16]

The existence of a sizable deadweight cost of government funds implies that competition across governments wanting to attract firms by means of financial incentives is likely to result into excessive aid, i.e., to amounts of aid which reduce overall social welfare (including the recipient's welfare in the calculation). The following simple example illustrates this point. Assume that a firm hesitates between locating in countries A and B, and that the benefit derived from its presence is 1,200 euros for the country it chooses. Assume also that, for each government, raising 1,000 euros in taxes involves a deadweight cost of 200 euros. Clearly, no government will want to offer more than 1,000 euros to the firm, because offering 1,000 euros involves a real cost of 1,200 euros (1,000 euros transferred to the recipient of aid, plus a deadweight cost of 200 euros): 1,000 euros is the absolute maximum that a rational government will want to offer. If the firm manages to exploit the rivalry between the two governments, it may succeed in obtaining this maximum amount. The outcome can thus be that one of the governments pays 1,000 euros to the firm. This aid reduces welfare because the loss to the country granting the aid (1,200 euros) is greater than the benefit to the recipient (1,000 euros). Notice that the benefit derived by the country from having the firm locating on its territory (1,200 euros) should not be taken into account when evaluating the impact of the aid because we assumed that the firm would have located in one of the two countries anyway, even without aid.

This reasoning is an illustration of the famous game-theoretical notion of the prisoner's dilemma. It is by no means limited to State aid. It is in fact a simple instance of the far more general phenomenon of tax competition, which causes governments to cut taxes on mobile factors (such as corporate income) and to make up for these cuts by raising taxes on immobile factors (such as labour). In fact, the granting of aid can be interpreted as a selective cut in corporate taxes.

bb) Two caveats

This analysis of State aid in terms of inefficient subsidy races lends itself to two criticisms – one economic, the other political.

From an economic viewpoint, the criticism is based on the claim that, in some circumstances, competition between governments to attract firms may raise, rather than decrease welfare. This may be the case if two conditions are met: the deadweight cost of taxation is low and the benefit derived from a firm's presence varies greatly across locations. In such a case, the countries or regions in which the presence of a firm would yield the largest benefits are willing to "bid" greater amounts than regions in which these benefits would be smaller. Just like price competition, cross-country competition thus reveals where the external benefits are

16 C. Ballard, J. Shoven and J. Whalley, General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States, *American Economic Review,* 75 (1), 1985; D. Jorgenson and K. Yun, Tax Reform and US Economic Growth, *Journal of Political Economy,* vol. 98(5), 1990 ; D. Jorgenson et K. Yun, The Excess Burden of Taxation in the United States, *Journal of Accounting and Finance,* vol. 6(4), 1991.

greatest, and it causes firms to locate where their presence is most valuable, which is desirable. In addition, this comes at little cost if the deadweight cost of taxation is low.[17]

Which model is more relevant is an empirical question. The available literature about the United States, where aid is not prohibited, lends support to a rather negative view of competition across states to attract firms. States seem to engage into costly competition simply in order to shift activities from neighbouring states to themselves, without much creation of new activities[18]. This destructive cross-state competition also seems to have intensified lately[19], and this has prompted some American authors to recommend a federal control over State aid.[20]

The other caveat is that justifying European State aid control by the need to prevent inefficient competition between member states for the attraction of firms is a bit paradoxical, given the absence of any coordination of corporate taxation. Governments can indeed compete in two ways in order to attract firms. One is to offer firm-specific aid, and the other is to cut corporate taxes across the board. If the inefficiencies generated by such competition are considered a serious problem, then the solution is to have some supranational control over both State aid and corporate tax rates. But this is not the case: there is no coordination over corporate taxation in Europe (if one excepts very recent progress towards harmonising the definition of the tax base), and vigorous tax competition has led some EU countries to adopt zero corporate tax rates. This remark does not imply that the need to limit tax competition is not a convincing justification for State aid control, but rather that, if this is the case, there is some inconsistency between this justification and the lack of European-wide fiscal coordination. Of course, the symmetric paradox exists in the United States: while competition between States unleashes large volumes of often inefficient aid to firms, the existence of a federal tax on corporate profits, at a rate of 35%, effectively solves the tax competition problem.

b) State aid, distortion of competition and strategic trade policy

In oligopolistic markets, State aid may also generate cross-country externalities by having an impact on the investment decisions of the rivals of the aid recipient. The underlying mechanism has been studied in the economic models of strategic trade policy[21], and can be summarised as follows. In an oligopoly, in which firms earn rents derived from their market power, a firm's profit increases if its rivals decrease their investment (to be understood in a broad

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17 W. Tiebout, A pure theory of local expenditures, *Journal of Political Economy*, vol. 64 (5), 1956; T. Besley and P. Seabright (supra n 1).

18 R. Tannenwald, Are State and Local Revenue Systems becoming Obsolete?, *National Tax Journal*, vol. 55 (2), sept. 2002.

19 K. Chi and D. Leatherby, *State Business Incentives: Trends and Options for the Future,*, Lexington, Kentucky: Council of State Governments, 1997.

20 P. Enrich, "Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business", *Harvard Law Review*, vol. 110 (2), 1996.

21 J. Brander and B. Spencer, Export Subsidies and International Market Share Rivalry, *Journal of International Economics*, vol. 18, 1985.

sense, including R&D, advertising, set-up costs in order to operate in a new country, etc.) Therefore, a national government may have an interest in inducing the foreign rivals of one of its national champions to scale down their investments. State aid may achieve this result in some circumstances. For example, if country A grants investment aid to a firm, competitors in country B may expect an expansion of the recipient of the aid, and thus a reduction in the residual demand facing them. This expectation may in turn induce them to scale down their investment. The overall result is a shift of part of the oligopoly rents towards the recipient of the aid, at the expense of its rivals.[22]

The granting of aid may thus allow the recipient to pre-empt a part of the demand which, absent any aid, would have been served by foreign rivals. This mechanism involves a cross-country negative externality because when a government grants aid, it fails to take into account the harm to foreign competitors.

However, the analysis should not stop there, because the granting of aid may also generate a positive cross-country externality: if the recipient of aid expands production, or investment, consumers may benefit, not only in the country whose government granted the aid, but also abroad. A government caring only about the welfare of domestic economic agents would fail to take this effect into account. If this positive externality is more important than the above-mentioned negative one, it could be the case that, even absent State aid control, governments grant too little, rather than too much aid!

Recent papers by David Collie[23] indeed show that if the deadweight cost of taxation is low, then the prohibition of State aid reduces social welfare. The reason is that the various governments' attempts to distort competition end up cancelling out, but welfare is increased in the process because subsidies cause firms to act on the basis of perceived costs that are lower than real costs, which induces them to expand output and cut prices. This partly counteracts the fact that under imperfect (i.e., oligopolistic) competition, firms tend too choose inefficiently low output levels and/or set inefficiently high prices. However, if the deadweight cost of taxation is high, then governments are induced to grant too much State aid from a supranational viewpoint and a ban on State aid increases welfare.

These analyses rely on a highly stylised model, and in particular they consider only some specific forms of aid. They are nevertheless important for several theoretical and empirical reasons.

First, they show that the very notion of distortion of competition, which lies at the core of State aid control policy, is quite ambiguous in economic terms. When State aid is motivated only by each national government's desire to induce Foreign firms to produce less and shift production to domestic firms, it may in the end cause welfare to increase as long as the deadweight cost of taxation is small enough. In this sense, the very idea that distortion of competi-

22 In some circumstances, the causality may be reversed. For example, a firm facing a decrease in its residual demand may have greater incentives to engage into R&D so as to re-establish a better market position.

23 See supra, n 1. See also J.-A. Garcia and D. Neven, State aid and Distortion of Competition, a Benchmark Model, HEI Working Paper No. 06/2005.

tion is bad, and that State aid should be allowed only when this "bad" is outweighed by some "good", is not always justified.

Second, the resulting rationale for State aid (in cases where the deadweight cost of taxation is low) could be framed in terms of market failures, in accordance with the current wording of State aid control policy.[24] The market failure simply results from the presence of oligopolistic, rather than perfect competition, which causes firms to base their decisions on marginal revenue rather than marginal cost calculations.

Finally, Collie's analyses point to the fact that the more differentiated a market is, the less likely it is that State aid might cause harm, at least if one assumes that national governments are rational and one does not take into account the various commitment problems mentioned above. The reason is that in a highly differentiated product market, aid to a firm does not cause much harm to Foreign competitors, but it benefits Foreign consumers, so that the overall net effect on Foreign agents is likely to be positive. Since the overall net effect on domestic agents (including the government, taking the deadweight cost of taxation into account) is necessarily positive (otherwise the government would not grant the aid in the first place), this implies that the effect of aid on total welfare (i.e., domestic and foreign combined) is positive as well. This points towards some practical guidance: the more differentiated a market is, the more lenient the assessment of aid should be.

c) State aid may decrease competition

Aid may be harmful because it risks making market structure less competitive in the long run. For example, an aid may allow a firm to engage into a predatory strategy which will cause rivals to exit or to be forced to merge with the recipient of the aid. Or, if the sector under consideration is subject to significant credit constraints, it may allow the recipient of the aid to gain access to a large volume of essential inputs, thereby raising rivals' costs and making them compete less aggressively. A variant of this effect is a situation in which the recipient of the aid ends up being the only one able to purchase smaller rivals and gain access to their assets, which may prevent a more balanced distribution of assets. This mechanism may in some cases entail a cross-border externality since the decrease in competition may generate a large transfer of surplus away from foreign consumers and competitors towards the recipient of the aid. Notice however that State aid may also change market structure in the opposite direction, making it more competitive (see infra).

24 See, e.g., the State aid Action Plan, pt. 23: *"One key element [in assessing compatibility] is the analysis of market failures."*

III. When can State aid be beneficial?

1. State aid may correct different types of market failure

Just like other public policies, State aid may in some circumstances alleviate market failures, which may be caused by the presence of externalities (for example in the case of public goods), by informational asymmetries, or by lack of competition. The various types of externalities giving rise, in some circumstances, to corrective aid measures are discussed in many excellent articles, and will thus be listed very briefly.

a) Externalities and public goods

Externalities arise when a transaction has an impact on other agents than the parties to the transaction. Externalities can be negative, for example in the case of pollution. Positive externalities may arise for a variety of reasons. One of them, in the case of R&D, is the presence of knowledge spillovers: a company's R&D efforts may benefit other companies because new knowledge diffuses outside the company undertaking R&D, through social and business interaction, or as a consequence of employees moving across companies. Several empirical studies have found the magnitude of such knowledge spillovers to be significant. They may explain, in particular, the success of clusters such as the Silicon Valley or its many imitations.[25] Another possible externality may result from the location of a firm in a region undergoing an economic crisis, through its impact on the regional unemployment rate as well as through possible "Keynesian" effects. Public goods can be seen as a particular type of externality, since any potential consumer can enjoy the consumption of the good without being a party to any transaction, due to the non-exclusionary nature of the good.

Markets fail in the presence of externalities because the external effects (be they positive or negative) are not taken into account by economic agents, in the absence of a transaction by which the external gainers would pay or the external losers would be compensated. This may warrant a corrective public policy, which can take the form of a tax (in the case of pollution), or, symmetrically, a subsidy. In some cases, the most efficient subsidy may have to be explicitly or implicitly selective, when the activity generating a positive externality is due to one specific firm.

b) Informational asymmetries

Informational asymmetries may cause markets to unravel, in particular as regards the provision of insurance and the provision of funds to firms. For example, if firms or potential inno-

25 R. Caballero and A. Jaffe, How High are the Giants' Shoulders: An Empirical Assessment of Knowledge Spillovers and Creative Destruction in a Model of Economic Growth, *NBER Macroeconomic Annual*, vol. 8, 1993; A. Agrawal, I. Cockburn and J. McHale, Gone But Not Forgotten: Knowledge Flows, Labor Mobility, and Enduring Social Relationships, *Journal of Economic Geography*, vol. 6(5), 2006; E. Moretti, Workers' Education, Spillovers and Productivity: Evidence from Plant-Level Production Functions, *American Economic Review,* vol. 94(3), 2004.

vators are better informed than investors about the true prospects of their projects, firms may lack access to capital. Jumping to the conclusion that governments should then replace failing markets may seem naïve at first glance, because the replacement of private investors and banks with a government would not cause the informational asymmetry to disappear: the government would not be better than private investors at distinguishing good projects from bad ones. However, this objection is only partly valid. Economic theory has shown that in the presence of asymmetric information, public intervention may raise overall welfare, even if the government is not better informed than private agents. In a nutshell, the reason is that private investors in general cannot appropriate the full value generated by the projects they fund – if they did, entrepreneurs would be left without any incentives to succeed, since they would not reap the benefits of success. As a result, subsidising entrepreneurs may raise overall welfare even when it is not privately profitable. This type of consideration may justify subsidies to firms in nascent high-technology sectors, in which informational asymmetries are likely to be large.

c) State aid as a means to create competition

Finally, State aid may help a new company to get off the ground and create or increase competition, to the benefit of consumers. In some circumstances, it is conceivable that the creation of a second firm, in the case of a monopoly, is not privately profitable, because set-up costs are too high relative to the flow of future profits. But when market structure shifts from monopoly to duopoly, consumers gain, and this gain is not taken into account when deciding whether to create a new company. This may in some cases justify the granting of State aid. A famous example is Airbus: it has been estimated that because of the increased competition in the aircraft sector fostered by the creation of Airbus, the corresponding subsidies significantly raised European welfare.[26].

However, this argument lacks generality. Economic theory does not come to the conclusion that there is in general too little entry because of potential entrants' failure to internalize consumer welfare. The reason is that this positive externality of entry is compensated by a negative externality, called the "business-stealing" effect: an entrant fails to take into account the decrease in incumbent profits induced by its potential entry.

d) State aid as a means to achieve "personalised corporate tax rates"

An additional possible justification for State aid is barely ever mentioned. Like all kinds of taxation, corporate taxation, distorts firms' behaviour. For instance, corporate taxation affects the cost of capital (through quite complex channels[27]), which has a strong impact on investment, with an elasticity estimated between –0.5 and -1.[28] Corporate tax rates also appear to have a

26 D. Neven and P. Seabright, European Industrial Policy: the Airbus Case, *Economic Policy*, 1995.

27 See A. Auerbach, Taxation and Capital Spending, UC Berkeley Economics Department Working Paper, 2005.

28 R. Caballero, E. Engel, and J. Haltiwanger, Plant-Level Adjustment and Aggregate Investment Dynamics, *Brookings Papers on Economic Activity*, 1995.

significant impact on firms' choices of organizational form.[29] The same could be said about other taxes paid by companies, such as taxes levied on firms' wage bills, which are known to have highly distortive effects on companies' arbitration between labour and capital.

But the impact of taxation on firms' investment, employment or organization decisions varies a lot across sectors, and probably across firms in each sector – just like the impact of personal income taxation on labour supply varies a lot across individuals. This may justify in theory "personalised" taxation. Rather than lower taxes on all firms, including those whose behaviour is little affected by them, it could be more efficient to target those most sensitive to taxation and offer tax breaks to these firms only. If they are granted with enough selectivity, such tax breaks would be considered as State aid.

Again, this rationale for State could be expressed in terms of the remedying of a market failure (albeit a government-created one) in that tax breaks targeted towards firms with the greatest sensitivity to taxation is justified by the divergence between socially and privately optimal decisions, which results from the existence of a tax wedge.

This justification for aid relying on the occasional superiority of "personalised" tax rates over uniform ones implies that selectivity need not be bad by itself, even in the absence of any market failure beyond those induced by corporate taxation.

2. Caveats

The likely presence of market failures in the real world should not be construed as a blanket justification for State aid. To start with, almost no real-world market fits the textbook paradigm of perfect markets, and in that sense, market failures are ubiquitous. Some discipline is thus needed in order to assess whether the nature and the magnitude of a particular market failure, as well as the imperfections (for example, due to informational asymmetries) of policies, make State aid a suitable corrective measure. In particular, other tools are often more appropriate than State aid. For example, many externalities can be dealt with using general, non-selective instruments such as taxes or subsidies, and, similarly, public services may often be provided through transparent tender processes.

Second, asymmetric information may render public policy very inefficient. For example, aid to R&D may miss its goal and crowd out private R&D rather than stimulating new investment.[30] More generally, firms may misrepresent the extent to which the decisions supposedly generating positive externalities (i.e. R&D, but also the choice to locate in a region undergoing economic hardship) are sensitive to the granting of aid, which may cause governments to grant inefficient aid.

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29 A. Goolsbee, The Impact and Inefficiency of the Corporate Income Tax: Evidence from State Organizational Form Data, *Journal of Public Economics*, vol. 88(11), 2004.

30 For a survey of empirical research on this topic, see P. David, B. Hall, and A. Toole, Is public R&D a complement or substitute for private R&D? A review of the econometric evidence, *Research Policy*, vol. 29(4-5), 2000. Their conclusion is mixed, meaning that a strong crowding-out effect cannot be ruled out.

Finally, as regards aid to R&D, much has been said about the inefficiencies of policies aimed at "picking winners", and about the intrinsically unpredictable nature of innovation. This can be illustrated, inter alia, by a comparison of the identity of the largest private companies in Europe and in the United States. While the top companies in Europe today are, with a few exceptions, the same as 25 years ago, this is not true in the United States, where large companies (such as IBM) have been dethroned, while new companies in the high-technology sector were rising to prominence, such as Microsoft, Sun, or Google. This casual observation invites a lot a caution over the idea that governments can identify companies and technological endeavours worthy of State aid: if the largest and most sophisticated corporations failed to identify and produce the most path-breaking innovations in the last two decades, which came instead from unexpected quarters, why should we expect governments to be more enlightened?

3. Correcting geographic disparities

The goal of redressing economic disparities across regions figures prominently in Article 87(3) of the Treaty. *"Aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious unemployment"* (point (a)) and *"aid to facilitate the development of certain economic activities or of certain economic areas"* (point (c)) may indeed be considered to be compatible with the common market.

Economic analysis cannot make a normative statement about the weight which public policy should put on the reduction in regional disparities, relative to other policy goals such as overall economic efficiency. It can however attempt to assess whether, and to what extent, State aid to companies is a proper tool to meet this goal.

Some empirical evidence shows that the knowledge spillovers flowing from efficient firms are very localized.[31] In Europe, they seem to be much stronger within than across regions.[32] This may provide a rationale for State aid control as an instrument to reduce geographic inequalities.

However, according to a recent study, while regional policy aiming to attract firms to poor or peripheral locations apparently succeeded, they were very costly because the distortion of firms' location choices resulted into inefficiencies.[33] The case for State aid as a tool for the alleviation of regional inequalities might thus not be very strong, and alternative policies, such as direct income transfers could be more efficient in many cases.[34]

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31 D.B. Audretsch and M. Feldman, R&D Spillovers and the geography of innovation and production, *American Economic Review*, vol. 86, 1996.

32 L. Bottazzi and G. Peri, Innovation and Spillovers in regions: Evidence from European patent data, *European Economic Review*, vol. 47(4), 2004.

33 K.-H. Midelfart-Knarvik and H.-G. Overman, Delocation and European Integration: Is structural spending justified, *Economic Policy*, vol. 35, 2002.

34 K.-H. Ulltveit-Moe, Regional policy design: An analysis of relocation, efficiency and equity, *European Economic Review*, vol. 51, 2007.

IV. The limits of economics analysis

1. Theoretical analyses offer few clear-cut prescriptions

a) *The role of market power*

Reflecting the variety of possible theories of harm and of the possible benefits of State aid, the various theoretical contributions described above cannot easily translate into a "check-list", i.e., into the identification of conditions making State aid more likely to be harmful, or on the contrary, beneficial. Consider for example the issue of whether State aid should be considered more harmful when affecting markets in which firms have market power. Among the various theories of harm, the "inefficient subsidy race" theory does not require the aid recipient to enjoy any market power. If a firm, even without any market power, is offered aid by a country willing to attract it in order to increase employment or tax revenues (even though the choice of location is neutral in terms of overall welfare and the firm would have located somewhere in the European Union even with no aid), then the granting of an aid entails an inefficiency from a European-wide viewpoint (if taxation has a deadweight cost, which is the case in practice). It would nevertheless be rational from the viewpoint of a benevolent national government. A rule authorising aid as soon as the recipient enjoys little market power would fail to solve this inefficiency, even though it results from the lack of internalisation of cross-border externalities by national governments and thus seems to be a prime candidate for supranational control.[35] Some other theories of harm, however, apply only if the recipient enjoys a lot of market power. This is the case, for instance, when the concern is that the recipient of aid might use its financial strength to engage into predatory strategies. This is also the case if aid is motivated by a national government's desire to shift rents from Foreign to Domestic firms. As seen above, such aid is not necessarily harmful from the overall European viewpoint. A necessary condition for it to be harmful is that the deadweight cost of taxation be high enough. Another one is the presence of some market power (for there would be no rents to start with otherwise). But the abovementioned theories offer complex guidance regarding the impact of market power, because they also stress that when product differentiation is maximal (a situation usually associated with a lot of market power), State aid is unlikely to be harmful. To sum up, according to the existing theories of state-aid-as-rent-shifting (one of many theories of harm, and one of several theories of harm-cum-cross-border-externalities), a ban is most likely to be justified (under a total welfare criterion) when the degree of competition is intermediate, i.e., when the recipient enjoys market power (so that there are rents) but there is a significant amount of competition between it and its rivals (so that rents can be shifted).

Also, since large firms (often – but not always - enjoying significant market power) are more likely than small ones to have political clout, the "interest group theory of harm" would lead

35 We thus beg to differ with T. Besley and P. Seabright (supra, n1) who recommend that market power be considered *"a necessary condition of the identification of cross-border externalities"* (p. 40).

one to be wary of aid granted to large, politically powerful firms.[36] Finally, empirical studies of the link between market power and innovation do not provide firm guidance, since firms' R&D efforts appear to first rise and then fall with market power,[37] making it difficult to know for which level of market concentration there is the greatest lack of innovation, and thus the greatest need for public support.

b) *Should State aid control be biased in favour of aid to R&D?*

All the praise lavished on aid to R&D notwithstanding, there is no compelling case for a particularly lenient control of aid to R&D, in the light of economic analysis, both theoretical and empirical. True, R&D combines externalities (due to knowledge spillovers) and informational asymmetries (which may result in underfunding). But these asymmetries, as noted above, also imply that aid to R&D may be inefficient for two reasons, namely because of the crowding out effect (governments may find it difficult to ascertain whether the subsidised R&D would have been undertaken without aid), and because of the possible inability of governments to effectively pick winners. This is not to say that aid to R&D is never desirable. The point is simply that economics offer no definitive argument to the effect that aid to R&D should be treated more favourably than, say, aid to a non-technological firm which could easily locate outside of Europe and conditions its presence (and the associated positive externalities, like for example tax revenues) on the granting of aid. To make matters even more confused, a recent theoretical model suggests, against much conventional wisdom, that the risk that unconstrained governments might grant too much aid is greater when the aid is targeted towards R&D than when it takes the form of a simple production subsidy.[38]

2. Some of the effects of State aid do not lend themselves to measurement

The assessment of the impact of an aid bears some similarities to the assessment of mergers. In both cases, the goal is to assess how the market will be affected by a given change. However, in the case of State aid, this exercise is far more complex that in the case of mergers.

The assessment of unilateral effects, which lies at the heart of horizontal merger control, provides for a helpful comparison. Its ambition, compared with the scope of the questions raised by the analysis of State aid control, is relatively narrow: it limits itself to short-run effects, and takes market structure as given (except for the merging parties, of course). It lends itself to the econometric technique of merger simulation, which yields quantitative predictions based on parsimonious data requests. Yet, even within this well-delineated framework, merger control is often seen as unpredictable, especially as regards the assessment of efficiencies.[39]

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36 This point is made in H. Friederiszick, L.-H. Röller and V. Verouden (supra n 1).

37 P. Aghion, N. Bloom, R. Blundell, R. Griffith and P. Howitt, Competition and Innovation: An Inverted U Relationship, *Quarterly Journal of Economics*, vol. 120(2), 2005.

38 D. Collie, State aid to Investment and R&D (supra n 1).

39 D. Gifford et R. Kudrle, Rhetoric and Reality in the Merger Standards of the United States, Canada and the European Union, *Antitrust Law Journal*, vol. 72, 2005.

But the questions which need to be addressed in order to assess a State aid measure are both more numerous, and often less liable to quantification than unilateral effects.

Consider for example aid to R&D. One of the main justifications for the granting of aid to R&D is the existence of a positive externality due to knowledge spillovers. But how can the likelihood of such spillovers be proved in an individual case? The empirical research on this topic almost never proceeded by identifying the presence of spillovers in individual cases; but rather by studying large datasets and identifying the existence of knowledge spillovers on average, using sophisticated statistical techniques. Besides, even this approach fails to end up on firm ground, since the findings of the various studies are significantly divergent. In the case of mergers, the study of past mergers in the same market can often be considered to have some predictive value. But in the case of R&D, such an approach is less promising, because of the difficulty of finding relevant precedents, especially when the goal is to assess an innovation which has not yet occurred and the nature of which is uncertain by definition. This difficulty is reminiscent of the one faced by firms making efficiency claims when defending a merger. Such claims are often rejected for want of verifiability up to competition authorities' high standards. But the problem should be even more acute for State aid control, since the innovations purportedly encouraged are more radical, and thus more uncertain and less verifiable, than the incremental improvements representing the majority of efficiency claims in merger control. And even if spillovers could be shown to be likely, one should also ascertain whether the amount of R&D is sensitive to the volume of aid. Answering this question requires one to know not only the cost of funds available to the firm and the possible credit constraints facing it, but also the list of alternative possible investments for the recipient of the aid, the impact of the R&D effort on the firm's future production costs, as well as an estimate of market demand and rivals' marginal costs, so as to calculate how a given cost reduction, if achieved thanks to R&D, will affect profits. In many cases, the question is even more complex because R&D often aims to create new products rather than to decrease the cost of producing existing ones. Therefore, in order to calculate whether the firm's behaviour is likely to be impacted by the aid, one needs to make assumptions about the demand function in the hypothetical post-R&D world, i.e., for example, about the elasticity of substitution between rivals' goods and the hypothetical, not yet existing new good which the subsidised R&D might – or might not – bring into existence.

This difficulty is by no means limited to R&D, as can be seen by moving to the question of dynamic inefficiencies - which is often, and probably rightly, mentioned as a justification for State aid control. There is simply no way of quantifying to what extent the granting of an aid will change economic agents' expectations in the long-run, and thus their investment and innovation behaviour. Answering this question would require one to assess the impact of any given aid on other firms' expectations as to the likelihood of being granted State aid in the future under different types of circumstances, and to measure the impact on this change in expectations on firms' future behaviour (excessive risk-taking or "X-inefficiency" resulting from the reinforced soft budget constraint, diversion of resources from productive to rent-seeking activity, etc.)

Finally, any quantitative assessment of the welfare impact of a State aid must start by making an assumption about the cost of public funds, because, when calculating the overall impact of an aid on welfare, the loss to taxpayers is usually a major element. In fact, in all simple models of distortionary State aid, as well as in simple models of subsidy races, there is no harm at all unless this deadweight cost of taxation is large enough.

3. The relationship between welfare standards and assessment rules

The issue of the desirable welfare standard for State aid control has been discussed in several recent contributions.[40] For example, H. Friederiszick, L.-H. Röller et V. Verouden recommend to focus on the combined surplus of consumers and taxpayers, on the grounds that these two categories of agents are politically less powerful than firms, so that omitting firms in the welfare criterion could offset this unbalance. In some cases, when all the relevant effects of the aid under scrutiny can be quantified, the welfare standard may offer precise guidance as to how to balance positive effects against distortionary ones. For example, in the case of a restructuring aid aimed at preventing a firm in an oligopolistic market from going bankrupt and exiting (legally falling under Article 87(3) point c), the abovementioned criterion would mandate a comparison between, on the one hand, the gain to consumers from a continuation of the recipient's activity (implying both an assessment of entry barriers, and an estimate of the remaining firms' behaviour after the recipient's exit, given the magnitude of entry barriers, cost structure and demand characteristics) and the loss to taxpayers (measured with reference to a predetermined value for the deadweight cost of taxation). In principle, this comparison could be undertaken using the same market estimation techniques as those routinely used for merger simulation.

However, in other, probably more frequent cases, the definition of a welfare standard cannot translate directly into predictable enforcement, because several important effects of State aid, both positive and negative, are difficult to measure. This problem can only be handled by complementing an abstract welfare standard with much more detailed policy rules defining filters, safe harbours and "shortcuts", and allowing the Commission to reach a decision without having to undertake a full-fledged balancing exercise in each case. In other words, the theoretical and practical limits of the economic analysis of any given State aid call for a "structured rule of reason", which could be far easier to administer than a pure rule of reason.[41]

The proponents of the aforementioned welfare standard themselves acknowledge that it is more about general principles than about providing detailed guidance for enforcement, and they advocate a practical rule largely departing from a pure rule of reason guided only by the compass of the consumer-plus-taxpayer welfare criterion. First, they recommend a combina-

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40 H. Friederiszick, L.-H. Röller and V. Verouden (supra n 1) ; S. Martin and C. Strasse, La politique communautaire des aides d'État est-elle une politique de la concurrence ?, *Concurrences*, nº 3-2005, p. 52; T. Kleiner and A. Alexis (supra n 15).

41 On the notion of structured rules of reason, see, e.g., F. Easterbrook, The limits of Antitrust, *Texas Law Review*, vol. 63, 1984.

tion of block exemptions for low-intensity aid and per se prohibition for high-intensity aid, leaving economic analysis to play a role only in intermediate situations. Second, they stress that *"State aid control should concentrate on a small set of well-defined market failures and specify those clearly in its guidelines"*. This is exactly the agenda of the ongoing overhaul of State aid control, as exemplified, for instance, in the recent *Community Framework For State aid for Research and Development and Innovation* (hereafter the "R&D&I Framework")[42], which lists specific types of market failures for the assessment of the positive effects of an aid and specific types of distortions for the assessment of the negative effects, leaving aside many, possibly important but hard-to-measure effects, such as, on the positive side, the increase in production due to a decrease in perceived costs, and on the negative side the cost to taxpayers or the impact on all firms' expectations and future behaviour. Whichever welfare standard is chosen, if any, State aid control outcomes will continue to be determined primarily by detailed procedural rules, reflecting presumptions about the magnitude and likelihood of these unmeasurable effects.

V. Conclusion

In two recent rulings (*Le Levant*[43] and *Wam*[44]), the Court of First Instance of the European Communities stated that in order to prohibit an aid, the Commission must present some proof of the risk that the aid would affect trade between member states and distort competition. These rulings reflect a literal interpretation of Article 87 (1) of the EC Treaty because distortion of competition and affectation of trade are deemed necessary conditions for a prohibition. They depart from much of the earlier case law which either disregarded the need to prove the risk of a distortion of competition (claiming, with no economic basis, that it followed automatically from the selective nature of an aid measure), or set a very low standard of proof.

These two recent rulings imply that the Commission can prohibit only aid which is likely to have a cross-country impact (through the "trade affectation" criterion). Even though the exact interpretation of the competition distortion and trade affectation criteria is a bit unclear, this amounts to an implicit rejection of the paternalistic justifications for state aid control, in that an aid measure constituting bad economic policy but causing no harm to neighbours cannot be banned.

Leaving aside the fact that this interpretation seems more consistent with the Treaty than the previous case law, two remarks must be made. First, there is no compelling economic case in favour or against this approach. Whether the European Commission should be the guardian of national governments' virtues is in the end a question of political philosophy. The answer depends on the relative weight one assigns to economic efficiency (which could call for a supranational control on both paternalistic and non-paternalistic grounds) and democratic

42 2006/C 323/01, December 30, 2006.

43 CFI, 22 February 2006, Eurl Le Levant v Commission, case T-34/02.

44 CFI, 6 September 2006, Italy and Wam SpA v Commission, case T 304/04.

accountability (which rules out paternalism). Second, the Commission's current overhaul of State aid control is at odds with the Court's recent rulings. While the latter tend to depart from the traditional acceptance of the paternalistic justifications for State aid control, the former, on the contrary, is embracing them enthusiastically, action plan after action plan, framework after framework. In the State Aid Action Plan, the Commission claims that *"State aid should only be used when it is an appropriate instrument for meeting a well defined objective, when it creates the right incentives, is proportionate and when it distorts competition to the least possible extent."*[45] The cumulative nature of these conditions means that the absence of a distortion of competition would not be enough for an aid measure to get clearance, in contradiction with the letter of Article 87 (1). The assessment method proposed in the R&D&I Framework is in line with this view, since according to it, showing both the existence of a market failure in need of redress, and the appropriateness of the aid measure, would be a necessary condition for clearance.

Whether the gap between the non-paternalistic letter of the Treaty, which the Courts seem to be belatedly adhering to, and the stricter, more paternalistic approach of the Commission can be bridged is a question left to the creativity of legal experts. Economics is, alas, of little use here.

45 State Aid Action Plan, pt. 11.

The most appropriate economic tool for a better targeted State aid policy

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I. Foreword

The impact on State aid of a higher degree of economic analysis can be threefold. First, economic considerations help the Commission to shape State aid Policy, *i.e.* defining the priorities and guidelines of its legislative and enforcement policy, taking into consideration the general objectives of the Treaty and the interaction with other Community policies. The Commission has given indications with regards to this issue in a number of Reports and documents relating to the implementation of the Lisbon Strategy[46] and its thinking on the subject is reflected in the State aid Action Plan (hereinafter, SAAP).

Second, an economic approach, together with legal considerations, identifies the most suitable tools for the advancement of State aid Policy, *i.e.* what the best assessment criteria or tests are. Again, this is an exercise that is reflected in the Action Plan, although it remains an ongoing process.

Third, economic concepts can help to elaborate methods of analysis to be used in the application of the Treaty rules and to achieve a refined and objective application of such rules, thus contributing to the improvement of the quality and efficiency of the Commission's enforcement policy.

As an example of the first issue (economic considerations help shape State aid Policy) one can take the Commission's choice to encourage Member States to grant more focused State aid and to shift the balance towards horizontal aid, especially R&D[47]. Examples of the second issue (economic approach as a means to identify appropriate policy tools) are the Commission's choice to devote more attention to the analysis of market failures and the definition of the parameters used in the assessment of cross-border externalities. Finally, examples of the third issue (economic analysis that help to achieve more objective enforcement) are the assessment of public shareholders' or public companies' behaviour in order to determine if given equity contributions or commercial transactions involve elements of aid (e.g., application of market investor principle, cross-subsidization, etc.).

The present contribution mainly focuses on the second issue, i.e., the determination of which tools, assessment criteria and screening devices could be put in place so as to achieve the priorities set out by the Commission, and does not discuss in detail the possible impact of economic analysis on the decision-making process with respect to each and every single aspect of Articles 87 and 88 EC. The background against which we base our (general) reflection is

46 See for instance the Report from the Commission to the Spring European Council "Delivering Lisbon – Reforms for the enlarged Union" of 21 January 2004 (COM 2004/29); the Communication from the Commission on the Implementation of the 2003-2005 Broad Economic Policy Guidelines of 21 January 2004 (COM 2004/20 final); the Commission Communication to the Spring European Council "Working together for growth and jobs – A new start for the Lisbon Strategy" of 2 February 2005, COM (2005) 24; the Commission Communication "Common Actions for Growth and Employment: The Community Lisbon Programme" of 20 July 2005, COM(2005) 330 final; the Commission's Lisbon Action Plan incorporating EU Lisbon Programme and recommendations for actions to Member States for inclusion in their national Lisbon Programmes of 4 February 2005, SEC(2005)192.

47 A trends towards horizontal objectives in the granting of State aid is well documented in the different versions of the Scoreboard, see "State aid: latest Scoreboard reveals continuing shift towards horizontal objectives", IP/06/1719, Brussels, 11 December 2006, pp.45-52.

represented by all relevant Treaty provisions (Articles 2, 3, 3a, 87 and 88 EC), which in our view are perfectly suited to their aims, as well as the objectives of State aid Policy, defined in such a way that they are fully coherent with the aforementioned provisions as interpreted by the EC Courts. We wish to clarify from the outset that, in any case, in our view the decision-making process remains essentially a legal exercise, consisting of the examination of facts and proofs, the qualification of the findings and the assessment of their legality against the legal background, defined on the basis of the interpretation of applicable laws.

After a few introductory remarks concerning the way in which the objectives of State aid control have been traditionally defined and to what extent they have been recently adapted (§ 2), we will proceed by reviewing the tools used in the Commission's traditional practice (§ 3). Then we will quickly review the State aid Action Plan in order to emphasise the novelties contained therein, especially with respect to the instruments and focus of the Commission's State aid Policy (§ 4). This will allow us to make an assessment of the measures announced in the Action Plan and to give our opinion on the desirable way forward in European State aid control, *i.e.* the choice of the priorities and most appropriate tools of State aid Policy in light of a refined economic approach (§ 5).

II. The definition of the objectives of State aid control in the EU as the background of our analysis

It has been alleged that the original primary objective of Article 92 EEC (then Article 87 EC) was to address concerns about export subsidies and strategic trade in general, including attempts to defeat imports by subsidising home producers.[48] It therefore combined elements of both competition policy and trade policy. However, the scope of European State aid control has considerably broadened since the Treaty of Rome up to nowadays. In this context, the current reform has generated a very useful debate about the *objectives* of the policy.

The Commission intervention in the field of State aid has been explained in the past by the need to ensure the establishment of a level-playing field among regions (as part of the creation of an Internal market) and among undertakings (as part of competition policy) and even with the need to decrease public expenditure or release the economic burden on tax-payers.[49] As correctly emphasized by a number of commentators, it is highly disputable whether these objectives are in line with consumer welfare, which has become the uniform standard in other fields of competition policy (e.g. assessment of agreements between undertakings, abuses of dominant position and merger control).

48 See William Bishop: "From Trade to Tutelage: State aid and Public Choice in the European Union", presentation at the ACE conference in Copenhagen, December 2005.

49 See for instance the analysis of past practice carried out by Stanislas Martin and Christophe Strasse, La politique communautaire des aides d'État est-elle une politique de concurrence ?, Concurrence N° 3 – 2005, Doctrine ; T. Kleiner and A. Alexis, T. Kleiner et A. Alexis, Politique des aides d'Etat : Une analyse économique plus fine au service de l'intérêt commun, Concurrences No° 4 – 2005, Doctrines, pp.45-52.

However, a number of recent contributions to the debate on State aid reform illustrate how these objectives can be reconciled with the consumer welfare standard.[50] In this regard, it is important to note that the SAAP seemingly indicated that the incompatibility of State aid – laid down in Article 87(1) EC – as a matter of principle aims to prevent harm to both efficiency and consumer welfare.[51] Hence, the impact on consumers is still considered as an important reference in the SAAP.

The debate on the objectives of State aid control reflects on the proposed criteria and standards to be used in order to assess the compatibility of State aid measures under Article 87(3) EC. Economists have advocated in favour of the use of alternative criteria to implement the condition set forth in the Treaty provision. Such criteria range from consumer welfare[52], consumer and taxpayers welfare[53] to total welfare.[54] Some statements by the European Commission provide an explicit recognition of total welfare as the ultimate aim of State aid control. In the Community Framework for State aid for Research & Development & Innovation,[55] for instance, the objective of State aid control is stated as follows:

> *"The objective is through State aid to enhance economic efficiency* (…)*."*

The footnote attached to this quote confirms that the maximisation of "total welfare" is the objective pursued:

> *"In economics, the term "efficiency" (or "economic efficiency") refers to the extent to which total welfare is optimised in a particular market or in the economy at large. Additional R&D&I increases economic efficiency by shifting market demand towards new or improved products, processes or services, which is equivalent to a decrease in the quality adjusted price of these goods."*

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50 David Spector, op.cit,. H. Friederiszick, L-H Röller and V Verouden, op,cit. . T. Kleiner et A. Alexis, op.cit. S. Martin et C. Strasse op.cit. Pietro Crocioni, Can State aid Policy Become more Economic Friendly, World Competition, 29(1), 2006.

51 SAAP, para. 7: *"State aid control comes from the need to maintain a level playing field for all undertakings active in the Single European Market, no matter in which Member State they are established. There is a particular need to be concerned with those State aid measures, which provide unwarranted selective advantages to some firms, preventing or delaying the market forces from rewarding the most competitive firms, thereby decreasing overall European competitiveness. It may also lead to a build-up of market power in the hands of some firms, for instance when companies that do not receive State aid (e.g. non-domestic firms) have to cut down on their market presence, or where State aid is used to erect entry barriers.* ***As a result of such distortions of competition, customers may be faced with higher prices, lower quality goods and less innovation"(emphasis added).***

52 As advocated by S. Martin and C. Strasse (op.cit).

53 As advocated by D. Spector and Friederiszick, H., L-H. Röller and V Verouden (*op.cit*).

54 As advocated by R. Nitsche and P. Heidhues (*op.cit*).

55 Community Framework for State aid for Research and Development and Innovation, OJ 2006 C 323/1.

Some recent contributions from economists have also confirmed that the total welfare criterion appears as the appropriate way forward by upholding the approach which considers both consumers' and taxpayers' welfare as the correct standard for State aid control (below, § 5).

In addition to the above, there are still questions regarding the effect on trade condition laid down in Article 87(1) EC, *i.e.* whether the Commission should fulfil the role of a supranational judge with respect to subsidies that may distort local competition with extremely limited negative effects on other Member States or whether the Commission should only focus on those subsidies that significantly affect trade (in the sense that there are negative externalities on other Member States).

The latter option would require a substantial shift in the interpretation and application of the *'effect on trade'* criterion. Indeed, the broad interpretation of the *'effect-on-trade'* requirement of the European Courts is well known[56]. The Vademecum 'Community Rules on State aid' summarises the current legal requirement as follows:

> *'It is sufficient, if it can be shown, that the beneficiary is involved in an economic activity and that he operates in a market in which there is trade between Member States.'*[57]

The current interpretation of the effect on trade condition extended the competence of the European Commission beyond subsidies with a significant cross-border effect[58]. As a result, the European Commission ends up assessing subsidies with a mainly local character (famous examples include the Brighton Pier in the UK and Austrian dentists).[59] Although this is probably not a deliberate choice of enforcement policy made by the Commission but rather the result of legal requirements that are easily satisfied, the question arises whether there is any justification to empower a supra-national authority to monitor subsidies granted by governments, even if these do not significantly affect other Member States. The Commission's answer is clearly "yes". In fact, political economy considerations suggest that supranational control may counterbalance government failures (such as national commitment problems or wasteful

56 For instance, it is irrelevant that the aided enterprise does not export its produce. An aid may be such that it affects trade between Member States and distorts competition when the undertaking competes with products coming from other Member States (Case 102/87 *France v Commission* (1988) ECR 4067). Likewise, when an undertaking is operating in a sector where there is excess production capacity, any aid awarded by the public authorities is likely to affect Community trade and hinder competition. The undertaking's continued presence on the market prevents competitors from increasing their market shares and reduces their opportunities to increase exports (C-305/89, *Italy v Commission*, (1991) ECR 1603.

57 According to past practice, it is also sufficient that intra-Community trade is *foreseeable* in the future.

58 As will be shown supra, case law seems to require a minimum effect on intra-Community trade, although the requirements set are met very easily. Indeed, even State aid to firms that operate in local markets can sometimes produce negative externalities in other Member States, as it occurs for instance with local services subject to tendering procedures and services offered and marketed on the net.

59 Commission Decision of 9 April 2002 C(2002) 942 fin., N 560/01 and NN 17/02 – United Kingdom Brighton West Pier; Judgment of 03/03/2005,C-172/03, *Heiser*, ECR (.2005) I-1627).

spending due to lobbying). While a mandate to take these effects into account seems to have been implicitly given to the Commission, this has never been explicitly recognized.

Such a stake taken in its practice by the Commission is consistent with the total welfare approach. If the European Commission intends to maximise total welfare in the European Union, local Government failure should also be considered. The Commission seems indeed inclined to stick to the wide interpretation of the condition that trade between Member States must be affected. This can be justified by "national government failure" arguments (i.e. monitor subsidies that do not generate significant cross-border externalities but may still locally distort competition in sectors that are open, actually or potentially, to competition from abroad). However, there are a number of arguments in favour of a more pronounced division of labour between the Member States and the European Commission. First, it needs to be recognised that the classic strategic trade incentive to provide excessive aid (other Member States carry the burden of negative cross-border externalities) is insignificant if the effect on trade is limited. Second, the practical need to prioritise State aid control efforts may provide arguments in favour of focussing on those cases where other Member States are significantly harmed.

We conclude that total welfare emerges as the ultimate objective of State aid control, although there is still considerable debate on the extent to which the effect on consumers should be investigated in actual State aid proceedings and it is widely recognised that it must be in specific cases, e.g. with respect to rescue and restructuring aid or individual aid in general.

Given the remaining uncertainties related to the practical shift towards total welfare as not only the ultimate objective of State aid control but also the policy standard, the following assessment of the tools used by the Commission in its traditional policy (§ 3) as well as to those indicated in the Action Plan (§ 4) refers to the "effect on rival standard" as well as to a "total welfare standard".

III. "State of the art" in State aid control: the tools used so far

1. Introduction

This section of the Report provides an overview of the substantive and procedural tools used so far by the European Commission in pursuing its traditional State aid policy. As the purpose of this exercise is to build up the background against which the current reform of the above-mentioned policy is to be evaluated, we will proceed by following the structure of the State aid Action Plan ("SAAP")[60], which contains a number of practical proposals to achieve the main objectives of the reform, including new or partially modified aid control tools (*infra*, § 4). Thus, in consideration of the prominent role attributed to the concept of market failure in the SAAP, we will first recall the role played by market failures in traditional State aid policy (§ 3.2). We will continue by evaluating the use of economic tools so far, *i.e.* the scope given

60 State aid Action Plan – Less and better targeted State aid: a roadmap for State aid reform 2005-2009, COM (2005) 107 final, Brussels 7 June 2005 (hereinafter, the "SAAP").

to economic analysis until now for the purpose of assessing State aid under Article 87(1) and (3) EC (§§ 3.3 and 3.4) and in the framework of Article 86(2) (§ 3.5).

2. The traditional market failure approach

The idea that an aid measure is supposed to target a market failure of some sort has also definitely been underlying State aid policy in the past. A review of the relevant doctrine and case-law reveals, however, that so far this has been no more than a general (and generic) assumption within the framework of the Article 87(1) EC analysis, while it played a greater role, albeit still insufficient, and limited to some categories of aid, in the compatibility assessment under Article 87(3) EC[61].

Building upon the relevant European Court of Justice case-law[62], the doctrine has constructed the so-called 'necessity test' according to which State aid may be deemed compatible only when market forces alone without State intervention could not ensure a sub-optimal development of production, *i.e.* when the aid is necessary to remedy a market failure[63]. This means that in principle incentives which would improve the financial situation of the recipient undertaking, but are not necessary for the attainment of the objectives specified in Article 87(3) EC, cannot be authorized.

In spite of this generally acknowledged understanding, so far there have been limited attempts[64] to list and categorize the various market failures which are liable to be compensated by State aid, which may explain the general lack of a detailed reasoning in the Commission's traditional practice and in the case-law. In most cases, the Commission contents itself with pointing out that the effect on trade and distortion of competition caused by the given measure does or does not appear justified in light of the Community interest ("compensatory justification criterion")[65].

The general prohibition at European level of operating aid seems also based on the above assumption insofar as, by definition, these are not related to new investments, hence they do not appear to be necessary to attain the fundamental objective of economic development set out by letters (a) and (c) of Article 87(3) EC[66]. It is interesting to note that regional operating

61 See First Report on Competition Policy, 1972.

62 Case 730/79, *Philip Morris v Commission* (1980) ECR 2671, paras. 17, 23-25.

63 See J.P.Keppenne, "Guide des aides d'Etat en droit communautaire", Bruylant 1999, § 498; also C.Quigley and A.M.Collins, "EC State aid Law and Policy", Hart Publishing 2003, § 2.3.

64 Some analysis of market failures has been carried out by Geradin, "Quel contrôle pour les aides d'Etat", in "les aides d'Etat en droit communautaire et en droit national", Bruylant, 1999, p. 68 *seq*. See also Merola, «Introduction à l'étude des règles communautaires en matière d'aides d'État aux entreprises», Revue Internationale de droit économique, 1994, pp.312-324.

65 See, *inter alia*, Commission Decision 97/611/EC of 2 April 1997 on aid to the sheepmeat industry (promotional aid), OJ L248/20. As explained by C.Quigley and A.M.Collins, *op. cit.*, § 2.3, the aid must contain a compensatory justification which takes the form of a contribution by the beneficiary over and above the effects of normal play of market forces to the achievement of the Community objectives.

66 Commission Decision 98/194/EC, Investment projects in the new Länder, OJ 1998 L73/38; Case T-9/98 *Mitteldeutsche Erdoel-Raffinerie GmbH v Commission* (2001) ECR II-3367, para. 123.

aid can be authorized only when they accompany and increase the efficiency of aid to development[67].

A more detailed consideration – and even some degree of economic analysis[68] – has been given to market failures in some of the existing guidelines and block exemption regulations, where the necessity of certain aid measures has been established via a legal presumption: in the case of aid to SMEs and for regional development, where it is presumed that the aid measure is necessary to compensate disadvantages created by factors such as the size of the firm or the geographical location when certain thresholds or conditions are met[69].

On the basis of the above, we can conclude that, whereas the idea that State aid can be granted only if necessary to compensate for some sort of market failure has definitely been the basis of the relevant doctrine, Commission's practice and also case-law as in the past, there has been neither a systematic nor a specific and detailed analysis of market failures.

3. Economic analysis under Article 87(1) EC so far: definition of State aid

There is a broad consensus on the fact that one of the few fields in which economic analysis had played an effective role in the past is the development and application of the Market Economy Investor Principle (MEIP), which dates back to the early 1980s[70]. At the very beginning, the private investor test was used in order to assess whether certain measures could be considered as financed through State resources when the behaviour of public holding companies or public undertakings is at stake. Subsequently, the MEIP was used more often in the assessment of the economic advantage for the recipient, always to establish whether a given measure fell within the scope of Article 87(1) EC. The MEIP is, of course, relevant only in those cases where the State intervenes by means comparable to private investors[71].

The economic analysis used to establish the MEIP is quite different in form and purpose from that now proposed in the SAAP (below, § 4). The MEIP was designed to establish whether the economics of the (proposed) transaction is equivalent to what a private party would do and constitutes a sort of benchmark against which to assess State behaviour. In doing so, it does not really look at the incentive effect or even market failures, but looks at whether the State acts as a fictitious private party to establish whether the measure falls within the scope of Article 87(1) EC. The SAAP, on the contrary, is primarily concerned with the exercise of State prerogative measures – *i.e.* whether State intervention in the economy can be justified

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67 Guidelines on national regional aid for 2007-2013, OJ 2006 C 54/13.

68 See Paul Heidhues and Rainer Nitsche, "Comments on State aid reform – Some implications of an effects-based approach", in EStAL I/2006, p. 23. On the limits of this analysis, see infra.

69 See Commission Regulation 70/2001 of 12 January 2001, published in the OJ L10, of 13 January 2001, pp. 33-42. Other examples include the consideration of positive externalities in the Commission Regulations on aid to employment (Reg. 2204/2002) and training (Reg. 68/2001) and negative externalities in the Community Guidelines on Environmental aid; the reference to asymmetric information in the Communication on aid and risk capital.

70 Case C 323/82, *Intermills v Commission* (1984) ECR, 3809.

71 See H. W. Friederiszick/L-H Röller/VVerouden, "European State aid Control: an economic framework", November 2005, p. 5.

according to economic analysis: therefore, some of the techniques can be similar but the object of the exercise is different.

A more recent example of the use of economic analysis, as in the past, is definitely provided by the assessment of the funding of services of general economic interests culminating in the landmark *Altmark* judgement[72], where the aid nature of public service compensations is ruled out upon fulfilment of four cumulative conditions, two of which (the compensation must a) not exceed the necessary costs and b) not exceed the costs of a "well-managed and well-equipped" undertaking)[73] are definitely of economic nature.

Both the foregoing examples of influence of economic considerations in the definition of State aid concern the element of "advantage" financed through State resources. The same cannot be said of the analysis of the selectivity criterion, which seems to have been carried out mainly on the basis of legal criteria[74]. This point is illustrated by the divergence in the appraisal of the criterion. For instance, in the *Italian textile* case[75], the ECJ considered that a measure open to all undertakings within a Member State may be deemed selective if it has the effect of favouring certain sectors. On the contrary, in the context of fiscal measures, the Commission considers that general measures having asymmetric effects normally fall outside Article 87(1) EC[76]. The same risk of inconsistency is identified regarding the selectivity criterion in cases where apparently selective measures are justified by the nature and the general scheme of a system[77].

We believe that the analysis of selectivity at present represents one of the major shortcomings of the current State aid policy as it either ignores the actual economic impact of aid measures on specific firms and industries, or it takes such impact into account in a rather superficial and inconsistent manner. This is due to the fact that the standard or background against which the selective character of the measure must be assessed has never been thoroughly clarified, and the Commission and Community Courts have never really attempted to do so. It follows

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72 Judgement of 24 July 2003, Case C-280/00, *Altmark-Trans*, ECR 2000, I-7747.

73 The other two conditions being, respectively, (i) that the Member State must have imposed clear public service obligations and (ii) that the parameters for the calculation of the compensation must have been fixed *ex ante*. For an extensive comment on the Altmark judgement, also in relation to the previous case-law of the Court of Justice, see Bo Vesterdorf, 'A comment on the new State aid concept as (re)shaped by Altmark", in "New developments in European State aid Law 2004", Proceedings of the Second Experts' Forum , Brussels 2004, p. 11; Barbara Rapp-Jung, "State financing of public services-The Commission's new approach", ibidem, p. 21; Massimo Merola/Caroline Medina, "De l'arrêt Ferring à l'arrêt Altmark: continuité ou revirement dans l'approche du financement des services publics", Cahiers de droit européen, 2003, 639.

74 The same can be said as far as the transfer-of-public-resources criterion is concerned, even after the famous *Stardust Marine* judgement, Case 482/99 *French Republic v Commission*, ECR 2002, I-4397. However this is understandable as there is objectively little scope for economic analysis in the assessment of a condition which is mainly to do with the links existing between the national governments and the bodies granting the aid.

75 Case 203/82, *Commission v Italy* [1983] ECR 2525.

76 See Commission notice on the application of the State aid rules to measures relating to direct business taxation, in OJ C 384/1998, pages 3-9.

77 Cases C143/99, *Adria Wien Pipeline Gmbh v Finanzlandesdirektion für Kärnten* (2001) ECR I-8365 and 173/73 Italy v Commission (1974) ECR 709. See also Christos Golfinopoulos, "Concept of Selectivity criterion in State aid definition following the Adria-Wien judgement – Measures justified by the nature or general scheme of a system", *European Competition Law Review* 2003, p. 543.

inevitably that many questions still remain largely unanswered [78]. It seems clear, in fact, that measures which are *de jure* not selective but may *de facto* have a highly divergent economic impact on firms, sectors or regions.

There are therefore many reasons to believe that the refined economic approach could at least help to provide some clarification in this field. Concerning the last two notions embodied in Article 87(1) EC (the requirements of incompatibility: effect on trade and distortion of competition), the relevant doctrine agrees that their appraisal by the competent European institutions has traditionally been rather rudimentary[79]. First, both the Commission and the EC Courts used to scrutinise the two criteria as a single criterion[80]. Furthermore, in most cases the criteria at stake were considered to be fulfilled for the simple fact that the measure is "selective" in terms of granting an advantage, when the sector concerned is open to international competition. With specific reference to the "distortion of competition" criterion, it must be noted that no actual proof was needed; but that a mere threat or abstract capability to distort competition was deemed sufficient[81].

Given the way the traditional practice and jurisprudence have deprived the distortion of competition and effect on trade conditions of any substance, there are many reasons to believe that even the most strenuous opponents of a wide use of economic analysis in State aid control would be prepared to accept that much clarification is needed in this field regarding the possible role of economic analysis.

Finally, it must be recalled that the Commission has taken the view that only small amounts of aid (*de minimis* aid) do not have a potential effect on competition and trade between Member States. More specifically, a measure is deemed to fall outside the scope of Article 87(1) EC if the € 200 000 *de minimis* threshold (recently set by Regulation 1998/2006)[82] is met and other conditions are fulfilled. The *de minimis* approach therefore amounts to a sort of *per se* rule according to which it is presumed (without further economic analysis) that aid below the thresholds do not distort competition nor have an effect on trade between Member States.

4. Economic analysis under Article 87(3) EC so far: compatibility assessment

As already mentioned under § 2.1 above, the general principle followed by the Commission in order to assess the compatibility of a given aid measure, has always been that of balancing the

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78 As an example, one may think of the uncertainty on the criteria used to establish selectivity in purely horizontal aid cases: see Opinion of Mr Advocate General Darmon in Joined cases C-72/91 and C-73/91, *Firma Sloman Neptun Schiffahrts AG v Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG*, ECR 1993 Page I-00887.

79 It's worth adding that, as in the assessment of the distortion of competition/effect on trade criterion, the focus has been on Member States rather than on undertakings, their traditional interpretation has remained very close to free movement rules.

80 See for instance the Commission's *Vademecum: Community Rules on State aid (2003)*, p. 3, referring to the two criteria as one and the same.

81 See Case T-288/97, *Regione Autonoma Friuli Venenzia Giulia v Commission* (2001) ECR II-1169, paras 49-50; Case T-35/99, *Keller SpA v Commission* (2002) ECR II-261, para 85.

82 Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid, OJ 2006 L 379/5.

positive impact of the measure in question (repairing a market failure or in any case pursuing an objective of common interest) against its potential negative effects (distortions of trade and competition). (balancing test or compensatory measure justification).

In the *Philip Morris* case[83], the Court of Justice set out certain guiding criteria upon which the Commission must carry out the above assessment. This assessment should take into account not only the necessity of an aid for the purpose of achieving an economic goal, but also any social objectives that are in the Community interest. The Commission subsequently stated that it will consider the following factors when reviewing proposed aid:

- the aid must promote or further a project that is in the Community interest as a whole (market failure in a broad sense);
- the aid must be necessary for the achievement of this result and the objective could not have been obtained in its absence ("necessity test");
- the duration, intensity and scope of the aid must be proportional to the importance of the intended result ("proportionality test")[84].

Notwithstanding the statements above, the Commission has not really developed a systematic and consistent analysis of the balance test at stake in their implementation. First, in most cases the Commission limits itself to recalling the general need of a balancing exercise, without actually carrying out a systematic and coherent assessment of the market failure to be repaired, the general benefit to be achieved, or analysis of the actual impact of the measure under scrutiny on the relevant market[85]. Second, whereas under Article 81 EC the Commission practice has progressively moved towards a coherent application of the provision, once efficiency and consumer welfare were singled out as the objectives of competition policy (thereby excluding social or other concerns),[86] the Commission has allowed itself to take account of a wide range of common interest objectives (social, political, economic) under the Article 87(3) EC assessment.[87] Accordingly, individual State aid cases have so far been decided on a case-by-case basis, with the Commission enjoying wide discretion.

Moreover, the European Courts acknowledge the Commission's wide margin of discretion in this respect, given the high degree of complexity and economic nature of the analysis

83 C-730/79, *Philip Morris*, *op. cit.*

84 See 12th Report on Competition Policy, § 160.

85 Likewise, when assessing large packages of aid, the Commission has simply stated that aid of such proportions cannot be justified "unless a serious and substantial quid pro quo is provided"; see judgement of 25 June 1998 case T 371 and 394/94, *British Airways v Commission* (1998).

86 See for instance the Guidelines on Vertical Restraints.

87 Sinnaeve, "State aid Control: Objectives and Procedures", in Bilal and Nicolaides (ed.), Understanding State aid Policy in the European Community (Kluwer, 1999), p. 15.

at stake, and therefore intervene only when they find that the Commission has committed a manifest error of assessment or misuse of powers[88].

One can find a more detailed analysis of the balance between the negative and positive effects of aid measures in the various block exemptions and guidelines, although the approach taken by the Commission therein is of a formalistic nature rather than effects-based. As with the *de minimis* rule mentioned above (§2.3), these procedural instruments establish legal presumptions according to which, whenever a certain number of conditions are met, the measures covered by block exemptions and notices are deemed *per se* compatible.

More specifically, block exemptions establish *per se* compatibility rules under which notification is not required[89] but they also provide for some exceptions on the basis of quantitative rules: *i.e.* certain categories of aid normally covered by the block exemption must be individually notified when above the threshold (as in the case of ad hoc regional aid).[90] These individual notifications are assessed on the basis of criteria established by the block exemption, although such criteria generally do not involve any in-depth economic analysis.

Following a similar approach, guidelines specify under which conditions the Commission may authorize certain categories of aid following notification[91]. The Commission's analysis mainly consists of checking that the criteria specified in the applicable guidelines are met. When a scheme is authorized by the Commission, Member States may grant individual aid in accordance with this scheme, without notification. By way of exception, certain categories of aid normally covered by schemes must nevertheless be notified when above a threshold (e.g., environmental aid exceeding EUR 5 million must be notified). These individual notifications are assessed on the basis of criteria established by the guidelines which involve no in-depth economic analysis.

Some commentators claim[92] that the current architecture of provisions on State aid, and particularly the soft law provisions, take a formalistic/quantitative approach to the compatibility test in that they define a set of "eligible costs" on the basis of which companies may receive State aid and the amount of subsidy is specified in terms of maximum aid intensities of the eligible costs[93]. More precisely, it is claimed that "*the implicit balancing inherent in this*

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88 See case C-456/00 *France v Commission*, 2002 ECR I-11949, paragraph 41. The Court affirms that *"it should be remembered, first, that the Commission, for the purposes of applying Article 87(3) EC, enjoys a wide discretion, the exercise of which involves assessments of an economic and social nature which must be made within a Community context* (see, *inter alia*, Case C-156/98 *Germany v Commission* [2000] ECR I-6857, paragraph 67, and Case C-310/99 *Italy v Commission* [2002] ECR I-2289, paragraph 45), *and second, that the Court, in reviewing whether that freedom was lawfully exercised, cannot substitute its own assessment for that of the competent authority but must restrict itself to examining whether the authority's assessment is vitiated by a manifest error or misuse of powers"*.

89 It must be acknowledged, however, that recently the Commission has been trying to overcome such an exclusively formalistic approach and to provide embryonic indications on the assessment criteria to be considered for the balance test: see for instance the new guidelines on risk capital.

90 Guidelines on National Regional Aid for 2007-2013, O.J. (2006) C 54/13.

91 Communication from the Commission – Multisectoral framework on regional aid for large investment projects, OJ 2002 C 70/8.

92 See H. W. Friederiszick/L-H Röller/VVerouden, op. cit.

93 For instance 50% of R&D expenditure can be covered by State aid.

approach is to obtain the positive impact of the aid measure by declaring expenses eligible which target objectives of common interest (like specific R&D expenses) while restricting the possible distortions of competition by limiting the aid intensities (e.g. to 50%)"[94].

The above approach, where applied, manifestly does not seek to identify the actual impact on markets as, in theory, there might be measures which do not comply with the criteria set out in the law provisions, but have no harmful effects on the market and the other way round. This results in a rather imprecise State aid enforcement policy.

5. Economic analysis under Article 86(2)

It is unquestionable that, in order to determine the extent of the derogation from competition rules in Article 86(2), the Commission and the European Courts have always tried to analyse the economic conditions in which public undertakings operate[95]. As a result, one could say that the analysis carried out by the Commission and the European Courts to establish whether a certain case falls within the scope of Article 86(2) has definitely taken into account economic criteria as well as legal ones[96]. It must, however, be pointed out that the economic analysis carried out in these cases is explained by the differences between the assessment under Article 87(3) and 86(2) EC respectively. Rather than an Article 87(3) EC balancing test of the effects of State aid on the markets, the true issue in all Article 86(2) EC cases is whether the compensation granted to public undertakings or undertakings, entrusted with the operation of services of general economic interest, exceed the actual costs incurred by the same. Moreover, all these measures intended to achieve a national objective (whose legitimacy is not disputed by the EC Treaty pursuant to Article 86(2) EC) and not a *"common interest"* objective.

With specific reference to State aid law, for many years the main issue has been whether Article 86(2) was actually applicable to State aid, in which case both the Member States and the undertakings concerned would be able to invoke the exception.

The Court of Justice's explicit (although theoretical) recognition of the potential application of the Article 86 (2) derogation in State aid matters came in 1994 with the ruling in Case 387/92, concerning tax relief granted to State-owned credit entities under Spanish legisla-

94 H. W. Friederiszick/L-H Röller/VVerouden, op. cit.

95 As an example, one can think of the famous *Corbeau* case (C)-320/91, (1993) ECR I-2533) in which the European Court of Justice applied this provision to postal services consisting in the obligation to collect, carry and distribute mail on behalf of all users throughout the territory of the Member States concerned at uniform tariffs and on similar quality conditions, irrespective of the specific situations or the degree of economic profitability of each individual operation.

96 See for instance C.Quigley and A. M. Collins, EC State aid law and Policy, 2003, p. 120. According to them: *"In determining the extent of the exemption from the competition rules which may be allowed in order to enable the undertaking entrusted with the task of general interest to perform it, it is necessary to take into consideration the economic conditions in which the undertaking operates, in particular the costs which it has to bear, and the legislation to which it is subject"*.

tion[97], subsequently confirmed by the Court of First instance in Case T-106/95[98] on fiscal benefits granted by the Belgian government to La Poste, which were held to be necessary for it to perform public service duties. The analysis carried out by the CFI was essentially of an economic nature as it consisted of evaluating the benefits at stake against the costs incurred by the public undertaking in providing relevant public services. As under Article 87(3) EC, the Commission seems to enjoy wide discretion in its assessment.[99]

IV. The tools proposed by the Commission in the context of the State aid Action Plan

1. Introduction

The overview on the substantive and procedural tools used so far in State aid policy, which was discussed in the preceding paragraphs, should allow a better understanding of the aims and contents of the reform as illustrated in the State aid Action Plan ('SAAP'). The SAAP aims, first, at lowering the general level of State aid and, second, at directing Member States' efforts in the field towards some political priorities. In order to achieve these two objectives, the Commission wishes to introduce new tools that were disregarded in its traditional practice. First of all, the Commission wishes to introduce a more refined economic approach in its analysis under Article 87 EC with respect to the existence of market failures. On the other hand, the SAAP clearly indicates what should be the Member States' priorities when granting State aid. It is suggested that the Commission arguably wishes to maintain its monopoly in the field of State aid control not only for the reasons traditionally put forward to explain this approach (impartiality, Community perspective in the assessment of aid, etc.) but also as a means to better contribute to the political objectives set out in the Lisbon Strategy. The present section will be completed by a discussion on the procedural tools envisaged by the Commission in the SAAP in order to lighten its workload.

2. The broader context of the Lisbon Strategy: a political trade-off?

The proposals laid down by the Commission in the State aid Action Plan can only be understood in light of the broader political context of the so-called Lisbon Strategy. The Lisbon Strategy encompasses a series of reforms aimed at making the European Union "the most dynamic and competitive knowledge-based economy in the world" by 2010.[100]

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97 *Banco de Credito Industrial* (1994) ECR I-877, although such recognition remained merely theoretical, in practice, the case was solved by considering the aid in question as an existing aid.

98 *FFSA*, (1997)ECR II-229.

99 See Case T-613/97, *Ufex and others v Commission* [2006] ECR II-1531.

100 See for example "Facing the Challenge – The Lisbon strategy for growth and employment", Report of the High Level Group chaired by Wim Kok, November 2004.

The idea of State intervention through the granting of State aid may, at first sight, seem at odds with the Lisbon Strategy, which mainly represents a move towards market liberalisation and flexibilisation. However, such intervention can potentially play a vital role in both contributing to the definition of national industrial policies consistent with the Community objectives and supporting some of the heterogeneous reforms that were outlined by the Member States. This is the case in particular of those reforms which aim to develop the European Union into a "knowledge society" (in particular via an increase in R&D expenditure), of the proposals which highlight the need to increase investment in human capital, as well as those referring to limited availability of risk capital. Unsurprisingly, when the Lisbon Strategy was given a renewed lease of life, before the 2005 Spring European Council,[101] the Commission announced that:

> *"As part of a major **reform of State aid policy** starting later this year, Member States, regional and other public actors will have more scope to support research and innovation, particularly by the EU's small and medium-sized businesses" (no emphasis added).*[102]

At the same time, and as a seemingly logical *quid pro quo* for the favourable stance of the Commission with regard to aid directed towards the achievement of the "Lisbon objectives", the European Council encouraged Member States of the European Community to reduce the amount of State aid granted, whilst concurrently emphasising the desirability of addressing market failures through subsidies:

> *"In addition to an active competition policy, the European Council calls on 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".*[103]

Such a move on the part of the European Council represents an important evolution in the field of State aid policy. In addition to the unfavourable stance vis-à-vis aid in general that is the result of the incompatibility principle laid down in Article 87(1) EC, Member States, meeting at the highest level, acknowledge the desirability of reducing the general level of State aid, although admissible according to the derogations provided for in the Treaty.

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101 Communication to the Spring European Council, "Working Together for growth and jobs – A new start for the Lisbon Strategy", COM (2005) 24, Brussels 2 February 2005. On the political re-launch of the Lisbon Strategy, see, in general, Doria and Briens "La Stratégie de Lisbonne revisitée dans son appropriation et les perspectives financières", *Revue du Marché commun et de l'Union européenne* (2006), n. 502, pp. 603-608.

102 Ibid., at p. 8.

103 European Council – Presidency Conclusions, Brussels, 22 and 23 March 2005, para. 23.

These two declarations paved the way for a reform of the State aid control regime within the European Community.

3. The SAAP: Bringing State aid policy in line with the political objectives of the Lisbon Strategy

The Commission launched the SAAP less than three months after the European Council encouraged Member States to reduce the amount of aid. In line with the developments referred to above, the Commission proposes a reform of the EC State aid regime so as to bring it in line with the two political objectives referred to above. On the one hand, the Commission advocates the granting of (1) "less" and (2) "better targeted" State aid. On the other hand, the institution commits itself to improve the cooperation mechanisms between itself and the Member States.

In order to uphold the first of these objectives, the Commission proposes the use of two complementary tools: (1) a more refined economic approach in the enforcement practice; (2) the favourable stance taken with respect to activities that are instrumental to achieving the economic objectives of the Lisbon Strategy. As for the second objective, the Commission proposes a series of tools that go beyond the mechanisms currently in place.

4. A refined economic approach to Articles 87 and 88 EC

The first and most prominent tool in the SAAP aims at strengthening the use of economic analysis in the realm of Articles 87 and 88 EC. In this regard, the idea of market failure, already outlined by the European Council, is central to the Commission. The institution identifies in the SAAP a series of market failures (i.e. situations in which the market does not provide efficient outcomes) that may justify the granting of State aid: externalities, public goods, imperfect information, coordination problems and market power. The reference by the Commission to the existence of market failures as a justification for the granting of State aid is obviously not new, nor is its analysis in the literature.[104] In reality, the existence of market failures lies behind the positive approach of the Commission to State aid granted to certain activities that currently benefit from block exemption regulations. Such is the case, for example, of training aid and aid granted to SMEs.

At the same time (and this is probably where the novelty stems from) the SAAP seems to reserve a prominent place for the existence of market failures in the assessment of the compatibility of a given measure with the common market:

> "*23. One key element in that respect* [making use of a more refined economic approach] *is the* ***analysis of market failures****, such as externalities, imperfect information or coordination problems, which may be reasons* ***why the markets do not achieve desired***

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104 Some of these were usually mentioned in the literature before the SAAP to justify the existence of State aid. See for example Geradin or Quigley and Collins, cited supra), pp. 440, at p. 68 *et seq*.

> ***objectives of common interest****, in particular if they are of an economic nature. In those cases, identifying the market failure at stake will help evaluate better whether State aid could be justified and acceptable, whether it would represent the most appropriate solution, and how it should be implemented to achieve the desired objective without distorting competition and trade to an extent contrary to the common interest*".

In the recent Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, the test presented in the SAAP has been outlined in more detail by the Commission, and applies as follows:

(1) Is the aid measure aimed at a well-defined objective of common interest, such as growth, employment, cohesion and environment?
(2) Is the aid well designed to deliver the objective of common interest, i.e., does the proposed aid address the market failure or other objective?
   (i) Is State aid an appropriate policy instrument?
   (ii) Is there an incentive effect, i.e. does the aid change the behaviour of firms and/or investors?
   (iii) Is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?
(3) Are the distortions of competition and effect on trade limited, so that the overall balance is positive? [105]

In this context, the increased use of economic analysis in the application of Article 87 EC may serve the objectives of the SAAP in different ways. If the perception of State aid is consolidated among the legal and business community as a means to tackle market failures only, Member States may plainly refuse to make use of this instrument to address other situations. In this same vein, the introduction of a strong economic approach may deter Member States from notifying aid not dealing with market failures. As can be seen, this whole movement is based on an increased self-education and self-assessment exercise on the part of Member States, which may have a positive impact on procedures before the Commission (decreased workload, shorter delays and more rigorous assessment of the measures). On the other hand, it can be argued that, by putting in place the so-called "three-step test", the Commission would impose heavy constraints on Member States, which would need to provide evidence that is not required under the current system.

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105 Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, O.J. [2006] L194/2, at p. 5. As declared by the Commission itself, the third of these steps involves further and more detailed economic analysis in order to determine "i) the procedure for selecting beneficiaries and the conditions attached to the aid, ii) characteristics of the market and of the beneficiary and iii) the amount and type of aid". See para. 20 of the SAAP. As already stressed by some commentators, such an approach would require to determine, first of all, the "subsidy characteristics" and secondly, the impact of the measure on competition. See for example Hancher, "Towards an Economic Analysis of State aid", 3 *European State aid Law Quarterly* (2005), 425.

5. The favourable approach to the activities in line with the economic objectives of the Lisbon Strategy

The SAAP already identifies several fields where the Commission is ready to adopt a more lenient approach towards aid granted by Member States in view of prominent political and economic objectives. Some of these aim primarily at improving Member States' competitiveness at international level. Others seek to achieve social or regional cohesion objectives. State aid intervention in all these fields is linked, at least to some extent, to the existence of a market failure.[106]

By identifying the "key priorities" for State intervention through subsidies or other forms of aid, it may be expected that Member States will refrain from devoting resources to other sectors or activities. Furthermore, the Commission may try to direct Member States' activity in the field of State aid towards these "key priorities" through the use of "procedural carrots", i.e. by easing the procedures and speeding up the compatibility assessment.

a) Aid to Innovation and Research and Development

The encouragement of Innovation and Research and Development (hereinafter, "R&D") activities constitutes one of the major concerns that triggered the Lisbon process. According to the Commission, several market failures can be identified regarding these activities: externalities, public goods and imperfect information.[107]

As regards the "procedural safe harbours" to direct State aid towards Innovation and R&D, the Commission foresees in the SAAP the adoption of a "Communication on State aid and innovation",[108] which was adopted three months later. This is one of the first texts in which the three-step test mentioned above is put in place. The SAAP also refers to the adoption of a Framework for R&D and Innovation, adopted in November 2006.[109] This text provides further details on the way the Commission intends to proceed in the future. First of all, the Commission identifies the market failures that are meant to explain the sub-optimal level of investment in the field of R&D and Innovation.

Concerning the second step of the test outlined in the SAAP (i.e. "(2) Is the aid well designed to deliver the objective of common interest?", as referred to *supra*); several instruments that can be used instead of State aid to tackle the said market failures are considered. These include, *inter alia*, "*increased investment*" in universities or the reduction of "*market barriers*". The Commission then continues by alluding to the incentive effect State aid must have for it to

106 The market failure argument is however less strong regarding regional aid. See for example Heidhues and Nitsche, "Comments on State aid Reform – some implications of an Effects-based approach", 1 *European State aid Law Quarterly* (2006), p. 23.

107 SAAP, para. 25.

108 Consultation Document on State aid for Innovation, COM (2005) 436 final, Brussels 21 September 2005.

109 Cited *supra*. The market failures identified by the Commission in the text are the following: positive externalities/ knowledge spill-overs; public goods/ knowledge spill-overs; imperfect and asymmetric information and coordination and network failures.

be considered an adequate instrument. The implementation of the second step of the test, continues with the isolation of certain situations where State aid is presumed to tackle market failures adequately (i.e. "(i) Is State aid an appropriate policy instrument?", as referred to *supra*).[110] More precisely, these cases concern:

- (1) Projects covering fundamental and industrial research and experimental development.
- (2) Industrial property rights costs for SMEs. Both cases are related to positive externalities, "*including public goods*".
- (3) Technical feasibility studies.
- (4) Young innovative undertakings, both related to imperfect and asymmetric information.
- (5) Process and organisational innovation, related to imperfect information and positive externalities.
- (6) Advisory services and innovation support services, in which case State aid would address problems related to "*insufficient information dissemination, externalities and lack of coordination*".
- (7) Loan of highly qualified professionals, as undertakings face problems related to imperfect information in the labour market in the EU.
- (8) Innovation clusters, whose creation often gives rise to "*coordination problems hampering* [its] *development*".

As far as the incentive effect of the aid is concerned (i.e. "(ii) […] *does the aid change the behaviour of firms and/or investors?*"), the Commission takes the view that the "*incentive effect is automatically met*" for (2) aid granted for industrial property rights costs for SMEs, (3) for technical feasibility studies, (4) for young innovative undertakings, (6) for advisory services and innovation support services and for (7) the loan of highly qualified professionals.[111] Conversely, regarding aid granted for (5) process and organisational innovation and for (8) innovation clusters, Member States will have the burden of proving that State intervention has an incentive effect "*on the basis of a counterfactual analysis comparing a situation without aid and a situation with aid being granted*". Regarding other measures granted to increase R&D and Innovation efforts, Member States will not benefit from any of the presumptions mentioned above.

The proportionality condition (i.e. (iii) Is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?) is unsurprisingly fulfilled if the aid intensities provided for in the framework are not exceeded and the eligible costs are respected.

As far as the negative effects of the aid are concerned (i.e. (3) Are the distortions of competition and effect on trade limited, so that the overall balance is positive?) the Commission identifies several situations in which negative effects threaten to prevail:

110 *Ibid.*, p. 9.

111 *Ibid.*, pp. 15-16

a. Disrupting the dynamic incentives of undertakings and crowding out
b. Supporting inefficient production
c. Exclusionary practices and enhancing market power
d. Effects on the localisation of economic activities across Member States
e. Effects on trade flows

There seems to be a slight overlap between this third step of the test and the last leg of the second step, since they both refer to the proportionality of the measures at stake. In reality, this third step of the test only comes into play for those measures that require a detailed assessment, i.e. those measures whose compatibility is not presumed in the Community framework.

Interestingly, the Commission uses in this text "procedural safe harbours" at different stages so as to direct Member States efforts in the field towards those measures that are perceived as being more closely related to market failures. Three different measures can thus be distinguished in the Framework:

– First of all, measures for which State aid is presumed to be an adequate instrument and for which the incentive effect is presumed;
– Measures for which State aid is presumed to be an adequate instrument and for which Member States will have to provide evidence of the incentive effect and
– Thirdly, measures that require full self-assessment on the part of the Member State before notification of the measure.

The use of *"procedural safe harbours"* as a tool to guide Member States efforts in the field bears some similarities with the new Commission approach towards horizontal and vertical agreements under Article 81 EC.[112] Indeed, the use of very detailed guidelines offering more precise examples on the market failures, aim to promote self-assessment on the part of Member States, thereby reducing the number of notifications, and, more precisely, of those cases that are said to be less likely to be declared compatible under Article 87(3) EC.

b) Risk capital

State aid in the field of risk capital is usually said to tackle the problem of imperfect or asymmetric information, a market failure that mainly affects SMEs. The Commission has further developed the question in its Guidelines on State aid and Risk Capital to Small- and Medium-Sized enterprises.[113] According to the Commission, said market failure arises from agency costs, transaction costs and risk aversion. In any case, the technique of setting "procedural safe harbours" at different stages is similar to the one outlined in the field of Innovation and Research and Development.

112 Commission Notice – Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements, OJ 2001 C 3/2; Commission Notice – Guidelines on Vertical Restraints, OJ 2000 C 291/1.

113 See reference supra.

Regarding the appropriate instruments to tackle market failures in the field of risk capital investment, the Commission takes the general view that "*risk capital provision is essentially a commercial activity involving commercial decisions*". Accordingly, State aid is not the primary instrument to remedy said market failure. However, the Draft Guidelines provide a number of incentives[114] that are perceived as adequate for investments to be driven on a profit-maximising basis:

- Constitution of investment funds in which the State is a partner, investor or participant.
- Guarantees to risk capital investors against a proportion of investment losses, or guarantees given in respect of loans to investors/funds for investment in risk capital.
- Other financial instruments in favour of risk capital investors or of venture capital funds to provide extra capital for investment
- Fiscal incentives to investment funds and/or their managers, or to investors to undertake risk capital investment.

c) Training aid

It is usually agreed that the existence of externalities explains current underinvestment of employers in training. These are positive externalities from the industrial and social point of view. State aid can therefore be used as a means to foster private investment in this field. The block exemption regulations for training and employment aid[115] have been recently prolonged until 2008.[116] It was expected that the Commission would simplify and consolidate them in the context of a general block exemption regulation.

d) Environment

The environment suffers from negative externalities of the economic activity, as in the case of pollution through industrial activity. Yet environmental protection is an essential objective and can be a source of competitive advantage for Europe, by providing opportunities for innovation, new markets and increased competitiveness through resource efficiency and investment.

With these objectives in mind, the Commission will review the Community Guidelines on State aid for environmental protection, which apply until 2007[117]. It is possible that certain

114 *Ibid*., p. 10.

115 Commission Regulation (EC) No 68/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to training aid, in OJ 2001 L 10/20, p. 20-29 and Commission Regulation (EC) No 2204/2002 of 12 December 2002 on the application of Articles 87 and 88 of the EC Treaty to State aid for employment, in OJ 2002 L 337/3.

116 Commission Regulation (EC) No 1976/2006 of 20 December 2006 amending Regulations (EC) No 2204/2002, (EC) No 70/2001 and (EC) No 68/2001 as regards the extension of the periods of application, OJ 2006 L 368/85.

117 Community Guidelines on State aid for environmental protection, in OJ C 37/2001, p. 3
The guidelines are currently under revision. In October 2005 the Commission issued a questionnaire for public consultation on the revision of the Guidelines. The results of the consultation were published on June 14, 2004 on the Commission's website at following address: http://ec.europa.eu/comm/competition/state_aid/others/rep_envhtml.

measures will be exempted from the obligation to notify the aid under the general block exemption.

e) *Regional cohesion*

After the issuing of the SAAP, the Commission has been very active in this regard, as shown for instance with the issuing of the new Guidelines on Regional Aid.[118] Notwithstanding this, regional aid policy remains largely independent from the trend towards an increased economic analysis. The Commission does not clarify in the SAAP the link between this reform and the Lisbon objectives.

f) *Services of general economic interest*

State aid granted to the operation of services of general economic interest (hereinafter, SGEI) forms part, according to the Commission, of a "European Social Model". Even though the Commission claims in the SAAP that high quality SGEIs "contribute to the competitiveness of the European economy", action in this field seems to be more a reaction of the Commission to the landmark *Altmark* ruling,[119] which put an end to an era of legal uncertainty and clarified the conditions for the application of Article 87(1) EC when the State remunerates an undertaking for providing a SGEI. The existence of a link between aid to SGEI and the Lisbon strategy remains to be checked.

g) *Infrastructures*

The Lisbon Strategy stresses the importance of modern transport, energy and information and communication technology infrastructures throughout Europe as a means to achieve sustainable progress. Member States are therefore invited to fulfil their commitments in terms of investments in the transport and energy sectors. As member States increasingly rely on Public-Private Partnerships to build infrastructures, the Commission aims at issuing guidance in this matter. An example of the new approach is provided by the recent Guidelines on Financing on Airports.[120] It is to be noted that the test laid down in the Guidelines is relatively stringent.

6. Procedural tools: obligations upon the Commission and Member States

The procedural tools presented by the Commission in the SAAP pursue a double objective. First of all, the Commission intends to encourage Member States' budgetary efforts towards expen-

118 See in particular the new Guidelines on National Regional Aid for 2007-2013 OJ (2006) C 54/13.

119 Case C-280/00, *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* [2003] ECR I-7747.

120 Guidelines on Financing on Airports and Start-Up aid to airlines departing from Regional Airports, O.J. (2005) C 312/1.

ditures in the fields linked to the Lisbon Strategy. As shown above, the Commission is ready to ease notification requirements for those measures bearing a link with the objectives privileged in the Lisbon Strategy. Alongside the proposed modernisation of practices and procedures, driven also by the Commission's concern to face the challenges of the enlargement,[121] the Commission advocates for the adoption of a general block exemption regulation. Unsurprisingly, this projected block exemption regulation would encompass several "Lisbon objectives" such as "aid related to SMEs, R&D, environment, employment, training and regional development". The Commission's intention is also to broaden the "range of exemptions". As declared in paragraph 59 of the SAAP, the Commission purports to give not only positive but also, and this constitutes an innovation, "negative effects" to the future block exemption regulation, so as to allow national judges to declare the incompatibility of certain measures[122] (below, § 5.4).

Secondly, the procedural tools identified by the Commission tend to ensure that Member States cooperate effectively with the Commission. Indeed, the SAAP's proposed reforms rely heavily on a self-assessment exercise on the part of Member States. Therefore, the procedural tools are not independent of the economics-based reform of State aid policy. Rather, they are strictly related to the objective of a stricter but more automatic control, allowing the Commission to play the guidance role toward a more effective use of the budgetary resources available within the Community with a view to the achievement of the Lisbon objectives.

As the SAAP is based on the granting of "less and better targeted" State aid (i.e. the promotion of self-restraint and self-assessment on the part of Member States), it is not surprising that the Commission insists considerably on cooperation by Member States to put in place the reformed system of control. For example, the Commission requires Member States to ensure that all projects are notified and that any illegal aid is subsequently detected and recovered. In order to achieve these two aims, the Commission firstly envisages addressing "best practice guidelines" to Member States. Interestingly, this advances the idea of setting up independent agencies in each of the Member States. Finally, and as it was the case for the "modernisation" of the enforcement of Articles 81 and 82 EC, the Commission also relies on the encouragement of "private enforcement" before national courts.

121 Concerning the procedure, the Commission commits to improve *"in the short term* (…) *its internal practice and administration, and increase efficiency, enforcement and monitoring"*. The institution also points at some formal obligations under Regulation 659/1999 (OJ (1999) L 83/1.), which may be subject to modification, as a possible explanation for the length of procedures under the current system. In this regard, the consequences of the recent enlargement of the EC seem to be a major concern for the Commission (in this regard, the SAAP proposes in para. 58 several options to *"save time and increase transparency"* as well as to *"achieve greater efficiency"*).

122 In other words, in the new block exemption, some criteria for exemption of notification would also be criteria for compatibility of aid, which will enable the national jurisdictions to apply block exemptions directly by declaring both the compatibility and the incompatibility of certain aid.

V. The appropriate tools: the way forward

The basic idea that we should keep in mind when discussing the "way forward" in State aid policy and public enforcement practice on the basis of the Action Plan is that one can only assess the achievement of such objectives and especially of the first one ("less State aid") against a clearly established benchmark, which depends on the definition of aid. In principle, less State aid means a reduced number and/or importance of States' unilateral measures supporting the productive sector, which should be achieved through a more rigorous control. In order to check the progress made in this direction, however, one must bear in mind that the notion of aid evolves constantly. First of all, the calculation of the amount of aid granted by Member States is mainly based on the aid notified to the Commission, and not on the aid actually granted.[123] Therefore, non-compliance by Member States of their obligation to notify under Article 88(3) EC might lead to the (wrong) conclusion that less State aid is being granted.

Secondly, it is undeniable that the activity of the Commission itself has an impact on the amount of State aid. In this regard, some authors claim that action by the Commission in the field has significantly evolved, in that it no longer focuses on the most obvious cases involving the grant of subsidies and tackles other measures whose qualification as State aid is less clear, such as tax regimes[124]. Thirdly, the scope of Article 87(1) EC is also influenced by the interpretation given by the ECJ as regards the constitutive elements of State aid. Suffice it to mention the evolution in the interpretation of the requirement that State aid must be granted by the State or through State resources[125], as well as the progress recently made in the clarification of the notion of advantage[126]. The same process seems to be occurring with the sophisticated refinement of the criterion of selectivity[127], in particular with respect to regional selectivity[128]. To sum up, one may conclude that the objective of granting "less State aid", rather than being an end in itself, shows the need for setting clear and predictable standards in the field.

Maintaining the same wide control as in the past, but making it far more precise and fine-tuned could be a key factor in achieving a less significant recourse to the State aid instrument in order to pursue economic policy objectives. Under this perspective, it seems worth exploring

123 In the autumn 2006 update of the State aid Scoreboard, COM(2006) 761, 11 December 2006 (available at http://ec.europa.eu/comm/competition/state_aid/studies_reports/2006_autumn_en.pdf), the Commission makes clear that the figures on the amount of measures falling under the scope of Article 87(1) EC that has been examined by the Commission (i.e. encompassing both notified measures and non notified measures brought to the attention of the Commission).

124 Waelbroeck, « "La condition de la sélectivité de la mesure" in Dony and Smits, *Aides d'Etat*, éd. de l'université de Bruxelles, 2005, p. 86.

125 For a complete review of the European Courts case-law on the notion of 'State origin', see Massimo Merola, "Le critère de l'utilisation des ressources publiques dans l'article 87, paragraphe 1, CE», Colloque sur les aides d'Etat – IEE/ULB 13.10.2004 ; add case-law quotes from the last two years.

126 See in particular Case C-280/00 *Altmark-Trans* [2003] ECR I-7747.

127 See for instance Case C-143/99 *Adria Wien Pipeline* [2001] ECR I-8365; Case C-200/97 *Ecotrade* [1999] ECR I-7907 and Joined Cases T-127/99, T-129/99 and T-148/99 *Alava* [2002] ECR II-1275.

128 See in particular Case C-88/03, *Portugal v Commission* [2006] nyr, where the ECJ clearly states the conditions under which aid granted by a region falls outside Article 87(1) EC.

whether a refined economic approach could be of help not only in the assessment of State aid – meaning the examination of the compatibility of the aid with the rules on common market and the possible application of the derogations from the principle of incompatibility provided for in the Treaty – but also in the assessment of the aid's constitutive elements and compatibility criteria embodied in Article 87(1) EC.

The remainder of the article is devoted to the question of whether there is a case for the introduction of deeper economic analysis in the assessment of State aid, and, to start with, the correct dividing line between the application of economic-type considerations in the framework of Article 87(1) EC and Article 87(3) EC respectively. Similarly, we aim at commenting on the position taken by the Commission in the SAAP and putting forward some preliminary recommendations regarding the most appropriate tools to be used in each of the two steps of the analysis.

1. Article 87(1) EC vs. Article 87(3) EC analysis

In the Action Plan the Commission does not express any specific view on the interplay between economic analysis and the definition of aid, nor does it take position on which kind of economic screening devices, if any, can be used in the framework of an Article 87(1) EC analysis as opposed to an Article 87(3) EC analysis. However, the Commission's approach is well known in the legal community: it tends to simplify as much as possible the Article 87(1) EC analysis and keep all considerations of an economic nature for the discretionary assessment under Article 87(3) EC.

Although this approach is clearly dictated by the Commission's wish to maintain the widest possible range of State measures under its control (or within its power to control), we must also mention here the widely supported view that the definition of aid should be as objective and ready for automatic application as possible[129].

As a matter of principle, it appears that the authors of the Treaty of Rome – the wording of Articles 87 and 88 EC having remained unchanged through the various reforms the Treaty has undergone – clearly intended to confine the weighing of the pro- and anti-competitive effects of State aid to Article 87(3) EC. This would go to suggest that economic analysis has

129 The Commission and the ECJ are often criticised for having so far followed a case-by-case approach, which went against legal certainty, making it impossible to predict the behaviour of the Commission. In this way, the requirement that aid must be selective is, by far, the condition that gives rise to the most uncertainties. For instance, it is difficult to reconcile the difference in approach between Case 203/82, *Commission v Italy* [1983] ECR 2525 (where a general measure that seemed prima facie general was found to be selective since in practice it favoured certain sectors) and the Commission Notice on Direct Business Taxation, O.J. (1998) C 384/3 (where the Commission seems to concede that even general measures may not have identical impact on all sectors of the economy). On this issue see Ahlborn and Berg, "Can State aid Control Learn from Antitrust? The Need for a Greater Role for Competition Analysis under the State aid Rules", in Biondi, Eeckhout and Flynn, The Law of State aid in the European Union (OUP, 2003), pp. 41-65. Legal certainty in the definition of State aid will arguably suffer after the *Altmark* case (Case C-280/00 [2003] ECR I-7747), where the ECJ laid down four criteria (involving complex economic assessments) under which compensation for public service obligations may fall outside Article 87(1) EC. The vagueness in the wording of the four criteria may lead to further litigation, see Szyszczak, "Financing Services of General Economic Interest", 67 Modern Law Review, pp. 982-992 at pp. 990-991.

no role to play under Article 87(1) EC. Indeed, the other side of such an approach has always been that the scope of Article 87(1) EC should be sufficiently wide to encompass all forms of State intervention favouring specific industries or undertakings, on the sole condition that they belong to the Community competence, which happens to be the case whenever the measure under examination alters, or is potentially liable to alter, the exchange flows between member States. This remains a logical interpretation of the Treaty provision, which remains true to its wording. It is thus not surprising that it has been upheld by Community courts.

It follows that, if economic analysis were to play a realistic role under Article 87(1) EC, one should make sure that the proposals do not run against the current interpretation of this provision by the ECJ. Nevertheless, with respect to both the conditions for the qualification of a State measure as aid and the requirements for incompatibility of the aid, we still believe that a refined economic assessment could make the application of some criteria normally used in the Commission practice more predictable, rigorous and precise. This possibility will be discussed in the following paragraphs.

2. Economic analysis and the constitutive elements of the aid

The use of economic analysis in the application of the constitutive elements of the aid (also referred to here as the qualification criteria) can affect several aspects of the Commission practice, such as the identification of a selective advantage or the 'use-of-State-resources' criterion.

To take the first example, and as already discussed above (§ 3.3), the case-law evolution of the notion of selectivity proves that a refinement in the Commission's analysis of this qualification criterion is still needed and an economic approach might play a decisive role in achieving this objective, particularly in order to help assessing the true impact of a given measure on the market. While the traditional approach to the selectivity condition has generally taken the form of a simple discrimination test, *i.e.* whether all or only some undertakings in the granting Member State are eligible for a measure involving State resources, in a few cases the Commission and the Court have tried to look beyond the form of the analysed measure and found that a seemingly general measure *de facto* sought to favour one particular industry[130]. As already mentioned however, the exercise of looking at the effects of the measure has never become systematic in the Commission's practice so far and in any event remained very superficial. In consideration of this problem, some economists have been recently advocating for an approach to selectivity that would look at asymmetric effects in a systematic way. Such a proposal certainly shows the advantages of an economic approach to Article 87(1) EC but also its limits. From the angle of quality improvement in the enforcement of State aid rules certainty, an economic approach to selectivity would definitely be an important improvement. One must be aware, however, that the same approach might occasionally prove impractical, as the determination of the selective effects of measures is an objectively difficult exer-

130 See references *supra* to the Italian textile case.

cise, which suggests that there is still some way to go before achieving an ideal solution of all interpretative problems.

A similar reasoning can be carried out in relation to the assessment of the transfer of public resources criterion. Indeed economic analysis could in principle prove useful to improve the level of precision and sophistication in the application of this criterion, despite the fact that the concept of transfer of public resources is essentially a legal one. However, some cases are a clear illustration of the limits of an economic approach. In the France Télécom case[131], the Commission took the view that the public declarations made by some French public officials concerning the commitment by the State to give support to France Télécom could in itself involve the use of State resources. The Commission claimed that even if the State was not legally bound to support the undertaking on the basis of public declarations (which in themselves are not to be characterised as State aid), investors (the lending banks) could be led to act in favour of France Télécom on the belief that the State would honour its word, in such way that a *de facto* irrevocable guarantee had been created with regard to market operators[132]. In this regard, it is open to question whether economic analysis could provide some guidance with regard to situations such as the one at stake, where the appraisal depends almost exclusively on subjective indicators. It may very well be claimed that an economic approach to this condition could lead to an oversimplification of previous case law and Commission practice and as such is undesirable.

In conclusion, checking whether the constitutive elements of an aid are met in any given case is (and should remain) mainly a legal exercise, as it implies a qualification of facts and interpretation of law in view of the permanently changing circumstances. However, we firmly believe that economic analysis could definitely provide additional parameters for the legal assessment and help obtain the correct data and factual elements for a reliable and objective conclusion on the qualification of a measure as State aid.

3. Economic analysis and the compatibility criteria embodied in Article 87(1) EC

Turning now to the other conditions embodied in Article 87(1) EC, namely the distortion of competition and the effect on trade, the conclusion can be different, as will be explained below, and is not necessarily the same for both factors. From a conceptual point of view, these two conditions clearly differ from the qualification criteria and might therefore require different treatment. The examination of such conditions tell us whether State aid is caught, at least in principle, by the ban (and is at first sight, therefore, incompatible with the common market), or rather falls outside the scope of the Treaty provision and the Community jurisdiction. Also, both conditions rely on the actual or potential effects of the aid for their application. They

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131 Commission Decision of 2 August 2004 on the State aid implemented by France for France Télécom, OJ (2006) L 257/11.

132 *Ibid.*, para. 192: "[…] *the Commission finds that a potential additional burden on the State's resources was created by the announcement of the provision of the shareholder loan coupled with the fulfilment of the preconditions for such provision (115), by the impression given to the market that the loan had actually been provided (116) and, lastly, by the dispatch to France Télécom of the loan contract initialled and signed by ERAP (117)*".

should not be confused with the constitutive elements (or qualification criteria) of the aid[133], which aim at distinguishing those forms of financial support to the productive sector that are under the responsibility of the State and have a microeconomic nature, as they deserve an analysis in the framework of the competition policy entrusted upon the Commission, from other measures able to affect competition but subject to a different type of control[134].

In principle, there seems to be no reason for not welcoming the advantages that a refined economic approach could bring to the analysis of the distortion of competition and effect on trade. The introduction of economic analysis in order to assess the distortions of competition and effect on trade could serve the objective of defining a series of screening devices that would leave out of the Commission scrutiny the least important cases[135]. This view seems to be supported by many economists. Some State aid law experts view this idea with caution, given that such a proposed use of economic analysis is likely to run counter to the fundamental aims of the Treaty provisions and would also be inconsistent with the well established practice of the Commission and with the Courts' case-law. Reference is made in this respect to the case law whereby the distortion of competition and the effect on trade between Member States need not necessarily be appreciable or significant[136].

Even if the Action Plan does not take a firm and clear view on this issue, the approach taken (albeit so far unofficially) by the Commission after the Action Plan is equally cautious[137], and seems justified by the need to maintain the overall consistency of the approach embodied in the Treaty, based on the principle of incompatibility of State-aid with the common market, as well as the effectiveness of State aid public enforcement.

The opposition to the use of economic analysis in this context is due to a basic misunderstanding. On the one hand, identifying and applying appropriate screening devices do not necessarily imply that given categories of aid rank outside the scope of Commission's control and are therefore *ipso facto* compatible with the common market. A more limited objective can be envisaged: the goal can be to classify the aid on the basis of its potential for distortion of competition and effect on trade with a view to applying a quantitative approach in the compatibility assessment, thus accruing the precision of such assessment. On the other hand, the objective would be to simplify the Commission's tasks and reduce the burden upon it, allowing the

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133 The authors of the report acknowledge that other authors take the opposite view and rely on recent cases (which seem to present the compatibility criteria as elements of the definition of the aid); see for instance Ehlermann and Vallery, "Giving Meaning to the Condition of Effect on Trade: The Court's Judgment in Xunta de Galicia, a Missed Opportunity?" *European State aid Law Quarterly*, 4/2005, pp. 709-712. However, the distinction between constitutive elements and compatibility criteria remains useful from a conceptual standpoint.

134 We refer to the possibility for the Commission to control State measures excluded from the scope of Article 87.1 (for instance measures of a general or regulatory nature) under Articles 81 and 82 CE or under Articles 96-97 CE.

135 See, *inter alia*, section 5 of Nitsche and Heidhues' "Study on methods to analyze the impact of State aid on competition" where it is proposed to develop screening methodologies tailored to the market failure and the aid instruments used.

136 See in particular Case 730/79, *Philip Morris*, *op. cit.*

137 The SAAP remains neutral on the question whether the principle of deeper economic analysis applies to the distortion of competition and effect on trade conditions. Accordingly, one may presume that the SAAP does not plead for a review of the interpretation of Article 87(1) EC.

Institution to set the priorities in the field and focus on the most relevant cases is an objective that can be achieved not only by defining the scope of application of Article 87 EC but also, and better, by reducing the number of cases examined by the Commission and rendering the analysis less time-consuming by increasing the automatic aspect of the review.

A first input from the economic analysis could concern precisely the definition of the most appropriate tools and parameters for screening out State aid on the basis of the distortion of competition and effect on trade conditions. A new approach regarding small amounts of aid or aid granted to local operators is perceived as being necessary as a result of the drawbacks inherent to the current *de minimis* Regulation. Following the launch of the SAAP, the Commission has approved a new *de minimis* regime[138], which increases the threshold from € 100 000 to € 200 000 (over a period of three fiscal years). Although this new legislative development is to be welcome, there are grounds to consider that a more ambitious approach to *de minimis* as a tool can still be envisaged. Indeed, it stems from the Commission practice that there are many measures that are well above the € 200 000 threshold that are found to fall outside Article 87(1) EC, showing that this approach is impractical and thus, there is scope for substantially stretching the *de minimis* notion beyond the current limits.

For instance, the Dorsten case[139] concerned a DM 2 million subsidy (i.e. approximately € 1 million) granted for the construction of a swimming pool. In spite of the fact that the amount was (at the time) ten times higher than the *de minimis* threshold, the Commission considered that the measure did not entail any effect on trade between Member States. In a different vein, economic analysis shows that thresholds arbitrarily set without regard to the true impact of a given measure on competition might be either too generous or too restrictive (as in the Dorsten case)[140]. In addition, the present *de minimis* approach may encourage aid that has nothing to do with the remedy of a market failure. Similarly, a low amount of aid is not necessarily without danger for competition and the optimal allocation of resources as they raise the suspicion that the activity would have been undertaken anyhow (in contrast with the necessity test). The problem with the current formalistic approach is that thresholds are set without regard to the true impact of a given measure on competition in the market (which, according to recent studies, very much depend on the structure of the market) and without considering the opportunity and shadow cost of the same in a total welfare perspective.

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138 See reference supra.

139 "On application by Germany, Commission decides that municipal aid for public swimming pool is not State aid", IP/00/1509, 21 December 2000.

140 See Nitsche and Heidhues "Study on methods to analyze the impact of State aid on competition", p. 114, where the reasons against considering the amount of aid as an indicator for the effect on competition are explained in greater detail as follows: (i) small absolute amounts can still have significant effects within a small relevant market/if only a few SME's are active in a relevant market preferential treatment of some of them can lead to a significant distortion of competition within that market; (ii) if the supported activity is undertaken with low aid intensities one may question whether the activity is really additional or whether it would have undertaken anyway; (iii) if there are any fixed costs in evaluating a project handing out low aid amounts through a project-based scheme leads to high administrative costs relative to the amount of aid handed out; (iv) if, alternatively, small aid intensities are sufficient to trigger additional activity, the latter activity may still have significant effects on competition as without aid it would have not been undertaken. See also p. 145 of the Study.

In this regard, it must be recalled that the Commission tried in the past to move beyond the current *de minimis* approach. More precisely, the Commission proposed to screen out aid measures having a limited impact either on competition or on intra-Community trade under the so-called "Significant Impact Tests" ("SIT"), which were subsequently abandoned by the Commission.[141] A first SIT test (the "Lesser Amount of State aid" test, hereinafter, "LASA") was proposed for measures having limited distortive effects on competition. The LASA set a € 1 M threshold over a three-year period. Likewise, the "Limited Effect on Trade" State aid ("LET")[142], which applied to the effect on trade condition, set a € 3 M threshold and a 30% aid intensity limit. As can be seen, both the LASA and LET tests still relied, as much as the *de minimis* Regulation, on fixed amounts of State aid. However, and unlike current approach, measures below the threshold were not deemed to fall outside Article 87(1) EC by the Commission.[143] Accordingly, the Commission remained competent to deal with these measures. It is submitted that the use of similar screening devices may open interesting possibilities, in line with what has been suggested above.

In the light of the example drawn from *Dorsten*, but also from other similar cases where the Commission took the view that trade between Member States was not affected[144], it is submitted that a more ambitious and sophisticated economic-based *de minimis* approach may be useful as a screening device. In a case concerning measures in favour of non-profit harbours for recreational crafts, the Commission gave some guidance in this regard. It considered that

"[...] even if some distortion of (local) competition is not excluded, the support (if any) has no effect on trade within the meaning of Article 87(1) EC. In particular, in these cases, also due to the geographical location of the marinas, their relatively small size, and the relatively small amounts of public support involved (in comparison with the number of moorings offered in the marinas), it can not reasonably be expected that this support will lead ship owners from other Member States to use the marinas concerned for mooring (be it fixed or daily) rather than a marina in another Member State".

The de minimis approach put forward here would therefore consist of setting different flexible thresholds depending on the degree of market concentration of an industry. The approach would take into account the foreseeable impact of the aid on competition depending on the nature of the activity/investment being supported[145]. This would have the effect of bringing

141 Draft Communication from the Commission: "A new framework for the assessment of lesser amounts of State aid"

142 Draft Communication from the Commission: "A new framework for the assessment of State aid which has limited effect on trade".

143 De minimis measures are deemed not to fulfil the distortion of competition and/or the effect on trade conditions, as shown in Recital 5 of the de minimis regulation (Commission Regulation 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to de minimis aid – OJ 2001 L 10/30): *"In the light of the Commission's experience, it can be established that aid not exceeding a ceiling of EUR 100 000 over any period of three years does not affect trade between Member States and/or does not distort or threaten to distort competition and therefore does not fall under Article 87(1) of the Treaty"* (emphasis added).

144 See for instance Commission Decision of 29 October 2003 on measures in favour of non-profit harbours for recreational crafts OJ (2004) L 34/63.

145 See García and Neven, "State aid and Distortion of Competition: a Benchmark Model", *Graduate Institute of International Studies, HEI Working Paper No: 06/2005*.

out the Commission priorities (but not outside its power to take action) State aid granted to players active on local markets, which are precisely those where the offer is usually atomistic. The different thresholds could be set using the HHI index with regard to the different industries. Except for this rather limited cases, the application of automatic devices and parameters in the context of Article 87(1) EC would not serve the purpose of screening out aid without a consideration of the Article 87(3) EC assessment criteria but would simply help quantifying the competition downsides of the aid in order to permit a smooth application of screening devices in the second step of the analysis, based on Article 87(3) EC.

It must be stressed that this approach would not constitute a complete departure from the Commission current practice. First of all, the experience drawn from cases like *Dorsten* already provides some guidance regarding the effects of measures on competition. Secondly, the institution itself took a favourable stance towards defining the impact of aid measures on the basis of the local character of the market in the past. For instance, in the Guidelines on State aid for undertakings in deprived urban areas[146], the Commission considers that aid granted to a series of activities with a local scope (inter alia, taxi services, restaurants, car repairers)[147] normally fall outside Article 87(1) EC. Thirdly, and as far as the compatibility of such a new *de minimis* approach is concerned, the ECJ accepted the legality of the former *de minimis* Notice (issued prior to the enabling regulation of 1998) in a *Spain v Council* case. According to the ECJ, the "*Commission was [...] entitled to reach the view, in the exercise of its discretion to assess the possible economic effects of aid, that, other than in certain sectors where competitive conditions are of a particular kind and except in respect of export aid, aid in amounts falling below those laid down in the Community guidelines on State aid for SMEs, and subsequently in its Notice on the de minimis rule for State aid (OJ 1996 C 68, p. 9), does not affect trade and is therefore not caught by Articles 92 and 93* [87 and 88] *of the Treaty. The amounts laid down by the Commission have not hitherto been challenged*".[148] Accordingly, it could be presumed that the proposed approach, which is nothing more than a refined and sophisticated *de minimis* Regulation that would adapt to the reality of the different markets – so as to avoid false positives and false negatives – could be upheld by the ECJ.

One should bear in mind that determining market concentrations might need a precise definition of the relevant market by the Commission. This might be perceived as a departure from the current approach, insofar as the ECJ never required the Commission to define the relevant market. However, the most recent documents issued by the Commission have shown that it is keen to provide detailed guidance in order to achieve its policy objectives. Indeed, and following the launch of the Commission has provided lengthy details regarding the market failures to be tackled and the common interest objectives to be achieved[149]. A *de minimis* approach that would follow the lines hereby described would differentiate between markets

146 O.J. (1997) C 146/6.

147 This example is referred to by Ehlermann and Vallery, op. cit. and Keppenne, op. cit.

148 Case C-351/98 *Spain v Commission* [2002] ECR I-8031, para 52.

149 See infra section 5.4.

depending on its concentrations and would thus demand a similar *ex ante* effort on the part of the Commission.

It must not be forgotten that the application of the effect on trade condition may be deemed to have important procedural implications. This is due to the twofold nature of this condition, which at the same time plays the role of an additional trigger for the application of the principle of incompatibility of State aid and also that of a threshold drawing the frontier between Community and national jurisdiction in the field of State aid. While for the first aspect similar considerations apply as for the requirement of distortion of competition, the second aspect involves an additional problem, i.e. avoiding to the extent possible any margin of flexibility and subjectivity in drawing the boundaries of the Community competence to review national spending decisions.

The effect on trade condition therefore brings about a different issue, i.e. subsidiarity and the sharing of competences between the Community and its Member States. As it is well known, under Articles 81 and 82 EC, this condition draws the line between Community and Member State competences. The modernisation of the system of State aid control and the objectives of the SAAP undoubtedly render a sharing of competences between EU and national agencies reasonable and advisable. Thus, a sophisticated version of the *de minimis* approach, as outlined above, would merely help the setting of priorities by the Commission and might even allow the latter to follow more closely the granting of aid at national level (through the activity of the agencies). In this regard, it is important to note that the SAAP already envisages the possibility of setting up national agencies to monitor compliance by Member States[150]. It is true that rules on jurisdiction must be as unambiguous and objective as possible. This, however, does not mean that they should always be straightforward in their application and do not require in-depth economic analysis. It follows from this that here again there is no reason to object, as a question of principle, to a wider and better use of economic or econometric instruments when assessing the effect on trade between member States. What really matters is that any screening device used to this effect brings increased automatism – as opposed to increased discretion – in the enforcement of State aid rules. In this regard, the use of these devices is not only liable to simplify and speed up the Commission task to examine cases falling within its competence; it also makes the control by national judges and (possibly) national agencies more predictable and uniform.

The division of tasks between the Commission and national agencies is based on an economic assumption. Indeed, it is presumed that, in the absence of cross-border externalities (i.e. in presence of local markets with low levels of concentration), Member States do not have a strategic incentive to provide excessive aid. Thus, national agencies could be qualified for examining State aid granted in such circumstances. The Commission would therefore focus its attention on cases in which other member States are likely to carry the burden of the aid, i.e. cases that imply a transfer of social or economic problems from one Member State to another.

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150 See para. 51 of the SAAP: "I*n this context, the Commission will examine whether* independent authorities in Member States could play a role as regards facilitating the task of the Commission in terms of State aid enforcement (detection and provisional recovery of illegal aid, execution of recovery decisions)".

The test would imply adding a second step to the customary verification of the existence of flows of trade between member States. The first step would still be whether the market is purely local or national, with inexistent commercial exchanges between member States. If this is not the case, the Commission would go through a second step, which would consist of checking, on the one hand, whether the member States other than the grantor of the aid are collectively significant net-exporters of the products or services that benefit from the aid and, on the other hand, whether there is any risk of foreclosure being facilitated by the granting of the aid, due to the market position of the recipient firm or the level of concentration therein.

If both questions are answered in the negative, the Commission would then be released from the obligation to further investigate the aid. In such circumstances, in fact, it is unlikely that the aid can bring any substantial harm to welfare as the advantage granted to domestic firms will mainly benefit consumers in other member States without granting the beneficiary undertaking any material benefit in terms of increased market power. There is therefore no significant strategic incentive for member States to grant aid and one can expect that they are kept to a minimum if the State acts in the best interest of its citizens. The new test would be sufficiently automatic in its application, as it should be possible to identify appropriate indexes of potential foreclosure in terms of market power of the beneficiary and market concentration. In any event, releasing the Commission from the burden of being under an obligation to investigate the aid does not mean that the Commission would not be empowered to act in exceptional circumstances, if it believes that this is in the Community interest. For instance, the Commission could check, through the relevant national agencies if the factual situation has changed. In this regard, it must not be forgotten that some types of local State aid (e.g. in the case of bidding markets) require a close scrutiny by the Commission.

Since both tests (the customary effect-on-trade test and the new LET test based on the welfare objective) can give contradictory results over time, the Commission is empowered to check at any appropriate moment if the factual situation has changed. If the result of the first test is different, i.e. there is now evidence of some degree of competition and commercial exchanges between member States, the aid would fall within Article 87(1) EC and Article 1 (b) (v) of Regulation 659/1999[151] would apply. If the result of the second test is different, i.e. there is a risk of foreclosure or the other member States are now net-exporters of the relevant goods or services, the aid would be treated as a new aid from the moment when the circumstances changed, as in any event the State measure at stake was already caught by Article 87(1) EC but only temporarily removed from the Commission's priorities.

The new effect-on-trade test (or subsidiarity test) would offer a potentially powerful filter to screen out cases where it can be easily shown that there is no effect on other member States,

151 Council Regulation 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, O.J. (1999) L 83/1. Article 1(b) (2) reads as follows: "*For the purpose of this Regulation: (b) 'existing aid` shall mean: (...) (v) aid which is deemed to be an existing aid because it can be established that at the time it was put into effect it did not constitute an aid, and subsequently became an aid due to the evolution of the common market and without having been altered by the Member State. Where certain measures become aid following the liberalisation of an activity by Community law, such measures shall not be considered as existing aid after the date fixed for liberalisation*".

or such effect is limited and positive if valued under a welfare perspective. In all cases where the result of applying the test is that the Commission would still investigate the case, the test can help measuring the degree of market impact in order to facilitate the application of a quantitative balance test under Article 87(3) EC.

A test similar to the new LET approach would help the setting of priorities by the Commission and might even allow the latter to follow more closely the granting of aid at national level (through the agencies). This, in turn, may encourage national agencies and/or legislators to implement and carry out a rigorous control over inefficient national spending. Depending on the powers vested on the agencies under national law, such control could indeed go even beyond the application of the Treaty provisions (lack of cross-border effects).

Review of State aid granted below the LET thresholds by national agencies may avoid political objection and is certainly consistent with the goals of the Treaty and the convergence objectives, at the time that it is a desirable political objective in a Community perspective as it improves the optimal allocation of resources at European level. A mere "waiver to the application of the Treaty rules" in account of the *de minimis* effect on trade would be, by contrast, inappropriate for the same reasons mentioned with respect to the requirement of distortion of competition.

To conclude on this aspect, when examining both requirements of incompatibility embodied in Article 87(1) EC a further refinement of the economic analysis – and especially the definition of criteria and parameters for the assessment of the seriousness of the effects on competition and trade is advisable. Thus, it will be possible to establish in a more precise way a scale of significance of the distortions caused by the aid (preparatory stage of compatibility assessment), which will permit, following the assessment, to make the assessment itself more rigorous and precise, i.e. to actually weigh up the advantages and disadvantages linked to the grant of the aid through a quantitative analysis. In addition, the use of economic parameters can bring about an objective and sufficiently automatic screening out of cases that are not relevant under a Community perspective, without implying a limitation of the scope of application of Article 87(1) EC but rather conferring upon national independent agencies powers to apply such provision under the control of the Commission. This, in turn, can put in motion a progressive process, leading to a broader and more rigorous control over inefficient national spending that would perfectly fit the Community objective of an optimal allocation of resources.

4. Economic analysis and the compatibility assessment of Article 87(3) EC

Article 87(3) EC may be seen as the privileged field for a refined economic approach. Indeed, It is widely acknowledged that economic analysis can give an important contribution to improve the quality and consistency of the enforcement practice. The objective should be first of all to assess the significance of the market failure to which it is being reacted and, second, to measure the degree of contribution to the solution of the problem that can be given by the aid in question, taking into account its specific characteristics. The more relevant the contribution the aid can give to remedy a market failure, and the more important such market failure is, the higher the distortion of competition and effect on trade that could be justified in view of the common interest. As will be shown below, however, there are also limits to the introduction of a more refined economic approach under Article 87(3) EC that should be kept in mind.

a) Welfare criterion and compatibility assessment

As mentioned in section 2 before, for the purposes of this contribution it is assumed that total welfare is the guiding economic objective or standard for the compatibility assessment under Article 87(3) EC. Nevertheless, some commentators do not entirely share this view and believe that it is too restrictive, particularly in that it seems to disregard a plurality of aims (social, political, economic) which lie at the very heart of the provision. This concern goes to show that not all derogations provided for in Article 87(3) EC can be treated in the same manner.

First of all, the introduction of a balancing test based on total welfare relies on the idea that State can only be declared compatible when it "*does not adversely affect trading conditions to an extent contrary to the common interest*". Yet, it appears at the outset that Articles 87(3) (c) and (d) EC are the only provisions where such wording is used. On the contrary, for the application of Article 87(3) (a) EC, the Commission is only required to check whether the criteria set out in the provision (serious underemployment and an abnormally low standard of living) have been correctly applied. In addition to that, the Commission can impose conditions and restrictions intended to guarantee the maximum effectiveness of the aid measures in the Community perspective (this for instance implies a verification of the sectoral repercussions of the aid). Likewise, Article 87(3) (b) EC, second limb, simply requires that the Commission verifies the existence of a "*serious disturbance in the economy of a Member State*" and apply the proportionality test thereof. In view of the above, it appears that a true and careful balancing test based on total welfare could only be definitely required under Article 87(3) (c) EC[152]. Arguably, a balancing test based on total welfare should also be introduced as far as the first limb of Article 87(3) (b) EC is concerned, insofar as it refers to an "*important project of common European interest*". On the contrary, Article 87(3) (a), the first limb of Article 87(3) (b) as well as (most likely) Article 87(3) (d), are seemingly only marginally affected by the trend towards a refined economic analysis. Indeed, these provisions are not so much concerned by the positive effects that State aid may have on total welfare but on the use of subsidies to achieve equity objectives. The introduction of a total welfare test for all derogations provided for in Article 87(3) EC would thus disregard important objectives expressly provided for in the Treaty.

In spite of this general assertion regarding Article 87(3) (c) EC, it is also submitted that a test based on total welfare is also unfit to assess some of the State aid measures examined under this provision. On the one hand, it is true that some of the derogations granted on the basis of the common interest test pursuant to Article 87(3) (c) EC (e.g., development of certain economic activities or promotion of high technology sectors, aid to small firms intended to compensate for information asymmetries between economic agents, aid to promote research and development activities justified by the positive spill-over effects, or externalities, of such

152 Despite the fact that the wording of the Treaty sets out expressly a balancing test, the same can be said with respect to Article 87(3) (d) EC, which refers to cultural pluralism.

activities, especially in the present situation of a gap between the resources devoted to R&D in the EU and in other industrialised areas of the world) seem to evoke *per se* objectives of economic efficiency. In this case, if the previously described three-step test leads to positive results and the aid falls within the scope of application of the derogation, it seems obvious that the authorisation of the aid is in the Community interest. In this case, the restraints on competition are generally overcompensated by the benefits of the aid for the European productive sector as a whole or, to state it in a different way, the contribution the aid can give to the achievement of macroeconomic objectives of the EU prevails over the discriminatory effect at microeconomic level. For this group of derogations, the balance between distortion on competition and trade on the one hand and economic benefits on the other hand is likely to be positive for the reasons indicated above.

Similar conclusions can be drawn as regards State aid aiming at fostering the development of specific industries, where the link between the aid and the market failure is more difficult to trace. In these "borderline" cases, where a conflict between such protected objectives and the basic interest of economic efficiency may potentially arise, it becomes of the utmost importance to carry out a careful balance test in view of the "common interest" as previously defined (i.e., from the total welfare perspective).

On the other hand, Article 87(3) (c) was used in the past to clear State aid on grounds unrelated to efficiency considerations. For instance, some categories of regional aid, which, by definition, serve equity objectives, come within the scope of this provision. Likewise, it is evident that rescue and restructuring aid serves a social objective, in that it aims to alleviate some of the side effects related to the normal play of market forces.

As can be seen, reliance on total welfare for all State measures would lead to unacceptable results, as it would not permit to take into account the complex nature of Article 87(3) EC, which sometimes requires an adequate consideration of long-term goals and non-efficiency objectives. The fact that total welfare may not serve all objectives referred to in Article 87(3) EC, does not mean that a rigorous balance based on economic analysis should not be used for all derogations. In the case of equity or other political considerations, economic analysis would help balance out restraints and advantages in an objective manner; in the case of sector-specific measures it should help neutralising the tendency of the average politician to discount heavily all events occurring beyond the horizon of his/her political life[153]. It is in fact well known that sector-specific objectives often arise as a consequence of strong lobbying efforts and depends on the lobbying ability of professional categories or group of producers.

The most appropriate theoretical justification for the need to clearly identify the market failure, as suggested in the action plan, lies precisely in the differences that we have just pointed out among the various derogatory clauses contained in Article 87 EC. This also explains and justifies why it would be advisable, theoretically at least, to elaborate different screening devices for the various market failures and the different categories of derogations as grouped

153 See for instance Krueger, "The Political Economy of the Rent-Seeking Society", 64 *American Economic Review* (1974), p. 291-303.

above, although it appears that the economic doctrine has not provided sufficiently concrete examples of such tailored screening devices and assessment criteria as yet.

b) The three-step test in practice

The action plan first suggests that the screening devices and assessment criteria should vary following the specific market failure invoked by the State to justify its intervention. This means that: (i) the State should explicitly state what concern or aim leads it to grant support to industries or companies; and (ii) the type, duration and intensity of the aid should be adapted to the problem or objective at stake.

An in-depth analysis of the specific market failure addressed by State action is a good point of the SAAP, as this should definitely lead to better-targeted State aid. Another issue concerns the methodology to be followed when carrying out the compatibility assessment, i.e. how to structure the analysis and identify the various steps to be followed when carrying out such assessment. Specifically, one should first define the market failure and carry out a quantitative economic analysis of its relevance. Second, the most appropriate tool to target the market failure (form and type of the aid) should be identified and the customary proportionality test applied as precisely as possible in order to assess the appropriate duration, frequency, intensity and conditions of the aid.

While we basically agree with the methodological indications given in the Action Plan, two issues need to be clarified. First, to oblige member States to state which market failure they address may indeed be a good idea for both educational and practical reasons. It imposes a more rigorous discipline to member States and facilitates the application of both screening devices tailored to that specific market failure and the balance test. One should not forget, however, that this approach risks being at odds with the doctrine of effects, which is a milestone principle of State aid and competition law in general. In order to avoid this risk, the Commission will first have to set out an exhaustive list of eligible market failures and, second, to be ready to carry out the appropriate ex-post investigation to double-check that all expenses authorised under a given project are appropriately earmarked and justified by the stated objective. It is therefore reasonable that the Commission gives indications if and how it intends to do so. Secondly, the SAAP clearly indicates that Member States should provide evidence that there are no other less distortive measures to tackle the market failure at stake. Although it is true that Article 87(1) EC embodies the principle of incompatibility, which in turn results in the application of the necessity test, it is much more difficult to infer such a requirement from the wording of Article 87(3) EC.

The most recent texts presented by the Commission in the SAAP, which are referred to above, show interesting examples on how the institution intends to proceed for block exemptions and horizontal aid. First of all, it has shown that in its Guidelines the Commission is ready to set very clear and very precise indications regarding the market failures tackled by each category of State aid, the incentive effect of the aid, and its adequate nature. In the case of the Guidelines on State aid and Risk Capital to Small- and Medium-Sized undertakings, the Commission did not hesitate to question the pertinence of State aid as an instrument replacing risk capital investments: "*risk capital provision is essentially a commercial activity involving commercial decisions*"[154]

It remains to be seen how the Commission intends to apply these same principles in individual cases, in particular the extent to which Member States will be required to provide evidence of the incentive effect of the State aid. It may well be that State aid will be rejected in individual cases if the Commission is ready to take the view that other measures address a market failure more adequately. This may give rise to an interesting debate, as member States may claim that they have the choice of the type of measure once it is established that market forces alone would not permit achieving the said objective. The Commission should therefore consider identifying the legal basis for the application of this double necessity test.

c) Procedural implications

The action plan further indicates a broader use of block exemptions as a tool to achieve subsidiarity. We share this opinion although the crucial issue is whether to give block exemptions a negative value, a point that is left open in the Action Plan. This means setting a rule whereby all measures that do not perfectly conform to the limits and conditions indicated in the group exemption should be considered automatically and *per se* incompatible, without any need for individual scrutiny.

While we understand and share the concern of introducing tools and devices intended to maintain the assessment of State aid under the Commission's control, albeit reducing at the time the Commission's workload, our main concern with this proposal is twofold: first, the inevitable lack of flexibility that the system would imply might result in a more formalistic than substantive approach and, second, the national jurisdiction would have the final say in the assessment when interpreting and applying the group exemption's provisions. This, in turn, may result in a lack of uniformity in the enforcement within the EU, which risks to be of special relevance during the learning phase (i.e., the period needed for national judges to gain experience in the matter), and in a sharp increase of the Court of Justice's workload on references for preliminary ruling. In addition, this would most likely require a new Council Regulation empowering the Commission to adopt block exemption of the new generation (i.e., having negative legal effect), as it is at least doubtful that the Commission enjoys sufficient powers to do so under Regulation No. 994/98.

The alternative would be to maintain the present value of block exemptions and simply developing and detailing as much as possible the criteria and conditions of compatibility set forth therein. If a national judge considers that such conditions are not met in a given case, it would have to draw all legal consequences permitted under national law from the lack of notification. The member States (and, indirectly, the recipient undertakings) would therefore carry the responsibility of assessing whether the group exemption's rules are fully satisfied and, in borderline cases, keep notifying the aid to the Commission. One should not overstate the risk that the number of notifications received by the Commission would remain unchanged

154 See *supra*.

in such a scenario. Member States are more than willing to proceed expeditiously without facing the Commission's scrutiny if they believe that the case would resist a review by the national judge. This solution, coupled with an improvement of the provisions on cooperation between the Commission and national jurisdictions in the field of State aid, would probably offer more guarantees during the "learning period", preparing for a further shift of competences to national jurisdictions at a later stage.

Comments on the paper "The most appropriate economic tools for a better targeted State aid policy"

Massimo Merola*

The SAAP has been the first, decisive step forward towards a comprehensive reform of State aid by illustrating the fundamental objectives of the reform itself quite clearly and drawing up a tentative list of possible new substantive and procedural tools to achieve these objectives.

Since then, the Commission has made a number of additional steps in this direction in terms of new legislation, including soft law, and has no doubt started testing the new approach in its decision-making in several cases, although this process is less visible to the 'external world'. Since we belong precisely to the 'external world', we can perhaps bring a detached view to the reform of State aid, without of course taking on the ambition of teaching 'big lessons' to the Commission, but certainly with the intention of contributing some ideas that – hopefully – will not appear as completely outdated in light of the progress made within the Commission itself in the meantime.

Three issues, among others, are crucial in the framework of the reform.

I. Article 87(1) v. Article 87(3)

A first point concerns the controversial question of whether an economic assessment of the relevant facts should already take place in the framework of the Article 87(1) analysis or should be entirely reserved for the later phase of the analysis, based on Article 87(3). In the Action Plan, the Commission does not take a position on what kind of economic screening devices, if any, could be used in the framework of an Article 87(1) analysis as opposed to an Article 87(3) analysis. So far however, for a number of reasons, the Commission's approach has been to simplify as much as possible the Article 87(1) analysis and reserve all considerations of economic nature for the discretionary assessment under Article 87(3).

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Let me point out that this issue has some, although limited, degree of similarity with the procedural problem of establishing a clear frontier between the kind of assessment that should be performed in the preliminary phase of the investigation and the more comprehensive assessment that is to be left for the formal investigation under Article 88(2). And, indeed, while the compatibility assessment, which certainly requires economic-type considerations, is embodied in both the preliminary and the formal phase of investigation (*prima facie* and final view), the more legalistic part of the work, *i.e.* checking that the qualification criteria for State aid are met and whether the aid is new or existent, should typically be carried out entirely in the first phase (Judgement 'Italgrani', 1994).

This means that, on the one hand, the Commission should be prepared to enter into some degree of economic analysis even in the preliminary phase and, on the other hand, the need to perform some sort of economic analysis is not a reason in itself to open a formal investigation if the use of economic tools or of an economic method of analysis is made in the framework of the qualification exercise. This could be the case, for instance, when applying the MEIP or identifying possible cross-subsidy issues in transaction internal to a public group of companies or again determining if the aid should be treated as new or existing under Article 1 (b) (v) of the procedural Regulation on the basis of the changing of market and trade circumstances over time.

Besides this procedural aspect, the answer provided by our working team to the question whether a refined economic approach could be of help in the realm of Article 87(1) is a clear "yes".

We believe that, with respect to both the conditions for the qualification of a State measure as aid and the requirements for incompatibility of the aid, but in particular, with respect to the latter, a refined economic assessment could make the application of some criteria normally used in the Commission's practice more predictable, rigorous and precise. In addition, it should be possible to incorporate into the analysis, appropriate devices or parameters that allow the Commission to screen out cases that are not of Community interest and that would be better dealt with through private enforcement means before national agencies or possibly, in the future, be left to national independent agencies.

In recent case law (Altmark), the Court tends to put qualification criteria and conditions of incompatibility in the same basket. We still believe, however, that there is a conceptual difference between the two categories of concepts embodied in Article 87(1):

– The analysis of the qualification criteria (or constitutive elements) aim at establishing whether the State is liable for the measure at stake (State origin and State resources used – see Stardust) and whether the measure should be dealt with under the rules on competition due to its microeconomic effect (selective advantage) or are rather subject to a different type of control (convergence objectives and harmonisation measures).
– On the contrary, the examination of the incompatibility conditions tells us whether State aid is caught by the ban, at least in principle, (and is, at first sight, incompatible with the common market) or rather whether it falls outside the scope of the Treaty provisions on competition and the Community jurisdiction.

The conceptual difference becomes relevant from a visual angle of a refined economic approach. The assessment regarding distortion of competition and the effect on trade is indeed a good playing field to introduce economic-based screening devices in the Article 87(1) analysis.

We would like to focus on each of the two aspects separately.

II. Distortion of competition and the de minimis rule

Under the distortion of competition criterion, a refined economic assessment could lead to the identification of some screening devices which permit the classification of aid measures on the basis of their potential in terms of distortion of competition, with a view to applying a quantitative approach in the compatibility assessment, thus accruing the precision of such assessment. The typical screening device in this context is the *de minimis* tool.

However, the present approach, whereby low volumes of aid are automatically excluded by State aid control, is not suitable as an indicator for the distortion of competition as it may encourage aid that has nothing to do with the remedy of a market failure. Operating aid is a clear example of inefficient *de minimis* aid, whereby the contribution to the Lisbon objectives is null and financial resources are prevented from being used more efficiently in view of the Community objectives.

We believe that there is absolutely no reason justifying a relaxation in the application of the Treaty provisions in this respect. If it can be justified that the Commission sets its own priorities, then there is no reason to pursue the present approach, confirmed again yesterday in the revised proposal of amendment of Regulation No. 69/2001, according to which transparent subsidies of €200,000 or less will not constitute State aid. The Commission should not give up powers vested on it by the Treaty, unless this can be done through a delegation of competences suitable to improve the overall effectiveness of the Treaty provisions. The Commission should play an educational role, not encourage a widespread use of resources.

We should bear in mind that the achievement of the first objective of the Action Plan ("less State aid"), which means a lower volume of State aid as a percentage, for instance, of GDP, can only be assessed against a clearly established benchmark, which depends on the definition of aid. In order to check the progress made in this direction, it is essential that the scope of State aid control remains as broad as it used to be in the past. Should the notion of aid shrink, any finding of a reduced volume of aid would have little meaning.

A new, alternative *de minimis* approach, which would set different flexible thresholds depending on the degree of market concentration and taking into account the foreseeable impact of the aid on competition depending on its nature and the kind of activity/investment being supported seems to us more economic-based and more coherent with the fundamental principles that have inspired the reform. In the field of regional aid the Commission has some experience of market structure- or market power-based parameters of automatic application. We suggest that it seeks to elaborate on this experience to work out a new and more sophisticated *de minimis* rule.

III. Effect on trade as a screening device

Concerning the 'effect-on-trade criterion', the question is slightly more complex in consideration of the 'double' nature of this condition: at the same time: a) a trigger for the application of the principle of incompatibility of State aid but also b) a threshold drawing the frontier between Community and national jurisdiction in the field of State aid.

We do not recommend a modification of the Community jurisdiction over State aid but we do believe that the use of economic parameters could allow the setting up of priorities for the Commission through an objective and sufficiently automatic screening out of cases that are not relevant from a Community perspective. This means leaving the power to apply Article 87(1) to this limited extent under the control of the Commission to national judges and, perhaps in the future, conferring upon independent national agencies.

In our opinion this can only lead to a broader and more rigorous control of inefficient national spending, which perfectly suits the Community objective of an optimal allocation of resources.

Once again, there is no reason for the Commission to give up powers vested in it by the Treaty, unless this could be done through a delegation of competences suitable to improving the overall effectiveness of the Treaty provisions.

In addition, this limited delegation of powers would go in the direction of increased subsidiarity and thus of the modernisation effort, and would have a strong educational value as it could encourage national legislators to introduce a domestic control by independent agencies over inefficient national spending beyond the limits of the Treaty. We know this is an ambitious aim, but the Commission has already proved, in this and other fields, to have enough talent and resources among its people to accomplish this.

Likewise, for the distortion of competition, we recommend a possible effect-on-trade economic-based parameter in our paper, which could help in drawing the boundaries between the retained and the delegated Commission competences and thus screen out cases that the Commission would not be obliged to investigate.

This device should be based, in our opinion, on cross-border externalities. The test would imply adding a second step to the customary verification of the existence of flows of trade between member States. The first step would still be whether the market is purely local or national, with inexistent commercial exchanges between member States. If this is not the case, the Commission would go through a second step, which would consist of checking, on the one hand, whether the member States other than the grantor of the aid are collectively significant net-exporters of the products or services that benefit from the aid and, on the other hand, whether there is any risk of foreclosure being facilitated by the granting of the aid, due to the market position of the recipient firm or the level of concentration therein. If both questions are answered in the negative, it would then be highly unlikely that the aid would bring any substantial harm to welfare as the advantage granted to domestic firms would mainly benefit consumers in other member States without granting the beneficiary undertaking any material benefit in terms of increased market power.

There would therefore be no significant strategic incentive for member States to grant aid and one could expect that such aid is kept to a minimum if the State acts in the best interest of its citizens. The new test would be sufficiently automatic in its application, as it should be possible to identify appropriate indices of potential foreclosure in terms of market power of the beneficiary and market concentration.

IV. Balance test and appropriate benchmarks

I come now, very briefly, to the issue of appropriate benchmarks for the balance test. It is widely acknowledged that economic analysis can give an important contribution to improve the quality and consistency of the enforcement practice. The objective should first of all be to assess the significance of the market failure to which it is being reacted and, second, to measure the degree of contribution to the solution of the problem that could be given by the aid in question, taking into account its specific characteristics.

In order to do so, however, one needs to ascertain the overall objective of State aid provisions against which the contribution given by the aid must be assessed and quantified, and we consider that total welfare is the appropriate benchmark.

A clear definition of the basic aims pursued by Article 87(3) and a clear identification of market failures is therefore the first challenge if we want that a refined economic approach to play an actual role in the assessment of State aid. Yet our feeling is that some work still needs be done in this respect.

Let's take the issue of market failures. The action plan clearly says that the assessment criteria should vary following the specific market failure invoked by the State to justify its intervention. This statement, however, is followed simply by the recommendation that the State explicitly points out what concern or aim leads it to grant support to industries or companies. No indication is provided as to the actual criteria to be taken into account when weighing up the specific market failure on the one hand and the aid measure on the other hand, which does not help the exercise in practice.

Therefore, we would encourage a deeper analysis of the market failure issue by the Commission and the consideration of different tools for the balancing test depending on the market failure and the derogation invoked by the State.

We have explained in our paper that not all the derogations can be treated in the same way, as the total welfare benchmark is relevant for only some of them. In addition, among the latter (mainly those based on Article 87(3c) some are based on efficiency considerations (aid to small firms intended to compensate for information asymmetries or R&D aid justified by the positive spill-over effects expected) and, therefore, the balance of interest is likely to bring positive results while others deserve more attention as they pursue mainly social or sectoral objectives (rescue and restructuring aid, employment aid or sector-specific R&D programmes).

For the first category, it is likely that the balance test will lead to positive results. It would be unreasonable to ban aid that directly contributes to efficiency objectives by removing the technological, physical, informational or psychological obstacles that prevent the full advantages to be drawn from the normal play of market forces. For this group of derogations, the balance between distortion on competition and trade on the one hand and economic benefits on the other hand is likely to be positive.

In contrast, as for the second category, it becomes of the utmost importance to carry out a careful assessment in view of the common interest and to balance out market and trade distortion on the one hand, and social benefits on the other, from a total welfare perspective.

The economic doctrine has not provided concrete examples of such tailored screening devices and assessment criteria as yet.

V. The appropriate procedural or methodological tools

Finally, two short remarks on the appropriate procedural tools.

We have been reflecting upon what is indicated in this respect in the Action plan and the tools foreseen to achieve such objectives. We would like to indicate at least two items that ,in our opinion, deserve further consideration by the Commission:

(i) One is the obligation upon member States to indicate which market failure they address. While we basically agree with this methodological indication, as it imposes more rigorous discipline on member States and facilitates the application of both screening devices tailored to that specific market failure and the balance test, one should not forget, however, that this approach risks being at odds with the doctrine of effects. The doctrine of effects is a milestone principle of State aid and competition law in general. In order to avoid this, the Commission would first have to set out an exhaustive list of eligible market failures and, second, be ready to carry out the appropriate ex-post investigation to double-check that all expenses authorized under a given project are appropriately earmarked and justified by the stated objective. It is, therefore, reasonable that the Commission gives indications on 'if' and 'how' it intends to do so. In other words, the Commission should be prepared to reinforce its ex-post control practice.

(ii) The second remark concerns group exemptions, where the Commission has left the question of a negative effect open. This is a crucial issue. Negative effect means that all measures that do not perfectly fall within the scope of the group exemption should automatically be considered incompatible *per se*, without any need for individual scrutiny. Our main concern with this proposal is twofold: a) the lack of flexibility of the system might result in a more formalistic rather than a substantive approach, and b) the national jurisdiction would have the final say in the assessment when interpreting and applying the group's exemption provisions. This, in turn, may result in a lack of uniformity in the enforcement at EU level, and a sharp increase of the Court of Justice's workload on references for preliminary ruling. We wonder whether it would not be preferable to maintain the present value of block exemptions and simply develop the criteria and conditions of compatibility set forth therein. If a national judge considers that such conditions are not met in a given case, he would have to draw all legal consequences permitted under national law from the lack of notification. The member States (and, indirectly, the recipient undertakings) would therefore bear the responsibility of assessing whether the group's exemption rules are fully satisfied and, in borderline cases, continue notifying the Commission of the aid. This solution, coupled with an improvement of the provisions on cooperation between the Commission and national jurisdictions in the field of State aid, would probably offer more guarantees during the "learning period", preparing for a further shift of competences to national jurisdictions later on.

Comments on the paper "The most appropriate economic tools for a better targeted State aid policy"

Thibaut Kleiner*

My contribution to the GCLC conference was as the third commentator on the presentation given by Rainer Nitsche of CRA International. The presentation was among other things remarkable, because it highlighted the links between the legal framework and the possible types of State aid economic assessment. Economists tend to spontaneously focus on the effects of State aid on some measurement of welfare, and do not always care much about who gets the power to decide on this point – whether the Commission or Member States. By contrast, the EC Treaty makes an important distinction between two stages of analysis: i) whether a measure qualifies as State aid within Article 87.1 EC and ii) whether it should be deemed compatible with the common market within Articles 87.2 and 87.3 EC. The first stage is necessary to find out whether the Commission has jurisdiction on the assessment of the measure according to State aid law.

Rainer Nitsche's presentation very well seized this tension and underlined that the choice of the economic tool and the objectives of State aid policy are intrinsically linked. In other words, the choice of economic tool is not a mere technicality but has deeper policy implications. In particular, economic tools could play a role not only to help judge on compatibility, but also in providing screening devices to identify those measures that should be subject to the Commission's scrutiny.

These implications were also clear to the two other commentators, Leigh Hancher, of Tilburg University and Allen & Overy, and Massimo Merola of Bonelli Erede Pappalardo and the College of Europe. They raised a series of issues that are worth mentioning. First, the objectives of State aid control were questioned, and notably whether the scope of State aid control should not be more limited and focus only on those measures that *significantly* affect trade – by opposition to all measures that affect trade -even remotely. Then, the State aid Action Plan (SAAP), in that context, was considered as only a limited break with the past. SAAP introduced some sophistication in the economic analysis of the Commission, which was present in State aid policy, albeit rudimentary and essentially based on legal presumptions. SAAP however did not break with the jurisprudence of the Court, in particular as it focused on Article 87.3 EC and did not attempt to change the scope of Article 87.1 EC. The commentators considered that the way forward for economic analysis should be to increase the economic assessment

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within Article 87.1, through a more sophisticated *de minimis* approach and through sharing competencies with Member States.

My presentation, in essence, tried to go back to the message of the SAAP and to confirm that the current State aid reform is not aiming at changing the EC Treaty nor the jurisprudence of the Court, but rather aiming at a better enforcement of the EC State aid law.

First of all, it is worth going back to the intentions and motivations for launching a State aid reform. Looking notably at the consultation that followed SAAP, it appears that there are two readings of the State aid reform intentions that ought to be corrected. The reform does not aim to use State aid as an instrument to second-guess Member States and through the use of concepts like 'market failures' to dictate some on-size-fits-all industrial policy to them. The reform does not either aim at dismantling State aid control through a de-centralisation of powers to Member States. In reality, the intentions behind State aid reform were more modest, trying to improve what were perceived as gaps and shortcomings, without attempting to change the Treaty or the jurisprudence. The SAAP was motivated by a series of factors. The re-launch of the Lisbon Strategy for growth and jobs was a clear influence. But it was not the only one: SAAP was also motivated by a series of frustrations with the policy enforcement of State aid, both by the Commission and by Member States[155]. SAAP was based on the diagnosis that there were a series of shortcomings in the way State aid law is complied with. First; the Commission has to deal with probably too many cases[156]. Secondly, the time required to make decisions is too long[157]. Thirdly, Member States too often fail to notify their State aid measures to the Commission. Fourthly, they do not recover sufficiently quickly – if they even do it at all- illegal or incompatible aid. Finally – even though one could possibly go on with the list- transparency is limited and Member States do not publicise their granting of aid.

The SAAP, in that context, did not try to change the Treaty, but tried to use economic tools in order to improve current State aid policy. It formalised practice and introduced a refined economic approach to assess State aid compatibility, with the aim of facilitating a better targeting of State aid towards areas that support growth and jobs. It introduced what has now been called the 'Balancing Test' to unify the analysis of State aid compatibility. This balancing test is a structured analysis, which disentangles positive effects from negative effects and tries to balance them to judge whether a measure should be deemed compatible. It thus looks at economic effects and ambitions to unify the State aid discipline, by being systematically used not only for the design of rules but also for cases. This test is very much the economic tool to build coherence and consistency across State aid many areas.

The second key element in SAAP was the promotion of a new architecture of rules, with more exemptions from notification, coupled with a greater scrutiny of cases a priori raising

155 See State aid Action Plan, paragraph 17.

156 Around 600 to 700 decisions are made by the Commission each year in the State aid field, which means as much as 7 decisions per case handler per year. In addition, 25% of these decisions concern complaints, and one may sometimes question the relevance for the Community to deal with a series of cases that could appear relatively mundane at first sight, or at least as implicating essentially competitors in one Member State.

157 75% of cases are dealt with in less than 6 months, but 88.2 procedures take up to 20 months for notified cases and up to 30 months for non-notified cases.

risks for competition and trade. Economic analysis is used here to design the thresholds above which the Commission goes from a formal compatibility analysis (in Block Exemption Regulations and part of guidelines) to a more effects-based analysis (for cases involving larger aid amounts).

These two elements – a single test and a new architecture of rules- operate within Article 87.3 EC. They do not reduce the scope of the Commission's jurisdiction, even though Block Exemptions look a little bit like de-centralisation within a centralised framework. Admittedly, it is legitimate to question whether economic tools could not also be used for Article 87.1. However, the wording of the Treaty and the jurisprudence leave very little margin of manoeuvre. Article 87.1 is interested not in substantial impact on competition, but actually even in aid that threatens to distort competition. There is little scope for raising the threshold in that context. More could maybe be done in what regards impact on trade, to establish criteria identifying when trade is substantially affected. However, this is not straightforward[158], as it is relatively easy to find even limited potential effects on trade resulting from an aid. Moreover, there are practical difficulties in trying to use economic tools to change the current standpoint on 87.1. First of all, most measures operate within schemes, for which it is very difficult to clearly determine the beneficiaries, affected markets and associated geographic dimensions. Secondly, as this exercise would have an impact on the possible jurisdiction of the Commission, it would be tempting for Member States to try and avoid that measures are considered State aid. Without proper information gathering powers, the Commission could have difficulties keeping control, which would lead to important legal uncertainties too. It would not be realistic either to have independent national authorities controlling the aid given by their own national administration, as the risk for national political capture would be too great.

In conclusion, the most appropriate economic tool for a better targeted State aid policy is today one that does not attempt to change the Treaty nor to challenge the jurisprudence too much. A lot has been accomplished since 2005 to systematise economic thinking in State aid and in developing tests and analyses that are helping a better targeting of State aid. More is needed. In that context, before developing new economic tools for Article 87.1 and risking weakening the Commission's role in the State aid system, it is important to properly enforce the existing State aid law.

158 One may refer to the Commission's failed attempt in 2005 to design a Significant Impact Test.

Compensation for SGEI: an economist's look at the Altmark test and the Community Framework

Jorge Padilla, Urs Haegler*

I. Introduction

Considerable attention has been given to the assessment of the compensation for the provision of services of general economic interest (SGEI) from the viewpoint of State aid law.[159] These services are economic activities deemed to be desirable by public authorities but which would not be supplied, or not supplied at the desired level of quality or at sufficiently low prices, absent their intervention. They are considered to play a vital role in achieving the objectives of the European Union as regards social and territorial cohesion as well as in promoting the

* Urs Haegler and Jorge Padilla are economists with LECG Consulting. This paper was prepared for presentation at GCLC Third Annual Conference on State aid held in Brussels on 21/22 September 2006. We wish to thank the comments and suggestions of Thomas Jestaedt, Damien Neven, Marc Pittie and Alison Oldale. We also would like to thank Joachim Keller for superior research assistance. The opinions in this paper are our own responsibility. Please send comments and suggestions to uhaegler@lecg.com and jpadilla@lecg.com.

159 P. Anestis and S. Drakakakis, "State aid policy and services of general economic interest: shedding some light on a controversial area," in The European Antitrust Review 2006. A Global Competition Review special report, 2006, Chapter 14; A. Boyd and J. Teal, "Interpreting the Altmark decision – the challenges from a private practitioner's perspective," unpublished manuscript, 31 May 2004; EAGCP, "Opinion Prepared by the State aid Group of EAGCP on Services of General Economic Interest," 29 June 2006; H. W. Friederiszick, L. H. Roeller and V Verouden, "European State aid Control: An Economic Framework," DG COMP, 2005; S. Santamato and N. Pesaresi, "Compensation for services of general economic interest: some thoughts on the Altmark ruling," Competition Policy Newletter, No. 1 (2004).

competitiveness of its economy.[160] Their significance has been established in Articles 16 and 86 of the EC Treaty.[161]

The firms entrusted with providing such services inevitably incur losses that need to be compensated. Otherwise there would be no need for public intervention: the market would provide those services without any involvement of the State. The use of State resources to compensate those losses gives rise to two fundamental questions. Does the compensation received by firms entrusted with the provision of SGEI constitute State aid within the meaning of Article 87(1) of the EC Treaty? And if so, under which conditions, if any, can such aid be found compatible with the Treaty under Article 86(2)?

In this paper we review the answers given to these questions by the Commission and the Community Courts over time and succinctly describe the current Community framework for the assessment of State aid in the form of public service compensation (Section 2). We then discuss the logic and limits of the *Altmark* test,[162] which specifies the conditions under which the compensation received by firms providing SGEI constitutes State aid (Section 3), and assess from an economic perspective the appropriateness of the current Community framework and, in particular, the conditions laid out for the Commission to declare compatible with the Treaty public service compensation which does not meet the four criteria set out by the European Court of Justice (ECJ) in *Altmark* (Section 4). We conclude with some suggestions aimed at facilitating the implementation of the *Altmark* test and clarifying the interplay between Articles 86(2) and 87(1) of the EC Treaty (Section 5).

II. State Financing of SGEI: Law

The Commission and the Community Courts have, on numerous occasions, been confronted with cases involving the remuneration for discharging (actual or claimed) SGEI. The decisions and judgments, respectively, made in those cases have shaped the legal framework within which State funding of SGEI is to be assessed. In particular, the Commission and the Community Courts have considered the following issues: (a) When is a service a SGEI?; (b) When does State funding of the provision of an SGEI constitute State aid?; (c) Under which circumstances does State funding of SGEI that is State aid have to be notified?; and (d). Under which

160 European Commission, ”Communication from the Commission to the European Parliament, the Council, the Eurpean Economic and Social Committee and the Committee of the Regions (entitled ”White Paper on services of general interest”),” COM (2004) 374, 12 May 2004. In a wider context, SGEIs also contribute to the goals of the Lisbon Agenda: more growth and jobs in Europe. The Lisbon Agenda was set up in 2000 as an action and development plan to boost productivity and growth by 2010.

161 Article 16 of the EC Treaty states: “Without prejudice to Articles 73, 86 and 87, and given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Community and the Member States, each within their respective powers and within the scope of application of this Treaty, shall take care that such services operate on the basis of principles and conditions which enable them to fulfil their missions”. Article 86 of the EC Treaty will be discussed in detail below.

162 Case C-280/00 *Altmark Trans GmbH,* OJ [2003] C 226/1.

circumstances will State funding of SGEI that is State aid be declared compatible with the Treaty? We consider each of these questions in turn.

1. What is a SGEI?

SGEI are not defined in the Treaty or the secondary legislation. However, according to the Commission,

"[...] in Community practice there is broad agreement that the term refers to services of an economic nature which the Member States or the Community subject to specific public service obligations by virtue of a general interest criterion. The concept of services of general economic interest thus covers in particular certain services provided by the big network industries such as transport, postal services, energy and communications. However, the term also extends to any other economic activity subject to public service obligations."[163]

There is no exhaustive list of what is to be regarded as SGEI. Examples of SGEI dealt with by the European Commission and the Community Courts include:[164]

- Administration of a State's most important waterway;[165]
- Operation of a universal and continuous mooring service at ports;[166]
- Operation of public telephone networks;[167]
- Broadcasting of television services;[168]
- Operation of the national public electricity supply;[169]
- Provision of basic postal services;[170]
- Provision of certain banking services.[171]

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163 European Commission, "Green Paper on Services of General Interest," COM (2003) 270, 21 May 2003.

164 See P. Anestis and S. Drakakakis (2006), *op.cit.*

165 Case 10/71 Ministère Public of Luxembourg v Muller [1971] ECR 723, 739.

166 Case C-266/96 *Corsica Ferries France* [1998] ECR I-3949.

167 See Case C-18/88 *RTT v GB-Inno-BM* [1991] ECR I-5941.

168 Case 155/73 *Sacchi* [1974] ECR 409; Case C-260/89 ERT [1991] ECR I-2925; Case T-69/89 Radio Telefis Eireann v Commission [1991] ECR II-485. However, following Exclusive right to broadcast television advertising in Flanders, OJ [1997] L 244/18 (upheld on appeal Case T-266/97 Vlaamse Televisie Maatschappij v Commission [1999] ECR II2329), the right to broadcast advertisements is not regarded as a SGEI.

169 Case C-393/92 *Almelo* [1994] ECR I-01477; Case C-157/94 Commission v Netherlands [1997] ECR I-5699; Case C-158/94 Commission v Italy [1997] ECR I-2789 and Case C-159/94 Commission v France [1997] ECR I-5815; Ijsselcentrale,OJ [1991] L28/32 (Para. 30). Similarly for water authorities, see the Commission's decision in NAVEWA-ANSEAU [1982] OJ L 167/39.

170 Case C-320/91 *Corbeau* [1993] ECR I-2533; Case T-106/95 FFSA [1997] ECR II-229; Joined Cases C-147 and C-148/97 Deutsche Post [2000] ECR I-825; Spanish Courier Services [1990] OJ L 233/19.

171 Report on services of general economic interest in the banking sector adopted by the Commission on 17.06.1998 and presented to the ECOFIN Council on 23.11.1998.

– Provision of a supplementary pension scheme;[172] and
– Operation of an air route which is not commercially viable, but which is necessary to operate for reasons of the general interest.[173]

In contrast, case law has found the following not to qualify as SGEI:

– Administration of authors' intellectual property rights;[174]
– General banking services;[175]
– Port services.[176]

Two additional aspects affecting the categorisation of SGEI are worth noting. First, for an activity to be classified as an SGEI it does not have to benefit the entire national economy, but only a certain group of the population.[177] Second, whether an undertaking operating a SGEI has public or private legal status in national law is irrelevant for the service to be considered a SGEI.[178]

Member States enjoy a great deal of discretion regarding the definition of the SGEI within their respective territories. Every Member State is free to specify which economic activities are in the general public interest.[179] However, this freedom is subject to scrutiny by the Commission whose role is to ensure that "*this margin of discretion is applied without manifest error*".[180]

Member States also enjoy considerable autonomy in choosing how to compensate firms entrusted with public service obligations.[181] Member States can use a wide range of mechanisms to fund the provision of SGEI, including:[182] (a) direct financial support through the State budget (e.g., subsidies or other financial advantages such as tax reductions); (b) special or exclusive rights (e.g., a legal monopoly); (c) contributions by market participants (e.g., a universal service fund); (d) tariff averaging (e.g., a uniform country-wide tariff in spite of considerable

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172 The Dutch Sectoral Pension Funds Cases Joined Cases C-180-184/98 *Pavel Pavlov & Others v Stichting Pensioe fonds Medjsche Specialisten* [2000] ECR I-6451.

173 Case 66/86 *Ahmed Saeed* [1989] ECR 803 (para. 55); Case T-260/94 Air Inter v Commission [1997] ECR II-997.

174 See Case 125/78 *GEMA* [1979] ECR 3173; Case 127/73 BRT v SABAM [1974] ECR 313; Case 7/82 GVL v Commission [1983] ECR 483.

175 Case 172/80 *Zuchner v Bayerische Vereinsbank* [1981] ECR 2021.

176 Case C-179/90 *Porto di Genova* [1991] ECR I-5889.

177 Advocate General Roemer in Case 82/71 *Pubblico Ministero Italiano v SAIL* [1972] ECR 119.

178 European Commission, "Decision on the application of Article 86(2) of the EC Treaty to State aid in the form public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest," Commission Decision 2005/842/EC, OJ [2005] L 312, p.67, Recital 2. The neutrality regarding the type of ownership of enterprises is guaranteed in Article 295 EC (see European Commission, "Communication from the Commission on Services of general interest in Europe," 2001/C 17/04, 19 January 2001, para. 21).

179 Case 155/73 *Sacchi* [1974] ECR 409, Para. 15. See also European Commission, "Communication from the Commision on Services of general interest in Europe," 2001/C 17/04, 19 January 2001 (para. 22).

180 European Commission, "Community framework for State aid in the form of public service compensation', OJ [2005] C 297, para 9.

181 The principle of the Member States' autonomy to make policy choices regarding services of general economic interest equally applies with regard to financing the latter. Indeed, Member States enjoy a wide margin of discretion when deciding whether and in what way to finance the provision of services of general economic interest. European Commission "White Paper" *op.cit.*, p. 13.

182 Ibid., and P. Anestis and S. Drakakakis (2006), op.cit.

differences in the cost of provision of the service); and (e) solidarity-based financing (e.g., social-security contributions).

However, their discretion is limited by the Community competition and State aid rules. Thus Member States are free to act as long as the selected compensation mechanism does not constitute State aid or, to the extent it does, it is necessary and proportionate and does not impede the development of trade to an extent contrary to the interests of the Community.

2. When does State funding of the provision of a SGEI constitute State aid?

This has been a hotly debated issue since the Court's ruling in *ADBHU* in 1985.[183] Article 87(1) 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, insofar as it affects trade between Member States, be incompatible with the common market."

For the purposes of our discussion in this section, the key condition in Article 87(1) is that it must confer an "advantage" (*favouring).*[184] In *ADBHU*,[185] the ECJ had ruled that there was no advantage within the meaning of Article 87(1) of the EC Treaty if the relevant State measure merely compensated its beneficiary for burdens associated with the fulfilment of legitimate public service obligations. This ruling was consistent with the Commission's prior practice.[186] However, in its judgments in *FFSA*[187] and *SIC*[188], the CFI did not follow the opinion of the Commission and the ECJ. In *FFSA*, the CFI held that financial advantage granted to undertakings entrusted with the provision of public service obligations constitutes State aid, since it places those firms in a relatively more favourable situation than others. The same reasoning was followed in the *SIC* case. The CFI ruling in *FFSA* was appealed to the ECJ, which confirmed the reasoning made by the CFI.[189] The ECJ further confirmed this reasoning in its judgment in *France v. Commission*.[190]

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183 Case 240/83 Procureur de la République v Association de défense des brûleurs d'huiles usagées (ADBHU) [1985] ECR 531.

184 K. Bacon, "The Concept of State aid: The Developing Jurisprudence in the European and UK Courts," *European Competition Law Review*, 24(2) (2003).

185 *ADBHU*, op. cit.

186 A. Sinnaeve, "State Financing of Public Services: The Court's Dilemma in the Altmark Case," *European State aid Law Quarterly*, 3 (2003) , pp. 352 and 353.

187 Case T-106/95 Fédération française des sociétés d'assurances (FFSA) and others v Commission [1997] ECR 229.

188 Case T-46/97 *SIC v Commission* [2000] ECR 2125.

189 Case C-174/97P Fédération française des sociétés d'assurances (FFSA) and others v Commission [1998] ECR 1303.

190 Case C-332/98 *France v Commission* [2000] ECR I-4833.

However, rather surprisingly, the ECJ returned to its *ADBHU* doctrine in *Ferring*.[191] The case concerned the wholesale distribution of medicinal products in France. According to the French legislation, pharmaceutical laboratories, like Ferring, had to pay taxes on the sales of medicines to pharmacies. However, this tax was not levied on sales of medicines by wholesale distributors. The justification for this discrimination was that wholesale distributors were under the obligation to keep a full range and certain stock levels of medicines permanently available. The asymmetric tax was thus seen as a mechanism to restore the balance of competition between the various distribution channels. Ferring took the view that this tax mechanism amounted to a grant of State aid to wholesale distributors and challenged the State measure.

Advocate General Tizzano, in his Opinion in this case, stated:[192]

"[I]f the State imposes certain public service obligations on an undertaking, then covering the additional costs arising from the performance of those obligations confers no advantage on the undertaking in question, but serves, if anything, to ensure that it is not unjustly disadvantaged vis-à-vis its competitors. In other words the imposition of the obligation and the provision of compensation cannot be considered as separate matters as they are two sides of the same public measure which is intended, as a whole, to guarantee that public interests of primary importance are satisfied. If that is the correct analysis, the conclusion that must be drawn in the situation under consideration is that the measure taken by the public authorities ends up having an economically neutral effect on the undertaking concerned, which derives from it neither advantage nor disadvantage."

He thus concluded:[193]

"[P]ublic measures which are strictly necessary to offset the additional net costs arising from the performance of public service obligations do not constitute State aid within the meaning of Article 92(1) of the Treaty."

The ECJ adopted the views of Advocate General Tizzano and concluded that where a tax exemption granted to an undertaking entrusted with the operation of a public service simply offsets the additional net costs of that service, then the recipient does not enjoy State aid within the meaning of Article 87 of the EC Treaty. Conversely, the amount of the exemption that exceeds what is necessary to discharge the public service tasks constitutes State aid.

The reasoning of the ECJ in *Ferring* came under severe criticism in Advocate General Léger's Opinion in *Altmark*.[194] The case concerned a local bus company in Germany, Altmark Trans, which had been issued 18 licenses for regional passenger transport. In order to provide

191 Case C-53/00 Ferring SA v Agence centrale des organismes de sécurité sociale (ACOSS) [2001] ECR I 9067.

192 Opinion of Advocate General Tizzano, *delivered on 8 May 2001* in Ferring, op.cit., para. 61.

193 *Ibid.*, para. 63.

194 Opinion of Advocate General Léger, delivered on 14 January 2003 in *Altmark*, op.cit.

its services, Altmark received a subsidy from the German authorities. This was challenged by a competitor. The issue before the ECJ was whether compensation granted by a Member State to an undertaking entrusted with the provision of SGEI constitutes State aid.

Advocate General Léger sustained that whether or not there is a *net* advantage to the recipient is irrelevant, because what is required under Article 87 (1) of the EC Treaty is that there exists a *gross* advantage.[195] In his view,

"the advantages given by the public authorities and what the recipient has to contribute in return must be examined separately. The existence of the contribution is of no relevance for determining whether the State measure constitutes aid within the meaning of Article [87] (1). It comes into consideration only at a later stage of the analysis, for assessing whether the aid is compatible with the common market."

This long-standing debate has allegedly been resolved by the ruling of the ECJ in *Altmark*.[196] In its judgment, the ECJ set out four conditions under which compensation for SGEI does not constitute State aid:[197]

"First, the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined. [...]"

"Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings. [...] Payment by a Member State of compensation for the loss incurred by an undertaking without the parameters of such compensation having been established beforehand, where it turns out after the event that the operation of certain services in connection with the discharge of public service obligations was not economically viable, therefore constitutes a financial measure which falls within the concept of State aid within the meaning of Article 92(1) [now Article 87(1)] of the Treaty."

"Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations. Compliance with such a condition is essential to ensure that the recipient undertaking is not given any advantage which distorts or threatens to distort competition by strengthening that undertaking's competitive position."

195 *Ibid*., para. 34. See sections 3.3 and 3.4 below for a critical assessment of the test.

196 *Altmark, op.cit.*, paras. 33 and ff.

197 *Ibid.*, paras. 90-94.

"Fourth, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations."

In contrast, where compensation fails to comply with one or more of those conditions, it constitutes State aid within the meaning of Article 87(1) of the EC Treaty.[198]

The first three conditions jointly aim at ruling out overcompensation of the undertaking entrusted with the provision of SGEI subject to a public service obligation. The *first condition* seeks to ensure that Member States do not abuse their considerable autonomy in determining whether or not a particular service is to be classified as being of general economic interest. The undertaking in question has to be given an explicit mandate to operate the SGEI and this has to be clearly defined. Merely establishing any of the following is not sufficient for this purpose: (a) the public authority has given its approval or endorsement of the undertaking's operations;[199] (b) the undertaking operates an SGEI (without being entrusted);[200] and (c) the undertaking is subject to certain public service obligations that are not specific to its activities.[201]

The *second condition* states that the compensation plan must be established *ex ante* so as to ensure that the recipient undertaking will not be overcompensated. It also makes clear that any *ex-post* benefit exceeding the compensation established *ex ante* will be regarded as State aid.

The *third condition* prevents (intended or actual) compensation from exceeding the costs incurred in discharging a public service obligation, including the cost of capital (accounted for as a "reasonable profit").

The *fourth condition* essentially requires that the entrusted undertaking be efficient and stipulates two alternative methods for testing whether this is the case. First, the public service obligation is awarded on the basis of a public procurement procedure which would select the undertaking capable of offering those services at the "least cost" to the community. Alternatively, where no such public procurement mechanism is employed, the level of compensation should be based on the costs that would be incurred by a "typical well-run company".

As noted by Advocate General Jacobs in his Opinion delivered to the ECJ in *GEMO*,[202] prior to the ECJ's ruling in *Altmark,*

198 *Ibid.*, para. 95.

199 *Uniform Eurocheques*, OJ [1985] L35/43.

200 Case C-203/96 *Dusseldorp* [1998] ECR I-4075, para. 103.

201 *GEMA*, OJ [1971] L 134/15.

202 Opinion of Advocate General Jacobs, delivered on 30 April 2002, in Case C-126/01, *Ministre de l'économie des finances et de l'industrie v GEMO SA, OJ [2004] C 7/4.*

"at least at first sight it seems that the Community Courts' case-law on the correct approach [for the assessment of public service compensation under EC State aid law] is inconsistent."[203]

The Community case law reflects a conflict between two alternative approaches.

The State aid approach. Under this approach, the State resources employed to fund public service obligations qualify as State aid within the meaning of Article 87(1) of the EC Treaty. However, that aid may be found compatible with the Treaty pursuant both Article 87(3) and Article 86(2) of the EC Treaty if the relevant conditions are satisfied.[204]

The compensation approach. Under this approach, if the State resources received by the undertaking entrusted with the provision of a SGEI are merely compensation for the disadvantage resulting from that public service obligation, then that remuneration does not constitute State aid within the meaning of Article 87(1) of the EC Treaty.[205]

While in *ADBHU*[206] the ECJ relied on the compensation approach, both the ECJ and the CFI, respectively, followed expressly or implicitly the State aid approach in subsequent cases.[207] More recently, the ECJ judgment in *Ferring* marked a return to the compensation approach.[208]

This is not a scholastic debate. The adoption of one or another approach to the assessment of a public service compensation measure has significant practical implications. Under the compensation approach the measure need not be notified to the Commission and can be implemented without delay; the opposite is true under the State aid approach. Indeed, Advocate General Léger, in his *Altmark* Opinion,[209] objected to the compensation approach adopted in *Ferring* because, *inter alia,* it "*effectively removes measures for financing public services from the Commission's control*".[210] Furthermore, as noted by Advocate General Jacobs in *GEMO*.[211]

A generalised application of the compensation approach would make it less risky for Member States not to notify certain potentially harmful unilateral State financing measures and would thus create an incentive to conceal those measures from scrutiny by the Commission.
In contrast, under the State aid approach, the Member States would be obliged, pursuant to Article 88(3) of the EC Treaty, to notify funding of any SGEI and await the approval of the Commission prior to implementing such a measure. According to Article 88(3) EC, notifying Member States are subject to a standstill provision, which prohibits them from granting aid absent the express approval by the Commission. Violations of the standstill clause could result in sanctions being imposed by national courts (suspension or recovery of the aid, damages to

203 *Ibid.*, para. 96.

204 *Ibid.*, para. 94.

205 *Ibid.*, para. 95.

206 *ADBHU*, op.cit., paras. 16-21.

207 The ECJ applied the State aid approach in Case C-387/92 *Banco Exterior de España* [1994] ECR I-877, and the CFI in FFSA, op.cit., and Case T-46/97 SIC [2000] ECR II-2125.

208 Ferring, op.cit.

209 Opinion of Advocate General Léger, delivered on 19 March 2002, in *Altmark , op.cit.*.

210 *Ibid.,* para. 91.

211 Opinion of Advocate General Jacobs in *GEMO*, op. cit., para. 116.

competitors of the beneficiaries from the Member State concerned) and by the Commission (suspension or recovery injunctions).[212] Notification is a costly and time-consuming process,[213] which may have the effect of disrupting the provision of SGEI. But one should stress that this is also the case for other State aid measures taken in more urgent situations (such as for rescuing and restructuring firms in difficulty) and one can also question the ability of the public authorities to monitor well in advance the need for compensating any kind of SGEI.[214]

To make sense of the seemingly contradictory case law, Advocate General Jacobs recommended the adoption a *hybrid approach* – also called a *quid-pro-quo approach*[215] – to the assessment of public service compensation. This approach distinguishes between two different categories of cases according to (a) the nature of link between the funding and the public service obligation imposed, and (b) how clearly those obligations have been defined:[216]

"[The] first category would comprise cases where the financing measures are clearly intended as a quid pro quo for clearly defined general interest obligations, or in other words where the link between, on the one hand, the State financing granted and, on the other hand, clearly defined general interest obligations imposed is direct and manifest.[217]

The second category consists of cases where it is not clear from the outset that the State funding is intended as a quid pro quo for clearly defined general interest obligations. In those cases the link between State funding and the general interest obligations imposed is either not direct or not manifest or the general interest obligations are not clearly defined."[218]

The four *Altmark* conditions could be interpreted as a test to assess whether or not a given case belongs to the first category. The first condition requires a clear definition of the public service obligation in question. The second condition seeks to establish the existence (or absence) of a clear link between remuneration and the public service obligation, whereas the third condition is a first step to ensuring a *quid pro quo* between the Member State and the undertaking entrusted with discharging the public service obligation. The fourth condition provides for an additional safeguard vis-à-vis public service obligation contracts that have not been awarded on the basis of a public tendering procedure and are therefore, presumably, more susceptible to the possibility of conferring a selective advantage on the recipient. In other words, the third and fourth conditions ensure that the funding measures under consideration do indeed represent a *quid pro quo.*

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212 P. Anestis and S. Drakakakis (2006), *op.cit.*

213 A. Boyd and J. Teal (2004), *op.cit.*

214 See M. Merola and C. Medina, "De l'arrêt Ferring à l'arrêt Altmark : continuité ou revirement dans l'approche du financement des services publics", *Cahiers de droit européen*, 2003.

215 A. Sinnaeve (2003), *op.cit.*, pp. 355 and 356.

216 Opinion of Advocate General Jacobs in *GEMO*, op. cit., para. 118.

217 *Ibid.*, para. 119.

218 *Ibid.*, para. 120. Advocate General Jacobs points to Banco Exterior de España, *op.cit.*, as a good example for the second category. In that case, all Spanish public banks were tax-exempted; the underlying law, however, did not indicate that the tax exemption was intended to be a *quid pro quo* for the fulfilment of general interest obligations, nor did it define exactly any such obligations.

Whether or not this interpretation is accepted, it seems to us that the *Altmark* judgement represents at the very least a partial compromise between the so-called compensation and State aid approaches – i.e., between the gross and net theories of aid in the terminology of Advocate General Léger.[219] The funding of a public service obligation with State resources does not constitute State aid if the funds received by the undertaking entrusted with the provision of the SGEI do not exceed the costs that would be incurred by an efficient operator. Otherwise, even if the funds received by the undertaking do not exceed the losses incurred in the provision of the SGEI so that they are merely compensatory, they will be regarded as State aid and subject to the standstill provision.

3. Under which circumstances does State funding of SGEI that is State aid have to be notified?

According to Article 88(3) of the EC Treaty,

"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."

The Commission's Decision on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest sets out the conditions under which State aid to compensate entrusted undertakings for the provision of SGEI is to be regarded as "compatible with the common market and exempt from the requirement of notification laid down in Article 88(3) of the Treaty."[220]

The Decision, in line with the principles underlying the State aid Action Plan (SAAP),[221] aims at increasing legal certainty and minimise transaction costs for public funding which is unlikely to distort competition and/or impede the development of trade by exempting from the

219 Not everybody agrees with us though. For example, Sinnaeve considers that the ECJ judgment in *Altmark* "simply repeated the position it had taken in the Ferring case". A. Sinnaeve (2003), op.cit., page 356.

220 European Commission, "Decision on the application of Article 86(2) of the EC Treaty to State aid in the form public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest," Commission Decision 2005/842/EC, OJ [2005] L 312, p. 67, Article 1.

221 European Commission, "State aid Action Plan – Less and better targeted State aid: a roadmap for State aid reform 2005-2009," Consultation Document, Com (2005) 107, 7 June 2005. In the SAAP, the Commission has laid down a roadmap for the ongoing reform of European State aid control. The document emphasizes the need for State aid to reach the goals of the Lisbon Agenda, growth and jobs, and advocates a more efficient and better targeted use of state resources.

obligation to notify any form of public service compensation which falls within the following categories, namely:[222]

- public service compensation granted to undertakings with an average pre-tax annual turnover of less than €100 million during the two financial years preceding that in which the service of general economic interest was assigned to them, which receive annual compensation for the services of less than €30 million;
- public service compensation granted to hospitals and social housing undertakings carrying out services of general economic interest;
- compensation payments for air or maritime transport to islands with annual traffic that does not exceed 300,000 passengers in the two years preceding that in which the service of general economic interest was assigned to them; and
- compensation for airports and ports which have annual average traffic of 1 million passengers (for airports) or 300,000 (for ports) in the two years preceding that in which the service of general economic interest was assigned to them.

This exemption will apply only if the responsibility for operating the SGEI is entrusted to the undertaking by way of an official act specifying the nature and duration of the public service obligation, the nature and territory concerned, the nature of exclusive and special rights assigned to the undertaking, the parameters for controlling and reviewing compensation and the arrangements for avoiding and repaying overcompensation.[223]

The Decision also provides that the amount of compensation paid shall not exceed what is necessary to cover the costs incurred in performing the public service obligations, and it describes the costs, revenues, and "reasonable-profit" allowance to be taken into account.[224] The Decision further requires that Member States carry out regular checks for overcompensation.[225]

4. Under which circumstances will state funding of SGEI that is State aid be declared compatible with the Treaty?

Public service compensation meeting the criteria for applicability of Article 87(1) of the EC Treaty may be declared compatible with the Treaty under Article 86(2) of the EC Treaty. Article 86(2) states

"Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, insofar as the application of such rules does

222 European Commission, "Decision on the application of Article 86(2) of the EC Treaty to State aid in the form public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest," Commission Decision 2005/842/EC, OJ [2005] L 312, Article 2.

223 *Ibid.*, Article 4.

224 *Ibid.*, Article 5.

225 *Ibid.*, Article 6.

not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community."

The Community framework for State aid in the form of public service compensation (the 'framework' hereinafter) establishes the criteria for the assessment of state funding of public service obligations where (i) the *Altmark* conditions are not satisfied and (ii) the size thresholds set out in the above mentioned Commission Decision are exceeded, so that prior notification according to Article 88 (3) is required.[226] The Community framework is not applicable to compensation granted to undertakings in the transport sector or the public service broadcasting sector, respectively, as each of these are covered in sector-specific legislation and measure.[227]

According to the framework, public service compensation constituting State aid may be declared compatible with the Treaty under Article 86 (2) If it is necessary to the operation of the SGEI and does not affect the development of trade to such an extent as would be contrary to the interests of the Community.[228] This will be the case under three conditions, which essentially coincide with the first three *Altmark* conditions.

First, the undertaking must be entrusted with a genuine service of general economic interest within the meaning of Article 86(2) of the EC Treaty.[229]

Second, there must be an instrument (a legislative or regulatory act or a contract) specifying the nature of the public service obligations, the undertakings concerned and the nature of the special and exclusive rights assigned to the undertaking. The instrument must also set out the methods and parameters for calculating and reviewing compensation and for calculating a reasonable profit and the arrangements for the avoidance and repayment of overcompensation.[230]

Third, the level of compensation must not exceed what is necessary to cover the costs incurred in discharging the public service obligations (this may cover all variable costs, an appropriate contribution to fixed costs and an appropriate return on capital assigned to the service), taking into account the relevant receipts and reasonable profit (considering the risk or absence of risk incurred by the undertaking by virtue of the intervention of the state) for discharging those obligations. The accounts of the undertaking must distinguish between any separate services of general economic interest and other services.[231] As under the Decision, Member States must ensure that there is no over-compensation and require repayment on specified terms.[232]

226 European Commission, "Community framework for State aid in the form of public service compensation," OJ [2005] C 297/4.

227 *Ibid.*, para. 3.

228 *Ibid.,* para. 8.

229 *Ibid.,* paras. 9 and 10.

230 *Ibid.,* paras. 11 to 13.

231 *Ibid.,* paras. 14 to 19.

232 *Ibid.,* paras. 20 to 23.

5. Conclusion

Figures 1 and 2 below summarize the current Community framework for the assessment of State aid in the form of public service compensation.

Figure 1 provides a *decision tree* to decide whether a remuneration for the discharge of a given public service (i) constitutes State aid and, if it is, when (ii) it can be considered compatible with the Treaty. The first step assesses whether the remuneration constitutes State aid by considering the four *Altmark* conditions. The remuneration under consideration does not constitute State aid if all four conditions are met; no further procedure is required in this case. In contrast, if the relevant remuneration does not fulfil all four *Altmark* conditions, it constitutes State aid and the analysis proceeds to step two. In this step, the relevant question is whether the remuneration can be declared State aid compatible with the Treaty or not. If the first three *Altmark* conditions are met, the remuneration can constitute aid compatible with the Treaty, subject to a decision by the Commission declaring it compatible. If they are not fulfilled, one can conclude that the remuneration is State aid incompatible with the Treaty.

Thus, the fulfilment of only the first three *Altmark* criteria is a necessary and sufficient condition for the remuneration to be eligible for a declaration of compatibility, while failing to meet any of the first three conditions is a necessary and sufficient condition for a public service to constitute incompatible State aid.

Figure 1. The Community framework: a decision tree

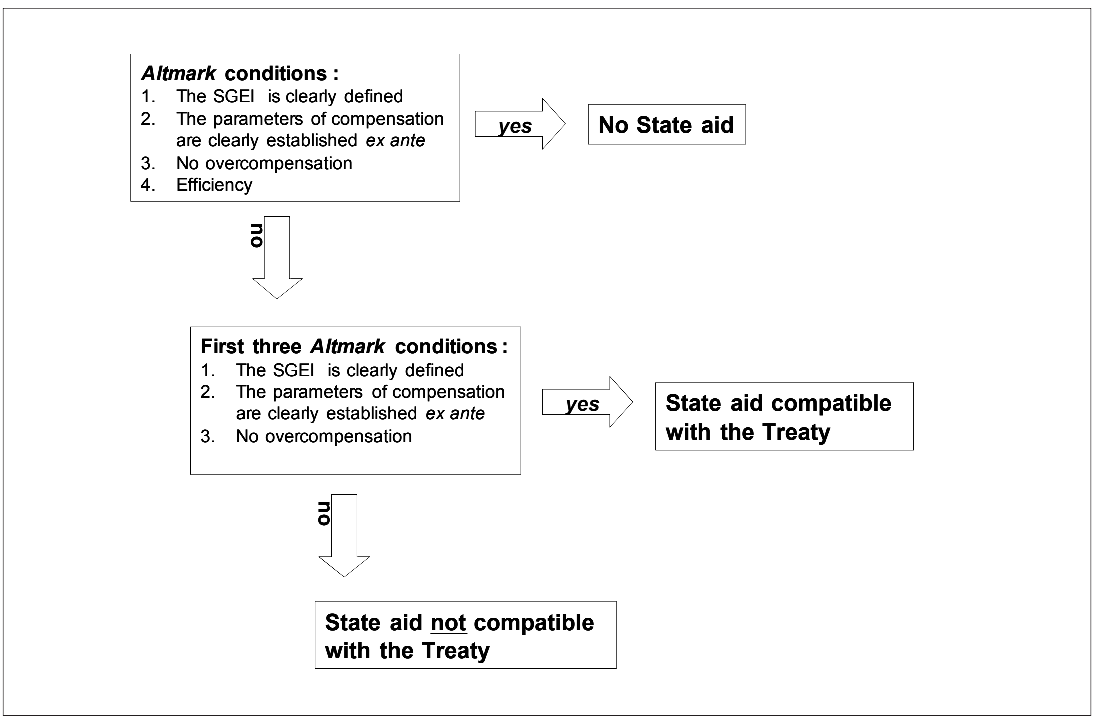
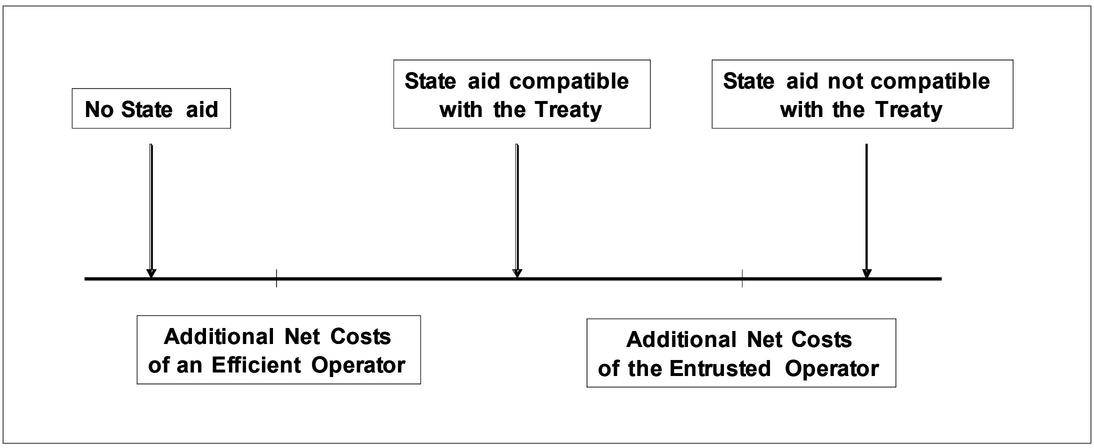


Figure 2 presents the two relevant cost thresholds for the application of Article 87(1) and Article 86(2) of the EC Treaty following the *Altmark* judgment and the Community framework. The difference between the cost threshold for an efficient operator and that of the entrusted operator represents the difference between fulfilment and non-fulfilment, respectively, of the fourth *Altmark* condition. Any compensation up to the additional net costs of an efficient operator does not constitute State aid (all four *Altmark* conditions are fulfilled). A compensation that is above the net costs of an efficient operator, but below or equal to the net costs of the entrusted operator represent State aid that is compatible with the Treaty (the first three *Altmark* conditions are fulfilled). A compensation that exceeds the cost of the entrusted operator constitutes State aid that is not compatible with the Treaty, since at least one of the first three *Altmark* conditions (in particular the third one) is not fulfilled.

Figure 2. The Community framework: the relevant thresholds



III. The logic and limits of the altmark test

In this section we consider the logic of the *Altmark* test from the viewpoint of an economic perspective. First, we explore the relationship between the *Altmark* test and the Market Economy Investor Principle. Then we assess the validity of the *Altmark* conditions under alternative policy goals, including consumer or total welfare. We conclude with a discussion of the practical pros and cons of the test.

1. Altmark and the Market Economy Investor Principle

Insofar as the four conditions in *Altmark* constitute a test of whether a public State measure establishing a compensation for the provision of a SGEI, they are intimately related to the Market Economy Investor Principle (MEIP). In fact, the MEIP "is a test of what the Treaty means by 'favour' in Article 87 (1)".[233] The *Altmark* test can thus be seen as an additional extension of the MEIP to the compensation of SGEI. According to the MEIP,[234]

"no aid is involved when the action of the State is in line with the hypothetical behaviour of a rational, profit driven investor, operating under normal market conditions."[235]

For example, in the case of a loan, the MEIP implies that the loan will only be considered State aid within the meaning of Article 87(1) of the EC Treaty if the compensation that the State receives in exchange for the loan is lower than what a private investor would have requested under such circumstances. Likewise, there will be State aid if the State purchases goods or services and the remuneration paid to the suppliers of those goods or services exceeds the market price.[236]

The same logic dictates that in the case of public service compensation for the provision of a SGEI there will be State aid whenever that compensation exceeds the remuneration that a rational, profit driven investor, operating under normal market conditions would pay. What a market economy investor would do is to search for and select as provider of the SGEI the firm which would be in a position to offer that service at the right level of quality and the lowest possible cost. Thus, according to the MEIP, there will not be State aid only when the recipient of the public service compensation is (a) not overcompensated and (b) efficient, which is precisely what conditions three and four of the *Altmark* test seek to ensure. Note, in particular, that the fourth *Altmark* condition, or efficiency condition, must hold for a public compensation measure to satisfy the MEIP.

2. An economic assessment

There is a long-standing debate concerning what should be the ultimate goal of State aid law.[237] The jurisprudence appears to be consistent with a "level playing field" or "effects-on-competitors" approach: a measure is not State aid if it leaves the market position of all competitors unchanged.[238] Economists, being bred as "utilitarian" creatures since the days of Bentham and the Classical economists,[239] have difficulties with this approach because, as we will see below

233 B. Slocock, "The Market Economy Investor Principle", *Competition Policy Newsletter*. DG Competition, (2002), p. 26.

234 Case 234/84 *Belgium v Commission* [1986] ECR 2263; Case 40/85 Belgium v Commission [1986] ECR 2321; and Case C-305/89 Italy v Commission [1991] ECR I-2459.

235 A. Sinnaeve (2003), op.cit., p. 352.

236 P. Nicolaides, "Competition and Services of General Economic Interest in the EU: Reconciling Economics and the Law", *European State aid Law Quarterly,* Vol. 2.2. (2003), p. 195.

237 See H. W. Friederiszick, L. H. Roeller and V Verouden (2005), *op. cit.*, Sections 5 and 6.

238 A. Biondi, 'State aid and obstacles to trade', in A. Biondi, P. Eeckhout and J. Flynn (eds), *EC State aid Law*, Oxford University Press, 2004.

239 Utilitarians evaluate the effects of public policy on social welfare in terms of whether the overall satisfaction of the households that are part of that society is raised or lowered. See J. Bentham, *Principles of Morals and Legislation,* London: Doubleday, 1791. See also R. W. Boadway and N. Bruce, Welfare Economics, Blackwell, 1984, chapter 3.

when evaluating the welfare impact of public service compensation, state measures which are found compatible with the market following the effect on competitors approach may prove welfare-reducing and vice versa.

Economists assess the effect of changes in market structure, in the pricing or non-pricing strategies of companies, or in government policy by looking at how those actions impact on social welfare. Sometimes, the welfare benchmark is consumer welfare (e.g., in merger control). Friederiszick, Roeller and Verouden argue that in the case of State aid, "*[t]here are good reasons to employ a welfare standard that takes explicitly into account consumer benefit and the effect on tax payers*".[240] But most often, economists employ as a benchmark total welfare, which is given by the sum of consumer surplus and industry profits. This analytical framework is also appropriate for the assessment of the economic effects of public service compensation.[241] This is the approach that we will follow in the remainder of this section. However, we will also make reference to the "modified" consumer welfare approach proposed by, *inter alia*, Friederiszick, Roeller and Verouden (2005) and Spector (2006).

Suppose that the provision of a given SGEI is entrusted to a particular undertaking, which we label R (for 'recipient'). The total welfare impact (ΔW) of a financial measure aimed at compensating that supplier under a public service obligation is given by the following expression:

$$\Delta W = \Delta\pi_R + \sum_{i \neq R} \Delta\pi_i + \Delta CS \quad (1)$$

where $\Delta\pi_R$ denotes the change in profits of the recipient, $\sum_{i \neq R} \Delta\pi_i$ is the total change in the profits of the competitors of the recipient in other markets, and ΔCS denotes the change in consumer welfare due to the State measure. In what follows, we will first analyse the impact of the State measure on the recipient's welfare and that of its competitors. Second, we will investigate the consumer and total welfare implications of that measure.

The change in profits of the recipient of the State funding $\Delta\pi_R$, which provides a measure of the financial "advantage" conferred by the State measure, can be decomposed into three terms. First, the provision of the SGEI involves some costs as well as some direct receipts. We denote as NC the additional net costs of discharging the public service obligation. Second, the recipient receives a financial compensation from the State, which we denote by F. Finally, the recipient may see its strategic position in the markets where it competes affected by the implementation of the public service obligation. We denote by S the financial impact of that strategic effect. We will refer to S as the "strategic advantage" enjoyed by the entrusted operator in what follows. In sum,

$$\Delta\pi_R = (F - NC) + S. \quad (2)$$

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240 H. W. Friederiszick, L. H. Roeller and V Verouden (2005), op. cit., page 36. A similar position is taken by D. Spector "L'économie politique des aides d'État et le choix du critère d'appréciation,“ *Concurrences,* 2006.

241 A. J. Padilla, "Efficiencies in Horizontal Mergers: Williamson Revisited," in W. D. Collins (ed.), *Issues in Comptition Law and Policy*, American Bar Association, forthcoming 2007.

The difference between compensation F and net cost NC represents the overcompensation *(OC)* from the State to the provider of the SGEI. It is useful to decompose *OC* into two elements. To this end, we define the net cost of the (most) efficient provider of the SGEI as $\underline{NC}$, and express *OC* as $(F - \underline{NC}) - (NC - \underline{NC})$.[242] The first term, $(F - \underline{NC})$, measures the extent to which the State funds, *F*, would overcompensate an efficient provider of the SGEI, whereas the second element, $(NC - \underline{NC})$, constitutes the efficiency loss *(EL)* resulting from the selection of an inefficient provider.

Equation (2) can be rewritten as,

$$\Delta\pi_R = [(F - \underline{NC}) - (NC - \underline{NC})] + S \tag{3}$$

The four *Altmark* Conditions are readily interpreted within the framework of Equation (3): *Altmark* Conditions 1 and 2 require that *F* and *NC* are clearly specified; *Altmark* Condition 3 requires that *OC* (=$[(F - \underline{NC}) - (NC - \underline{NC})]$) be zero; and Altmark Condition 4 requires that the efficiency loss *EL* (= $NC - \underline{NC}$) also be zero. As explained above, the current Community framework for the assessment of State aid in the form of public service compensation disregards *Altmark* Condition 4; provided that there is no overcompensation (i.e., *OC* equal to zero), State aid will be declared compatible with the EC Treaty even if it entails an efficiency loss (*EL* > 0). Note, finally, that neither the current Community framework nor the *Altmark* test give any consideration to the sign and magnitude of the strategic effect, *S*.

This effect will be positive or negative depending on various factors. For example, it will take a positive sign if the mandate to provide the SGEI helps the entrusted undertaking to exploit economies of scope – e.g., production for the (unprofitable) public service market may lower the production costs in another market – or enjoy demand externalities – e.g., if the existence of low-valuation users in the public service market increase the demand for the more lucrative products that are also provided by the entrusted undertaking. S may also be positive because of the positive signalling and reputational effect that the award of the government contract may have. In contrast, *S* will be negative if the public service obligation entails the use of a scarce resource which is essential for production in more lucrative markets. The actual sign of *S* is, in any event, quite difficult to predict.[243]

From Equations (1) to (3), we can derive the following results:

Proposition 1. Public State measures aimed at compensating a firm entrusted with the provision of a SGEI will confer an advantage to the recipient if the level of the compensation *F* exceeds the difference between the additional net costs arising from the performance of the public service obligation and the financial impact of the change in the strategic position of the entrusted undertaking in adjacent markets; i.e., if $F > NC - S$ (or, equivalently, $\Delta\pi_R > 0$).

242 Note that this expression is equivalent to $F - NC$.

243 Opinion Prepared by the State aid Group of EAGCP on Services of General Economic Interest, 29 June 2006, p. 4.

Thus, the recipient of a public State measure will obtain an advantage if (i) the level of compensation exceeds what is strictly necessary to offset the additional net costs of providing the SGEI and/or (ii) the public State measure in question improves the position of the entrusted undertaking vis-à-vis its competitors in adjacent markets. Note that, even when S equals zero, a level of compensation that exceeds the additional net costs of providing a service may distort competition in the presence of imperfect capital markets,[244] because (a) it may provide the entrusted operator with funds to invest in R&D, capacity expansion, or other projects, which will not be available to competitors; and (b) it may help the recipient to remain in the market even if its considerably less efficient than its competitors.

Corollary 1. A public State measure which strictly offsets the additional net costs arising from the performance of a SGEI (i.e., $F = NC$) will confer an advantage to the recipient if and only if $S > 0$.

Under the *Altmark* test, the level of compensation must not exceed what is necessary to cover the additional net costs incurred in discharging the public service obligations efficiently. That is, $(F \leq \underline{NC})$. Then, from Proposition 1 and Corollary 1 we obtain:

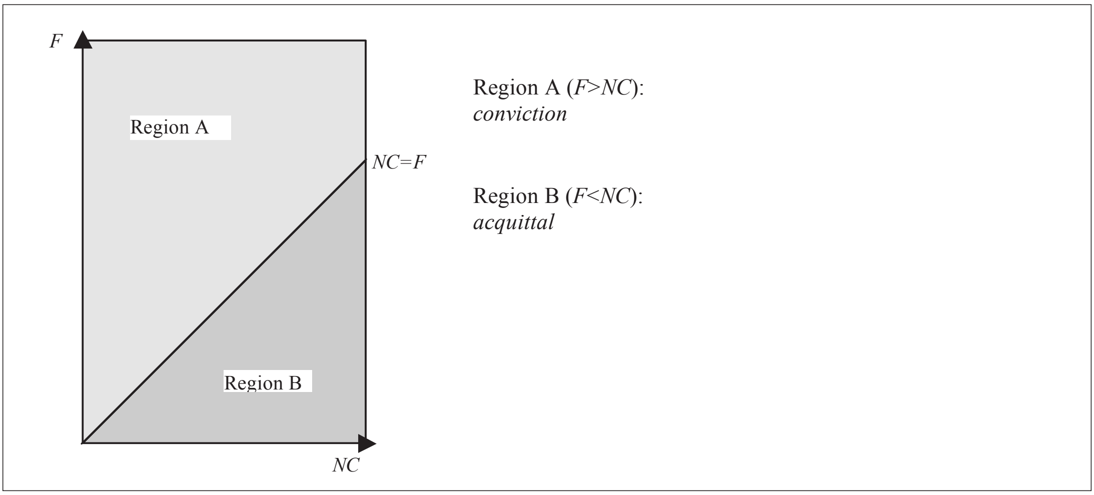
Corollary 2. If the strategic advantage resulting from the public service compensation measure, S, is zero or negative and the level of compensation F satisfies Condition 3 of the *Altmark* test, then the public State measure will not confer an advantage to ('overcompensate') the recipient of those funds. In other words, if $S \leq 0$ then the *Altmark* test provides a *sufficient condition* for the public State measure not to confer an advantage within the meaning of Article 87(1). However, it provides a *necessary* and *sufficient condition* for the public State measure not to confer an advantage within the meaning of Article 87(1) only when $S = 0$.

This is shown in Figure 3a. The level of compensation F is depicted on the vertical axis, while the additional net costs of discharging the obligation are represented on the horizontal axis. On the ascending 45 degree line, the compensation F equals the net costs NC. The region above the line (Region A) describes the situation where F is greater than NC and where the *Altmark* test correctly convicts a given policy. In the region below the line (Region B), the compensation does not cover the net costs and the *Altmark* test acquits a policy of this type.

In plain words, the *Altmark* test provides a valid benchmark to distinguish between financial measures conferring an advantage from those that do not, *only when* the financial impact of the change in the strategic position of the entrusted operator in markets adjacent to the public service market, S, is zero.

244 *Ibid.*, p. 5.

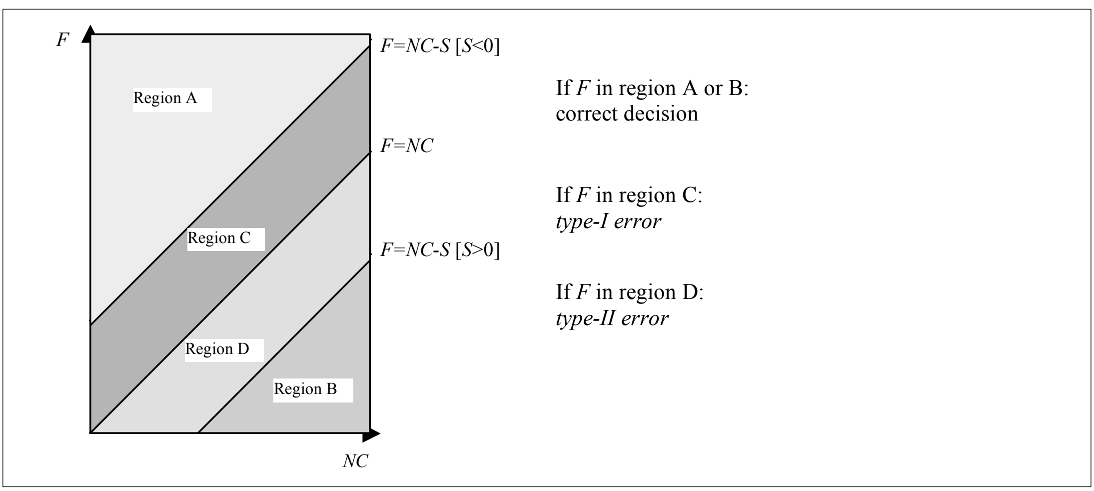
Figure 3a: The *Altmark* test in the absence of strategic effects (S = 0)



However, as noted above, it is nearly impossible to predict what the sign of S will be in general. Even in the context of a case-by-case analysis, ascertaining what will be the sign, let alone the magnitude, of S may prove too difficult. So we cannot exclude that in some instances $S \neq 0$, in which case the *Altmark* test may not provide the right answer as regards the existence of an advantage.

When S is different from zero, F lying above the $F = NC$-line should no longer be automatically lead to a finding of an advantage being conferred, and likewise, F lying below the $F = NC$-line should no longer be automatically lead to the finding of no advantage being conferred. Unfortunately, this is precisely what happens under the *Altmark* test, as is illustrated in Figure 3b below.

Figure 3b. The scope for errors of the *Altmark* test



The *Altmark* test delivers the correct results if the compensation F is either in Region A or Region B. If F exceeds the net costs NC plus the cost of an eventual strategic disadvantage ($S < 0$), as in Region A, the *Altmark* test will correctly assert that the measure confers an advantage. Similarly, if the compensation F is smaller than the net costs NC minus the benefits of the strategic advantage (Region B), the test correctly holds that there is no advantage.

Region C and Region D describe the situations where the *Altmark* test may cause errors. When the level of compensation F exceeds NC but is lower than the sum of NC and the eventual cost of a strategic disadvantage, the test will cause a type-I error. That is, it will conclude that there is an advantage when there is none. Instead, when F is lower than NC, but higher than the sum of NC and an eventual benefit of a strategic advantage ($S > 0$), the *Altmark* test will cause a type-II error. That is, it will conclude that there is no advantage when there is one. The *Altmark* test's shortcoming is that it uses NC instead of NC-S as the benchmark for F. Whether this is a serious problem or not depends on the magnitude of S. In our opinion, S cannot be presumed small; among other reasons because a government may entrust an operator with a SGEI with the objective of tilting the competitive balance in adjacent markets to the benefit of the entrusted operator.

Most importantly, from Equation (1) we have that the overall welfare impact of a public financial measure aimed at compensating a firm under a public service obligation does not only depend on whether this confers an advantage to the recipient, but it also depends on its *net external effect* (NEE):

$$NEE = \sum_{i \neq R} \Delta\pi_i + \Delta CS \tag{4}$$

That is, on its impact on consumer welfare as well as on the profits of the competitors of the entrusted operators. Economic theory suggests that in general this last effect will be negative when the financial measure confers an advantage on the recipient, and vice versa.[245] That is,

$$\Delta\pi_R > 0 \Rightarrow \sum_{i \neq R} \Delta\pi_i < 0 \text{ and } \Delta\pi_R < 0 \Rightarrow \sum_{i \neq R} \Delta\pi_i > 0\,. \tag{5}$$

From (5) it is clear that a test like the *Altmark* test, which identifies whether or not a public State measure confers an advantage on the recipient, is useful to determine whether that measure has an adverse impact on the competitors of the recipient of the public service compensation. More formally,

245 However, there may be exceptions to this rule as a matter of theory. For example, suppose that the entrusted operator operates under limited liability. Suppose further that it is financially weak and there is a likelihood that it will fall in financial distress. In that case, the entrusted operator may price aggressively in order to avoid falling into financial distress and incurring in the costs of reorganisation. If the compensation for the provision of the SGEI is large enough to reduce the likelihood of financial distress, then the entrusted operator may increase prices. As a result, both the SGEI operator and its competitors will be better off.

Proposition 2. If $S = 0$, then the *Altmark* test provides a *sufficient condition*[246] for the public State measure not to cause an adverse effect on competitors' profits, i.e., to preserve the "level playing field".

However, as is well known, a measure that has an adverse impact on competitors need not distort competition. Assessing whether a public State measure distorts competition requires investigating the impact of that measure on consumer welfare as well.

Economic theory is less clear regarding the sign of the impact on consumer welfare, ΔCS. On the one hand, some consumers will benefit because the public service obligation gives them access to products and services to which they not have access otherwise, or would only be able to obtain at higher prices or lower quality. Furthermore, they may also benefit from lower prices in markets other than the public service market if, as a result of the public State measure, the recipient engages in more aggressive pricing. On the other hand, consumers may end up being worse off in the long term if the adoption of the public State measure allows the recipient to exclude more efficient competitors and achieve market power in other markets.

In sum, the net external effect of a public financial measure aimed at compensating a firm under a public service obligation, like the net external effect of a horizontal merger,[247] may be positive or negative. Determining the size of this effect requires a case-by-case analysis.

Proposition 3. The overall welfare impact of a public financial measure aimed at compensating a firm under a public service obligation may be positive even when that measure confers an advantage to the recipient (i.e., $\Delta\pi_R > 0$). A *sufficient condition* for that to be the case is that $NEE = \sum_{i \neq R} \Delta\pi_i + \Delta CS > 0$, which in turn requires that (a) the public State measure benefits consumers (i.e., $\Delta CS > 0$) and (b) the positive impact on consumers exceeds the negative effect on rivals, (i.e., $\Delta CS > \left|\sum_{i \neq R} \Delta\pi_i\right|$).

Thus, according to Proposition 3, a public State measure may fail the *Altmark* test and yet have a positive effect on total welfare.

Proposition 4. The overall welfare impact of a public financial measure aimed at compensating a firm under a public service obligation may be negative even if that measure confers no advantage to the recipient (i.e., $\Delta\pi_R \leq 0$). A *sufficient condition* for that to be the case is that $NEE = \Delta CS + \sum_{i \neq R} \Delta\pi_i < 0$.

That is, a public State measure may pass the *Altmark* test and yet have a negative welfare effect. Taking Propositions 3 and 4 together, we conclude that the *Altmark* test provides no useful indication of the overall welfare effect of a public financial measure aimed at compensating a firm under a public service obligation, as it may cause both false convictions (type-I errors) and false acquittals (type-II errors). Furthermore, these two propositions question the existing practice, which appears to assume that distortions of competition are necessarily

246 The reason for this being a sufficient condition only is that, as noted in the previous footnote, there are circumstances when $F > NC$ and competitors are better off.

247 J. Farrell and C. Shapiro, "Horizontal Mergers: An Equilibrium Analysis," *American Economic Review*, Vol. 80(1) (1990).

present when the measure confers an advantage and is selective, that is when the market position of the recipient vis-à-vis its competitors is improved by the measure.[248]

A similar result would obtain if, instead of using a total welfare approach, we relied on the modified consumer welfare approach proposed by Friederiszick, Roeller and Verouden (2005) and Spector (2006):

$$\Delta CS - \eta(F), \tag{6}$$

where the second term represents the welfare cost of the taxes needed to fund F. We can easily show that:

Proposition 5. The impact of a public financial measure aimed at compensating a firm under a public service obligation on the modified consumer welfare measure in (6) may be negative even if that measure confers no advantage to the recipient (i.e., $\Delta\pi_R \leq 0$). This will be the case either if (i) the public State measure makes consumers worse off (i.e., $\Delta CS < 0$), or (ii) the positive impact on consumers is smaller than the tax distortion, (i.e., $\Delta CS < \eta(F)$ at $F = NC - S$).

Note in conclusion that the criticisms to the *Altmark* test in this section extend automatically to the MEIP and, more in general, to any assessment of whether a State measure constitutes State aid that assumes that the fact that such a measure confers an advantage necessarily implies that it also distorts competition.

3. The Altmark test in practice

While the first condition of the test is reasonably easy to implement in practice, the other three conditions involve substantial difficulties. Concerning the second and third conditions, the calculation of the additional net costs resulting from a public service obligation represents a significant technical challenge. Furthermore, the *Altmark* test remains silent about what a "reasonable profit" would be. This challenge is however no different from the challenged posed by the application of the MEIP in general.[249]

The most complex condition from a practical viewpoint is the fourth. This is for two reasons. First, in many, if not all, cases involving SGEI where a public procurement mechanism is not employed there may be no hypothetical efficient reference company available. Note, however, that, as noted by the ECJ in *Chronopost*,[250]

248 See H. W. Friederiszick, L. H. Roeller and V Verouden (2005), *op.cit.* See also Nicolaides (2005), op.cit.

249 See, for example, H. W. Friederiszick and M. Troege, "Applying the MEIP to State Owned Companies – Lessons Learned from the German Landesbanken Cases", *Competition Policy Newsletter,* (2006).

250 In that regard, one could consider Altmark and Chronopost as complementary: Altmark as indicating a *general approach* for SGEI measures and Chronopost as applying, to all kind of State aid measures (and not only compensation for SGEI), a specific approach where the beneficiary has no actual competitor for the service or product at stake. For further discussion, see A. Bartosch, "Clarification or Confusion? How to reconcile the ECJ's rulings in Altmark and Chronopost", European State aid Law Quarterly, 2003.

"in the absence of any possibility of comparing the situation of [the entrusted undertaking] with that of a private group of undertakings not operating in a reserved sector, normal market conditions, which are necessarily hypothetical, must be assessed by reference to the objective and verifiable elements which are available. In the present case, the costs borne by [the entrusted undertaking] in respect to the provision to its subsidiary of logistical and commercial assistance can constitute such objective and verifiable elements".[251]

Second, economic theory shows that identifying a public procurement procedure "which would allow for the selection of the tenderer capable of providing those services at the least cost to the community" is not an easy task. On the one hand, the ECJ has not clarified what "the least cost to the community" means. On the other, no typical tender mechanism guarantees an efficient outcome in all circumstances.[252] An open tender may facilitate collusion and bias the selection process in favour of the incumbents.[253] A sealed-bid auction instead may not guarantee sufficiently aggressive bidding due to, inter alia, the "winner's curse".[254] Moreover, in general, public tenders may not be capable of removing economic rents when the number of bidders is too small. Though strictly correct from an economic theory perspective, this last criticism may go too far from a pragmatic viewpoint. After all, if all SGEI were allocated via open and non-discriminatory public procurement procedures, most concerns in this area will vanish.[255]

IV. An Assessment of the structure of the community framework

As we saw in section II.4 above, a public State measure aimed at compensating an undertaking for the provision a SGEI which (i) satisfies the first three conditions of the *Altmark* test but (ii)

251 Joined Cases C-83/01 P, C-93/01 P and C-94/01 P *Chronopost and Others*, OJ [2003] C 200/4, para. 33 and ff.

252 See for an overview of auction theory P. Klemperer, "Auction Theory," *Journal of Economic Surveys*, Vol. 13 (1999); P. Klemperer, "What Really Matters in Auction Design," Journal of Economic Perspectives, Vol. 16 (2002); P. Klemperer, "Auctions: Theory and Practice," Princeton University Press, Princeton, US(2004); P. Klemperer, "The Economic Theory of Auctions (ed.)," Edward Elgar (pub.), Cheltenham, UK (2000). See also S. Santamato and N. Pesaresi (2004), op.cit.

253 Paul Klemperer has compared the outcome of 3G auctions in Europe and explained the relative low auction prices in some countries with the use of an open bid ascending auction that is susceptible to to collusive bidding and that had a deterrent effect on entrants who were not active in the (2G) mobile market before. See P. Klemperer, "How (not) to run auctions: the European 3G telecom auctions," European Economic Review, Vol. 46 (2002).

254 The "winners' curse" is a phenomenon that occurs in auctions where the value of the good is roughly equal to all bidders and where the latter have imperfect information on the true value. The winner of a (sealed bid) auction learns that his estimate of the true value was much higher than the other bidders' estimates, making him regret his high bid. The bidders will therefore bid only cautiously for a common value good in a sealed bid auction.

255 In fact, as suggested by Damien Neven in his discussion during the GCLC Third Annual Conference on State aid held in Brussels on 21/22 September 2006, under some conditions a public procurement procedure would ensure that the level of compensation equals $\underline{NC} - S$, thus solving the problem identified in Proposition 1 and Corollaries 1 and 2.

fails to meet the fourth condition qualifies as State aid *but* is nonetheless regarded as compatible with the Treaty according to the *lex specialis* of Article 86(2) of the Treaty.

This framework is problematic from a welfare (utilitarian) perspective. It follows immediately from Propositions 3 and 4 in Section 3.2 that a public service compensation which is compatible with the Treaty according to the Community framework in the sense that it does not result in overcompensation may still cause a distortion of competition (i.e., a reduction in overall total welfare or in consumer welfare). The opposite is also true.

Furthermore, the framework raises a big puzzle. How can the adoption of a public service compensation measure that fails the efficiency condition in *Altmark* be regarded "proportionate" and, therefore, compatible with the Treaty? From an economic perspective, such a measure does not appear to be proportionate *unless* the State can demonstrate that (a) there is *de facto* no other undertaking to be taken as a standard for comparison, or (b) it has no flexibility in the selection of the entrusted undertaking. However, in practice, that standard of proof in case (b) may be hard to meet: even when the State may be forced *de facto* or *de iure* to award the provision of a SGEI to a given undertaking, it still may have the option to require subcontracting the provision of that service to an efficient operator. This issue requires further debate.

V. Concluding remarks

In this paper we have reviewed and critically assessed the current Community framework on the application of Articles 87(1) and 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of SGEI. We have summarised the case law and explained in some detail the *Altmark* test. We have also discussed the logic and limits of this test from an economic perspective.

We have concluded that while the *Altmark* test and the soft law provisions published by the Commission in November 2005 have contributed to clarify the law with respect to the compensation of SGEI, they do not appear to be justified from a welfare economics perspective. That is, a public State measure found compatible with the Treaty under the current framework may still be distortionary, i.e. welfare-reducing.

We have also noted that the conditions laid out in the Community framework for the treatment of State aid in the form of public service compensation may lead to a finding that a certain State measure is compatible with the Treaty when it is neither necessary nor proportionate *stricto sensu*. At the very least the State granting the aid should justify why it has to pay for the provision of the SGEI more than what a rational, private driven market operator would do. A consistent application of EC State aid law may require that, absent such motivated explanation, any measure failing the fourth condition, or efficiency condition, in *Altmark* were regarded incompatible with the Treaty.

An economic approach to the assessment of compensatory aid measures would require abandoning the formalism of the current rules so as to adopt an *effects-based framework*, where each measure is analysed on a case-by-case basis in terms of its effects on total welfare (or, according to other authors,[256] consumer welfare). However, an effects-based framework may be difficult to implement and may have a negative impact on legal certainty. So, any moves in that direction should be carefully considered. That, however, is a terribly difficult, albeit important, issue which exceeds the scope of this paper. The debate concerning the treatment of compensation for the provision of SGEI from the viewpoint of State aid law is not concluded and may well prove another fascinating *never ending story*.

256 H. W. Friederiszick, L. H. Roeller and V Verouden (2005), *op.cit*.

Transfer of State resources

Pierre Kirch, Olivier d'Ormesson, José Wenceslao Rodriguez Curiel*

I. Introduction

Under classic State aid analysis, a measure may be deemed to constitute State aid where it may be characterized by the following four features: (i) transfer of public resources to one or several beneficiary undertakings, (ii) free economic advantage without consideration (or an economic advantage granted without sufficient consideration being paid by the beneficiary); (iii) selective nature of the measure amongst undertakings in such way as to distort competition; (iv) effect on trade between the Member States. Although there are some variations in the presentation of this four-pronged approach (which is also sometimes presented as a three-pronged approach) in Commission decisions and the case law as well as in scholarly writing, the reference to aid "*granted by a Member State or through State resources in any form whatsoever*" is consistently presented in the same way since the wording itself is to be found in the text of Article 87(1) EC. For this reason, it is generally included as the first of the four cumulative criteria in the determination of whether an individual measure may be characterized as State aid[257]. Moreover, the reference in the text of Article 87(1) EC to "*State resources*" should be understood as encompassing any and all "*public*" resources, as this concept has been defined by the Commission in its decisional practice and by the European Courts (this is true of State aid criteria in general). Thus, in the interest of accuracy, reference is made in this paper to "*public resources*".

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257 As an example of where the Commission did not follow the usual order of the four cumulative criteria which gave rise, according to the Court of First Instance to certain problems of comprehension of the decision, see Court of First Instance ruling of January 18, 2005 in case T-93/02, *Confédération national du Crédit mutuel v Commission*, [2005] ECR II-143.

The consideration of how to interpret the rules on State aid in light of a "*more refined economic approach*" is a different matter. Much has been written about the "*more refined economic approach*" advocated by the Commission in its State Aid Action Plan, issued on June 7, 2005. However, as of the present, little or nothing has been said about how economic analysis might lead to an enrichment of the concept of "public resources" or even a restatement of the concept in line with economic principles.

On November 18, 2005, in the framework of State aid reform analysis, the Commission's Chief Economist and his team published a working paper entitled, "*European State aid control: an economic framework*". This study of more than 50 pages includes a short section entitled, "Jurisdiction – the legal definition of State aid". According to the Chief Economist and his team, there are three areas in which economic analysis can play a role in the definition of State aid (i.e. "determination of jurisdiction") (p. 5):

– "First, economic analysis is relevant for establishing the extent to which an aid measure confers an economic advantage to the recipient of the aid"
– "Second, economic analysis has a potential role to play in determining whether a measure is 'selective' or not"
– "Third, economic analysis may be relevant in analyzing whether the selectivity of the aid translates into actual or likely distortive effects on competition or trade"

The Chief Economist and his team make no mention of transfer of public resources in such economic approach. Indeed, on the basis of the Chief Economist's three-point approach, one might be tempted to conclude that economic analysis has no role to play in the determination of whether there has been a transfer of public resources and that such determination is only factual and legal from an analytical point of view.

Such formalistic position is manifestly limited in its approach to the economic issues deriving form the definition of State aid.

A first area of analysis derives from the extension of the concept to encompass imputabilty issues. Indeed, in light of the imputability test initially set out in the Court's ruling of December 12, 1996, in the *Air France* case[258], then clarified in the Court's ruling of May 16, 2002, in *Stardust Marine*[259], and confirmed in the *Pearle* ruling of July 15, 2004[260], the issue arises whether a refined economic analysis could provide a contribution to the clarification of imputability concepts.

In the same way, and as a second area of analysis, the Commission has extended the concept of transfer of public resources to the case of unremunerated irrevocable guarantees granted by the public sector in favor of undertakings as well as commitments of support which the Commission seems to equate with guarantees. Following the *Landesbanken* case (judgment

258 Case T-358/94, Compagnie nationale Air France v Commission. [1996] ECR II-02109.
259 Case C-482/99, *French Republic v Commission*, [2002] ECR I-4397.
260 Case C-345/02, *Pearle BV v Hoofdbedrijfschap Ambachten*, [2004] ECR I-7139, point 35.

of March 6, 2003)[261], the Commission in its decision of August 2, 2004 in *France Telecom*[262], extended the same type of guarantee analysis to public declarations which could commit and thus jeopardize State resources to the extent that, even where the State were not legally bound to support an undertaking on the basis of public declarations (which, in and of themselves, are not to be characterized as State aid), investors could be led to act in favor of the undertaking concerned on the belief that the State would honor its word, in such way that a de facto irrevocable guarantee had been created with regard to market operators. This latter case does involve economic analysis, since the Commission is saying, in summary, that the State may grant State aid by creating a factual situation which would lead the private sector (investors, lending banks) to create a more favorable economic environment for the undertaking than would be the case in the absence of creation of such factual situation.

In this context, it is proposed to analyze the contributions and limits of the economic analysis to the transfer of public resources test in light of two distinct approaches:

- The economics of the imputability test in the use of public resources;
- The economics of Government declarations tantamount to an irrevocable guarantee and the effect of such declarations on market expectations.

II. The Economics of the imputability test in the use of public resources

The concept of public resources is defined in such a way as to be broad enough to cover all State measures that may have a negative impact on competition without excessively encroaching upon the competence of public authorities and their liberty to define public policy. Through the evolution of the case law, the concept of public resources has crystallized under two purely legal concepts: (i) the use of public funds, (ii) in a way which is imputable to the State or another public body. These two ideas are examined through the prism of an economic analysis.

1. Public resources: the use of public funds

Public resources are, first of all, public funds. The Court has stated that public resources cover "*all the financial means by which the public authorities may actually support undertakings, irrespective of whether or not those means are permanent assets of the public sector*"[263]. The traditional approach of the concept of public resources is therefore based on purely legal criteria (funds that belongs to the public sector) and is extremely broad. It covers not only the

261 Joined cases T-228/99 and T-233/99, *Westdeutsche Landesbank Girozentrale and Land Nordrhein-Westfalen v Commission*, [2003] ECR Page II-00435.

262 Commission Decision 2006/621/EC of 2 August 2004 on the State Aid implemented by France for France Télécom, OJ L. 257/11/.

263 Case C-482/99, *French Republic v Commission*, [2002] I-4397, at point 37.

centralized authority of a country, but also regional and local authorities and publicly owned companies.

In addition, the form of the aid does not matter, as long as it implies the direct or indirect use of public funds: not only financial transfers but also the foregoing of revenues may constitute State aid once their public origin has been proved.

On the other hand, the Court has concluded that where only private undertakings are at stake, there could not be any State aid, even if a selective advantage has been created by law. The landmark *PreussenElektra* judgment[264] is a good example of that point.

PreussenElektra AG was an electricity supplier which operated more than 20 conventional and nuclear power stations in Germany. Schleswag AG, a regional electricity supplier partially owned by PreussenElektra, was obliged by a governmental statute to purchase electricity from renewable sources produced at minimum prices within its area of supply. According to the same statute, PreussenElektra, as the upstream network operator, was "*obliged to reimburse the electricity supply undertaking in respect of the supplementary costs*"[265] resulting from the purchase of electricity from renewable sources. In 1998, Schleswag therefore invoiced PreussenElektra for the additional costs entailed by the purchase of electricity from renewable energy sources, but this was contested by PreussenElektra which claimed that such payment was contrary to the directly applicable provisions of the Treaty on State aid. The German court then referred the case to the Court of Justice for a preliminary ruling under Article 234 EC, asking whether the rules on payment and compensation for supplies of electricity laid down in the above-mentioned governmental statute constituted State aid for the purposes of Article 87 EC.

The Court held that the obligation imposed on private electricity supply undertakings to purchase electricity produced from renewable energy sources at fixed minimum prices does not involve any direct or indirect transfer of public resources to undertakings which produce that type of electricity[266]. There was, however, a selective advantage for the producers of electricity since, by law, they were to be paid at a price higher than the real economic value of that type of electricity.

The Commission criticized the narrow interpretation taken by the Court of Justice and Advocate General Jacobs on grounds that, if an action by a Member State could escape the State aid rules by meeting certain criteria, the Member States would naturally try to exploit that loophole. This may be true in some cases. For instance, suppose that a similar situation arose with Electricité de France ("EDF") instead of PreussenElektra. EDF is a public company. According to the definition of public resources, the price paid by EDF to the producers of electricity, on the basis of a law, would automatically become State aid.

The Court of Justice has analyzed a measure on legal criteria but irrespective of its practical "economic" effects in the market. As the effects of the measure become irrelevant in the absence of the other criteria, the Court has left no room, at this stage, for the economic analysis.

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264 Case C-379/98, *PreussenElektra AG v Schleswag AG*, [2001] I-2099.

265 *Id*, at point 10.

266 *Id*, at point 66.

However, such a measure does not become less anti-competitive merely by way of absence, strictly speaking, of public resources. Hence, a purely legal criterion which does not take into account any economic analysis may lead to two opposite conclusions (depending on whether the distributor is a public or private entity) while the economic effect of the aid to the producer remains the same. Would another approach be more satisfactory ? In this regard, one could argue that the legal analysis of public resources should be superseded to give more weight to a look at the underlying economic reality of a public measure, in the same way in which one analyses whether companies are private or public by looking at the underlying economic reality rather than legal form[267].

The opinion of Advocate General Marco Darmon, delivered on March 17, 1992 in the *Sloman Neptun AG* case, also merits to be mentioned here, since it sheds another light on these issues. Advocate General Darmon considered whether a measure designated to lessen the costs borne by certain undertakings may be classified as aid in the absence of any transfer of resources by a public body. After summarizing the pre-1992 case law, Advocate General Darmon used as a hypothetical example an extreme case where a public measure were to require individual consumers, workers, trading companies or any other category of private persons to pay certain sums to a given undertaking or a given sector of industry. Would this be State aid? According to Advocate General Darmon, the "public" nature of aid as set out in Article 87(1) EC relates more to the authority which has adopted the *measure* disrupting normal market conditions (the State or other public authority) than to the body or person which has financed the measure. Under the teleological approach of *Steinike and Weilig* (" regard must primarily, be had to the effect of the aid on the undertakings or productions favored")[268], there would be, according to Advocate General Darmon, "*no special need (...) to take into account the origin of the funds*[269]". He concludes on this point: "*Where an undertaking is favoured as a result of derogation arising from specific conduct by the State, regardless of the origin of the financing, the conditions of competition are affected and Articles [87 and 88] of the Treaty must then be applied"*.

Advocate General Darmon's position would seem to be that any public measure which had a selective impact on a market could be characterized as State aid, regardless of whether there was actual transfer of public resources. The logical conclusion could be in such case that the transfer of public resources criterion was unnecessary to the analysis. However, such approach would be dangerous, and this for several reasons. First, it would substantially alter the case law approach to the meaning of the words "*granted by a Member State or through State resources*" as set out in Article 87(1) EC. In terms of legal security, it could be *problematical* that *all public measures* could potentially be viewed as including some aid (if there were some measure of selectivity limited to the public measure). In such case, and in the absence of a transfer of public resources criterion within the traditional meaning, a "more

267 Case C-188/89, *Foster v British Gas*, [1990] ECR I-3313.

268 Case 78/76 *Steinike und Weinlig v Germany* [1977] ECR 595.

269 Opinion of Advocate General Marco Darmon, joined cases C-72/91 and C-73/91 *Firma Sloman Neptun Schiffahrts AG*, [1993] ECR I-887 at points 40 and 41.

refined economic approach" might indeed be used to demonstrate selectivity and thus State aid. Secondly, as pointed out by Advocate General Francis Jacobs in his opinion in the *PreussenElektra* case, an overly-extensive understanding of the concept of financing through public resources could bring a vast amount of legislation regulating the relations between enterprises within the scope of the State aid rules. To this observation, Advocate General Jacobs added in his opinion: "*It would have an absurd result in that a Member State would probably have to exempt the publicly owned undertakings from the obligation affecting the other undertakings in order to comply with the State aid rules. That would obviously distort competition between the different types of undertakings on the financing side of the measure. Those considerations might explain why the Court emphasized in* Ecotrade *and in* Piaggio *that the State or public bodies should be the principal creditors or be among the chief creditors of the undertaking in difficulty*[270] ". In this context, it may be considered that a traditional legalistic application of the transfer of public resources criterion constitutes a buffer to mark as clearly as possible, in the vast majority of cases, the frontier between the State aid rules and the rights of Member States when they act in a fully sovereign capacity.

2. State resources: the imputability test

As the definition of public funds might be too broad, the other landmark case, *Stardust Marine*[271]*,* added the concept of imputability to narrow down the range of situations where there could be State aid. Indeed, as explained above, any measures taken by public undertakings which result in aid being granted will fall within the scope of Article 87 (1) EC. Nevertheless, even a public undertaking may act with more or less independence, according to the degree of autonomy accorded to it by the State.

Stardust Marine was a company specialized in yacht chartering and management services. In the 1990s, Stardust Marine made substantial losses over several years. The Crédit Lyonnais group, at that time a publicly-owned bank, had helped Stardust Marine via its subsidiary SBT-Batif and this through a series of loans, loan guarantees and injections of risk capital. The Commission, following a complaint from a competitor, considered that these facilities constituted State aid and ordered their repayment since the assistance to SBT-Batif "*was not consistent with the normal actions of a private investor operating under market economy conditions*"[272].

The Commission decision was quashed by the Court of Justice which stated that, for an advantage to be able to be categorized as aid within the meaning of Article 87 (1) EC, it must be imputable to the State. The Court rejected the idea that such imputability could derive from the mere fact that a measure was taken by a public undertaking. On the contrary, "*It is*

270 At point 175 of the opinion.

271 Case C-482/99, *French Republic v Commission*, 2002, [2002] I-4397.

272 Commission, decision 2000/513 EC of September 8, 1999, [2000] OJ L 206/6, at point 114.

(…) *necessary to examine whether the public authorities must be regarded as having been involved, in one way or another, in the adoption of those measures*"[273].

The use of resources of a public undertaking may often be quite remote from the public authority. For public undertakings, the imputability test reduces the potential scope of application of the State aid since it restricts the concept of public resources, of public understandings to only those resources whose use is directly imputable to public authority.

At this stage, no attention is given to the effect of an action taken by a public undertaking. Hence, a public undertaking may act in a way which would clearly be different from "*the normal actions of a private investor operating under the market economy conditions*" but such measures may or may not be considered as State aid depending on whether such public undertaking has acted under a certain degree of influence from the public authority.

The imputability criterion is thus again purely legal. It nevertheless gives a more "realistic" view of the diversity of situations but is not, as such, really "economic" and somehow remains based on a certain degree of subjectivity. It should be added that, although private funds were used in *PreussenElektra*, the undertaking itself no longer had control over them by virtue of the state measure. Therefore, in order to put the emphasis on the economic effect of a measure, the imputability criterion could be "reversed" to imply that funds, regardless of public or private "ownership", are considered as public resources where it is the State that has formal control over them.

3. What room is there for an economic analysis of public resources under the traditional public resources test?

Given the above considerations, the two main criteria attached to the concept of public resources should be examined in order to take into account whether a more refined economic approach may contribute to the application of what are purely legal definitions.

In this respect, it may be questioned whether an economic analysis could really provide a useful contribution or any contribution at all at this level of analysis of an aid. The concept of public resources is complex, which explains why the case law took numerous years to evolve to the current criteria of *PreussenElektra* and *Stardust Marine*, and it would be difficult to grasp such notions intrinsically linked to the concept of State aid merely though an economic approach.

However, some form of economic approach may help in certain situations for the application of the two criteria. In the *Pearle* judgment of July 15, 2004, there was a certain analysis of economic flows, but more akin to an accountancy analysis than economics.

Pearle BV and the other appellants were companies established in the Netherlands that traded optical equipment. In that capacity and pursuant to a Dutch law, the "WBO", they joined the Board, a trade association governed by public law. In 1988, the Board for the first time imposed on its members, pursuant to by-laws established by the WBO, a "compulsory earmarked levy" to finance a collective advertising campaign for opticians' businesses. A

273 Case C-482/99, *French Republic v Commission*, [2002] ECR I-4397, at point 52.

similar levy was subsequently imposed every year. The appellants brought proceedings against the Board before the District Court of The Hague, arguing that the services provided by means of the advertising campaign constituted State aid. The Dutch Courts decided to stay proceedings and to request a preliminary ruling by the Court on the nature of the levy and its use.

In the *Pearle* judgment of July 15, 2004, the Court first recalled that "*for advantages to be capable of being categorized as aid within the meaning of Article [87] (1) of the Treaty, they must, first, be granted directly or indirectly through State resources and, second, be imputable to the State*" [274]. Although the Board was a public body, the Court concluded that there were no State resources involved. This was done through a simple economic reasoning of comparison of costs of the advertising campaign levies received. The Court not only considered that the sums used by the Board to fund the advertising campaign were collected from its members who benefited from the campaign, but it also examined whether "*the costs incurred by the public body for the purposes of that campaign were offset in full by the levies imposed on the* [members]"[275] and, as a consequence, that there was no additional burden for the State or such public body. Thus, in *Pearle,* there was no under- or overcompensation of the State. The measures were placed in a closed loop not creating a burden for the State, excluding the existence of a transfer of State resources despite the public nature of the Board[276].

On October 20, 2004, the Commission adopted a decision in case NN 136/2003, *Fonds sectoriels belges,* which clarified the Commission's interpretation of the Court of Justice's position in *Pearle (Pearle* had been handed down several months earlier). In *Fonds sectoriels belges,* the Commission noted that the Court had established four *cumulative* conditions which must be fulfilled in order for the revenues from mandatory contributions for all enterprises in a given sector to not be considered as public resources: (i) the objectives targeted by the mandatory contributions of undertakings must be set by the professional body and not by public authority; (ii) the State (or another public body) must not contribute to the funds collected, (iii) the means of financing and the rates of the contributions must be determined by the professional bodies and their members, not by public authority and (iv) public authority must not intervene in the decisions concerning the use which will be given to the funds collected through the mandatory contribution[277].

274 Case C-345/02, *Pearle BV v Hoofdbedrijfschap Ambachten*, July 15, [2004] ECR I-7139, at point 35.

275 *Id*, at point 36.

276 *Id*, at point 38.

277 Commission, decision of October 20, 2004, case NN 136/2003, *Fonds sectoriels belges*.

III. The Economics of government declarations tantamount to an irrevocable guarantee and market expectations

1. The *France Télécom* case

In the *France Télécom* case, which led to a Commission decision of August 2, 2004,[278] the Commission extended the concept of State aid under EU law to new frontiers by ruling that the State-controlled (55.6% shareholding) telecommunications operator had received aid as a result of a December 2002 announcement that it would benefit from a €9 billion credit line from the government, whereas said credit line was never put to use. As it was unfolding, the case gave rise to some new but unofficial State aid concepts, such as what some lawyers have variously called "*psychological aid*," "*virtual aid*" and "*verbal aid*." This said, it should be emphasized that the Commission's analysis was not based simply on the public declarations themselves: the French Government's declarations were not, in and of themselves, State aid. Rather, the aid derived from a combination of various factors leading to the conclusion that there was an irrevocable commitment of the French State in favor of France Telecom (tantamount to a guarantee) and including (i) the public announcement of the €9 billion credit line, (ii) the appearance given to market operators that the credit line was available for use by France Telecom, (iii) the preparation and dispatch of a contract concerning that credit line to France Telecom (France Telecom never signed), (iv) the *de facto* impossibility (even if the contract had not been returned signed), given the market expectations thus created, for the French State to renege upon its public commitment concerning the credit line.

The Commission ruled that the announcement of the shareholder's advance of €9 billion on December 4, 2002, although never used or formalized in a binding agreement, contained some State aid components, but that its decision on this point was sufficiently innovative as to justify not issuing an order for recovery of the aid (reference to Article 14(1), Regulation 659/1999).

Several statements concerning France Télécom were issued by the French Minister of the Treasury, and in particular an interview that the Minister gave to the French business daily *Les Echos*, published on July 12, 2002. In this interview, in response to a question concerning the volatility of France Télécom's share price and whether the State as majority shareholder of the group had a "message to send," the Minister said, in particular: "*I feel responsible for the assets of the French State. The State as shareholder will act as a prudent investor. Should France Télécom have difficulties, we will take the appropriate measures. [...] I repeat that, if France Télécom were to have financial problems, which is not the case at present, the French State will make the decisions necessary to overcome them*" (translation from the French).

The Commission's decision seems to have been posited on the idea that the Government's declarations alone moved financial markets in their opinion on France Télécom, and not necessarily the confidence that investors might have had in new management or other factors linked

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278 Commission Decision 2006/621/EC of 2 August 2004 on the State Aid implemented by France for France Télécom, OJ L. 257/11.

to the future of the business. In the Commission's view, the key event took place on December 4, 2002. On that day, the Board of Directors of France Télécom adopted an action plan – "Ambition France Télécom 2005". This concerned the means by which the group planned to obtain the necessary financing as well as to reduce debt and reconstitute shareholder equity through a capital increase. It was adopted by the Board of Directors and announced to the public two months after a change in the CEO of France Télécom. As part of the plan, it was announced that, among the various measures that would be taken to reestablish the situation, the French State, as majority shareholder, would make available, on a short-term basis, a shareholder's advance in the form of a credit line of up to €9 billion.

2. Use of public resources

In point of fact, most of the Commission's analysis with regard to the definition of State aid is concentrated on the private market investor principle. However the Commission does state, with regard to the transfer of public resources, the following:

> *"As to the condition relating to state resources, the Commission would point out that the fact that an advantage results from the giving of a state commitment leading to a potential, but not immediate, transfer of resources does not rule out the possibility that the advantage may have been granted through state resources. 'In that respect, it should first be noted that, according to settled case-law, it is not necessary to establish in every case that there has been a transfer of State resources for the advantage granted to one or more undertakings to be capable of being regarded as a State aid within the meaning of Article 87(1) EC'. Thus, even an advantage granted through a potential additional burden for the State constitutes state aid where it affects competition and trade between Member States. [...] The Commission finds that a potential additional burden on the State's resources was created by the announcement of the provision of the shareholder loan coupled with the fulfilment of the preconditions for such provision, by the impression given to the market that the loan had actually been provided and, lastly, by the dispatch to France Télécom of the loan contract initialled and signed by ERAP. While it is true that the contract was never signed by France Télécom, this does not mean that there was no potential commitment of state resources. In so far as the document constituted a contractual offer and as long as it was not rescinded, France Télécom could have signed it at any time, thereby acquiring the right to obtain immediate payment of the sum of EUR 9 billion. Inasmuch as it could not be unaware of this, the State accordingly had to keep at France Télécom's disposal through ERAP the amount of the corresponding resources".*[279]

The Commission's position according to which the announcement of the €9 billion credit line involved the use of public resources was essentially based on a passage from the Court

279 *Id.*, point 195.

of First Instance's ruling on May 16, 2002 in *Stardust Marine,* according to which: "*It is not necessary to establish in every case that there has been a transfer of State resources for the advantage granted to one or more undertakings to be capable of being regarded as a State aid within the meaning of article 87(1) EC*".[280]

Thus, according to the Commission, which also based itself upon, *inter alia*, the Court's *Ecotrade* judgment of December 1, 1998[281], and the Court of First Instance's judgment of June 13, 2000 in *EPAC*[282], an advantage that could represent a mitigation of the charges which are normally included in the budget of an undertaking may be deemed to constitute State resources within the meaning of article 87(1) EC, provided that, as stated in *EPAC*: "*the recipient undertaking receives an economic advantage which it would not have obtained under normal market conditions [...]. With regard to the absence of a transfer of State resources, the advantage conferred on EPAC will entail an additional burden for the State budget in the event of implementation of the guarantee*".

Both the *Ecotrade* and *EPAC* cases concerned the conditions in which advantages conferred by public authorities might entail a burden for public resources in the form of a State guarantee. In *France Télécom*, the Commission seems to have transposed this reasoning on a guarantee to the situation following announcement of the shareholder's advance in the form of a credit line. It conceded that the French State, through its emanation, ERAP, never actually entered into an agreement with France Télécom concerning the credit line.

However, according to the Commission and based on information supplied by the French government, ERAP sent an undated draft of a shareholder's advance agreement to France Télécom on December 20, 2002, which France Télécom never signed or returned – although, according to the Commission, it could have done both.

For the Commission, the French State/ERAP had made an offer to contract which, for as long as it was not withdrawn, represented a potential charge for the State, since :

> *"France Télécom could have signed it at any time, thereby acquiring the right to obtain immediate payment of the sum of EUR 9 billion. Inasmuch as it could not be unaware of this, the State accordingly had to keep at France Télécom's disposal through ERAP the amount of the corresponding resources".*[283]

Thus, the Commission appears to have reasoned with regard to the use of public resources in the case of public declarations by authorities in the same way as it would have done with regard to a State guarantee, which is deemed to constitute aid from the moment when it is granted, and not from the moment when it is called or payments are made under the guarantee. The Commission said that it could not exclude the possibility that a private investor would be bound by such declarations. The Commission went further in intimating that it is irrele-

280 Case C-482/99, *French Republic v Commission*, [2002] ECR I-4397, at point 36.

281 Case C-200/97, *Ecotrade v Altiforni* [1998] ECR I-7907.

282 Case T -204/97 and T-270/97, *EPAC v Commission* [2000] ECR II-2267, at points 65 and 80.

283 *France Télécom*, point 195.

vant to determine whether the public authority in question is bound in the strictly legal sense in cases where market operators are led to believe that the State will honor its word, and then adapt their market behavior on the basis of that understanding. According to the Commission, although the State is not legally bound to respect its public declarations, it is nevertheless constrained to honor statements made by a whole series of practical considerations. If the State did not follow through on its declarations, it would lose its credibility:

> *"A loss of credibility would therefore have not negligible consequences both for its reputation as a major economic operator and issuer on the international markets and for its reputation as a major political actor"*[284].

On this basis, the Commission nevertheless launched the theory that public declarations *could* meet the public resources test for characterization of a measure as State aid:

> *"Taken as a whole, these factors may be deemed to actually endanger state resources (either by incurring the State's responsibility vis-à-vis investors, or by increasing the cost of the State's future transactions). The argument to the effect that the French authorities' declarations as from July 2002 are aid is therefore innovative, but probably not without foundation"*[285].

The Commission thus appears to carefully build a case for the idea that public declarations can potentially commit public resources, suggesting that such *"innovative"* conclusions would *"probably not [be] without foundation"* before stepping away at the precipice on grounds of prudence:

> *"The Commission does not, however, have sufficient evidence in the present case to establish irrefutably the existence of aid on the basis of this innovative argument. On the other hand, it does consider that it can establish the existence of aid elements by following a more traditional approach, taking as a basis the December measures which were the subject-matter of the notification."*[286]

This conclusion is then followed by a reasoning in which the Commission links the prudent investor test to the public resources test in an innovative –perhaps even paradoxal – way:

> *"For one thing, the existence of a commitment of state resources is clear in December. For another, the existence of an advantage for the Company in December is also evident as soon as one takes account of the impact on the markets of the prior declarations and measures. (...)*

284 *Id.*, point 217.
285 *Id.*, point 218.
286 *Id.*, point 189.

> *In this connection, the 'private investor in a market economy' test cannot be used to justify this December intervention as the French authorities claim, inasmuch as economic operators' conduct in December was clearly influenced by the prior actions and declarations of the Government since July. While it may be doubted that the July declarations were sufficiently concrete to constitute aid in themselves, there is scarcely any doubt that such declarations were more than sufficient to 'contaminate' the markets' perception and to influence economic operators' subsequent conduct. If such is the case, this conduct on the part of economic operators cannot be taken as a neutral point of comparison from which to judge the State's conduct. The presumption based on the 'private investor in a market economy' test cannot therefore take as point of departure the market situation as it was in December but ought logically to be based on a market situation uncontaminated by the impact of the prior declarations.'*[287]

This reasoning can be reduced to the following table:

TABLE A

France Télécom : concept of aid

For a measure to be considered State aid there must be – inter alia – a transfer of State Resources + the proof that that measure would have not been taken by a prudent private investor operating in a market economy.

	Is there a transfer of public resources?	**Is the measure contrary to that of a prudent private investor in a market economy?**
Declaration of the Minister of July 2002	No (points 188-189)	Yes (point 230)
Shareholder's advance of December 2002	Yes (point 196)	No (point 263)
Together : comprehensive assessment	Yes	Yes

For the Commission the commitment of a shareholder's advance (to be implemented thanks to a credit line by the French State) decided in the "Action Plan France Télécom" of December 2002 constituted a transfer of public resources. According to the Commission, this advance, if taken alone, would probably have been considered typical of the behavior of a prudent investor (thereby not conferring any economic advantage), in reality such advance would have never

287 *Id.*, points 190 and 191.

be granted if the State had not changed the market situation by providing an informal guarantee in the form of the July 2002 declarations by the Minister.

As shown in table A, the Commission thus analyzes events in a dynamic way highlighting the cause and effects relationship between (i) the July declarations of the Minister, not transferring public resources but contrary to the behavior of a prudent investor and (ii) the December commitment of a shareholders' advance that constituted, for the Commission, a transfer of State resources despite being, at least potentially, economically sound for a prudent investor. The Commission seems to adopt a holistic and perhaps paradoxal approach that somehow blends together the criterion of transfer of public resources and that of the conferral of an economic advantage which may occur when the State fails to act as a prudent investor in a market economy.

IV. Conclusion

Although the transfer of public resources criterion of State aid constitutes essentially a legalistic concept, there are cases where economic analysis is used to determine whether such transfer exists as a factual matter. In this context, the contribution of a "more refined economic approach" would normally be limited to certain cases where economic flows could be taken into account and analyzed. This said, given the legal complexity which exists in certain cases of determination of whether there has been a transfer of public resources, it would not seem possible to grasp such notion intrinsically limited to the concept of State aid merely through an economic approach.

Selectivity, economic advantage, distortion of competition and effect on trade

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I. Executive Summary

Article 87(1) EC prohibits State aid that "… *distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods (...) insofar as it affects trade between Member States*". Under Article 87(3) EC, the Commission may however exempt State aid from this general prohibition if the aid fulfils other objectives (e.g. correct market failures, improve regional cohesion).

Article 87(1) EC therefore acts as the *screen* identifying aid measures that the Commission should further scrutinize in order to assess whether Article 87(3) EC is fulfilled (i.e. the so-called compatibility test). In particular, the way case-law has come to interpret Article 87(1) EC is to determine whether an aid measure can be deemed "*State aid*". If a measure is characterized as "State aid" (in the meaning of Article 87(1) EC), a notification to the Commission is necessary for further assessment. State measures that do not satisfy Article 87(1) EC are deemed "non-aid" and are excluded from the Commission's scrutiny. The interpretation of Article 87(1) EC therefore determines the Commission's workload in the area of State aid.

Over the years, case-law has established that Article 87(1) EC covers four conditions that must be jointly satisfied for a State measure to be deemed "State aid": (a) there should be a transfer of State resources; (b) the aid should confer an economic advantage; (c) the aid should distort (or threaten to distort) competition and (d) trade between Member States should be affected by the aid. There is potentially a fifth condition: the selectivity of the aid (i.e. is the State aid available only to one firm or a group of firms within a Member State?). Selectivity is deemed an additional criterion by some commentators and part of the economic advantage test by others.

The focus of this paper is on the "distortion of competition" and "effect on trade" criteria and their role so far in establishing whether State measures should be scrutinized by the Commission. An economic assessment of these two conditions requires, however, a discussion of the concepts of "selectivity" and "economic advantage". Indeed, while the "distortion of competition" and "effect on trade" conditions are central to the text of Article 87(1) EC, their role has in practice been rather limited. Under current case-law, a finding of "selectivity" presupposes that the aid *will* distort competition and affect trade.[288] Further, selectivity cannot be disentangled from the economic advantage criterion because both concepts are often used interchangeably or, in effect, jointly as in the SAAP which refers to a "*selective advantage*".

In view of the above, a major criticism addressed against past Commission practice and judgments by the Courts has been the lack of actual analysis of the "distortion of competition" and "effect on trade" conditions. In other words, these criteria may have been interpreted too widely, leading the Commission to devote scarce resources on cases that presumably have limited effects on competition and/or on trade.

288 See Friederiszick H., Röller L-H. and Verouden v European State aid Control: An Economic Framework, 21 February 2006, forthcoming in Advances in the Economics of Competition Law, Paolo Buccirossi (ed.), MIT Press. Available at: http://ec.europa.eu/comm/dgs/competition/esac.pdf.

This paper explores whether the screening role of the "distortion of competition" and "effect on trade" criteria should and/or could be improved in order to distinguish clearly inoffensive aid from aid that requires further investigation. This paper will argue that the interpretation of these criteria will ultimately depend on the objectives of European State aid control, an area still subject to debate. Whichever the ultimate objectives pursued by the Commission in the State aid area, this paper argues that the use of the terminology "selective advantage" under Article 87(1) EC should be favoured as it more properly identifies State measures that could potentially lead to competition distortions and / or affect trade. While economists would advocate a more systematic approach to identify measures that confer a selective advantage (which would entail identifying the group of competing firms that the aid may affect), there may be reasons to reject such an approach. Finally, this paper argues that there is scope for refining and clarifying the interpretation of the *"distortion of competition"* and *"effect on trade"* criteria.

If Article 87(1) EC is seen as a screening device to identify those cases that warrant further investigation, factors like clarity and simplicity of guidance to Member States and beneficiaries, the cost involved in applying the screen, the likelihood that measures are harmful and the likely strength of that harm should guide the development of detailed rules and guidance. It is not within the scope of this paper to propose an exact test. Rather we attempt to identify key issues that must be addressed when considering a revised interpretation of Article 87(1) EC. In particular, the major observations made in this paper from an economic point of view are as follows.

1) **Identifying measures that do not confer a selective advantage as non aid is an appropriate first step, if the effect on rivals' profits is the policy standard.** In the past, there has been little further investigation under Article 87(1) EC beyond studying advantage and selectivity: measures found to confer a selective advantage were investigated under Article 87(3) EC while other measures were approved without further analysis of the "distortion of competition" and "effect on trade" conditions.[289] There are sound economic arguments to exclude from further scrutiny measures that do not confer a selective advantage if State aid policy is concerned the effect of aid measures on rivals' profits only (i.e. it is unlikely that rivals would be harmed if no selective advantage is conferred to one or more firm(s) vis-à-vis competitors). A selective advantage is a necessary condition for a negative effect on rivals' profits.
2) **Identifying measures that do not confer a selective advantage as non aid may not be an appropriate first step, if total welfare is the policy standard.** Under a total welfare standard (where the cost to taxpayers is taken into account), measures that do not convey a selective advantage could still be welfare-reducing in the sense that taxpayers are worse-off as the subsidy entails a transfer from taxpayers to the aid recipient(s) (even if no competitor

289 As will be seen in detail below, the Court may have hinted that a more thorough and systematic analysis of the distortion of competition and effect of trade conditions is required but the circumstances of these cases were very specific, potentially affecting competition outside the EU.

is harmed). Under a total welfare criterion, the selective advantage criterion is therefore not necessarily a good screening device. Moreover, there is a tension between the absence of an economic advantage and the existence of a market failure (that would justify the aid). Under a total welfare criterion, identifying whether the aid measure targets a market failure would constitute the appropriate first step under Article 87(1) EC. The current architecture of State aid control would have to be significantly overhauled to move to a "market failure" test under Article 87(1) EC given that, according to the State aid Action Plan, the market failure test is the first step in the analysis of the compatibility of the aid with the Common Market.

3) **A possible option would be to apply a "rival's profit" standard under Article 87(1) EC to screen out measures that do not confer a selective advantage and undertake the detailed analysis of market failures and the impact on total welfare under Article 87(3) EC for measures that confer a selective advantage.** While this approach would exclude from further scrutiny measures that might reduce total welfare (if this is the ultimate standard), this may be an appropriate approach if the proportion of measures that reduce total welfare without affecting rivals' profits is small. This "dual" screen would in fact keep the architecture of State aid control as it currently is: the Article 87(1) EC screen would be based on rival's profits (in line with the current architecture) while the Article 87(3) EC compatibility analysis would rely on a total welfare standard, with a focus on market failures (as suggested in the SAAP).
4) **Currently the interpretation of a selective advantage does not systematically trace the effect on competition.** Case-law offers useful guidance with respect to determining selective measures based primarily on an assessment of the eligibility criteria used for distributing the aid. However, a systematic economic approach that focuses on the effect on competition would advocate looking at the *asymmetric effect* of a measure irrespective of its eligibility criteria (i.e. does the measure provide a cost advantage or any other advantage to the recipient that is not available to its competitors?[290]). This would constitute a departure from the past practice, in which case-law has mainly identified selective measures as opposed to general ones on the basis of the eligibility criteria within Member States. The main reason for this approach in case law is to exclude from the Commission's scrutiny measures that affect competing firms in asymmetric ways due to differences in national tax regulations. Such measures are covered by other provisions of the EC Treaty (e.g. tax harmonisation).[291] In fact, the *"effects-based"* approach that economists would favour to define a selective advantage would differ most from the current approach in cases where

290 The Courts have in some cases considered whether the effect of measures is asymmetric (e.g. when general measures affect certain firms more than others) but in most cases, the meaning of selectivity relates to the notion of "discrimination" between firms in a given country rather than the "asymmetric effect" notion that economists would have in mind – i.e. whether a measure affects *competing firms* in asymmetric ways.

291 Articles 90 to 93 EC – tax provisions – or Articles 96 and 97 EC – general approximation of laws when there is a "difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortion needs to be eliminated" – Article 96 EC).

the relevant market is either wider or narrower than the jurisdiction deciding on granting the aid.

5) **A potential five-step approach to identify measures that confer a selective advantage.** An economic approach to identify measures that confer a "selective advantage" incorporating elements of case-law would suggest the following five-step test. The economic approach would incorporate an assessment of the eligibility criteria and identify an economic advantage by determining whether the measure implies a selective (or asymmetric) *effect on competing firms* (national and/or foreign). Asymmetric effects arising from differences in national tax legislations would continue to be excluded from State aid control, but still legal commentators are extremely wary about such a proposal as it might in fact imply that *more* measures could be caught by State aid rules. This is indeed a possible consequence of such an approach in which measures available to all competing firms might become "selective" if competing firms differ significantly. On the other hand, measures that are currently deemed selective (e.g. sectoral or regional aid) might be excluded if all competing firms are affected in the same way by the measure. Note that a move from an assessment of selective advantage based on eligibility criteria and jurisdictional boundaries to a market based assessment would, conceptually, require the definition of relevant markets. There are significant and justified concerns regarding the use of a full fledged market definition exercise as part of a screening process. Moreover, it may well be argued that all measures have asymmetric effects to some degree and case law would have to develop in order to establish useful guidance. Considering these reservations, we do not argue that the proposed five-step approach may not necessarily be the most effective screen as there may be (legal and practical) grounds for rejecting such an approach. However, we wish to stress that, conceptually, any systematic economic approach would advocate the identification of the *selective impact on competing firms* irrespective of whether the measure is generic or targeted at one or a group of firms.
6) **Measures that *do* confer a selective advantage – under a rivals' profits standard – do not necessarily lead to a distortion of competition (as is currently assumed).** If the Commission is concerned about the welfare effect of subsidies on rivals' profits, then an additional step is required once a selective advantage has been identified. The impact of the measure on *firm behaviour* should be assessed. If the recipient's behaviour is not affected (i.e. if it does not affect marginal cost or facilitate exclusionary behaviour), the measure should not be qualified as State aid as it is unlikely that competition would be distorted (in the sense that rivals' profits would be affected). Some authors have suggested the use of criteria such as the amount of the aid, concentration on the market, asymmetries in market positions or the degree of differentiations to screen out more measures under Article 87(1) EC. None of these is entirely satisfactory in the area of State aid without *also* incorporating the analysis of the market failure that the aid attempts to address and the type of measure (e.g. a small subsidy to a small competitor could distort competition if the recipient has high production costs and the subsidy perpetuates inefficient production). An "across-the-board" safe harbour such as market share thresholds would be extremely hard to design as the relationship between such filters and the potential distortion is not straightforward and

will depend on the circumstances at stake (in particular the type of aid). While devising simple rules to screen out cases is attractive, the potential for errors in the area of State aid calls for caution. It is therefore suggested that such factors be analysed under Article 87(3) EC as part of the compatibility assessment. The same conclusion is reached if the Commission is concerned about subsidies that reduce total welfare.

7) Given the difficulty in designing general screening rules under the "*distortion of competition*" criterion that fit into the current architecture, **the interpretation of the effect on trade condition appears to be the area where the Commission could most efficiently achieve a significant reduction of its workload by clarifying its role in monitoring State aid measures**. Indeed, we identify that the "*effect on trade*" criterion could be given a more prominent role in screening aid measures. The scope of the "*effect on trade*" criterion will depend on subsidiarity objectives and the role that State aid control is expected to play in policing national governments. A measure that confers a selective advantage and distorts competition will not necessarily affect trade between Member States. To date, the wide interpretation of the effect on trade criterion has brought a large number of cases into the Commission's net and this may cause a wasteful use of Commission resources. Whether the *"effect on trade"* criterion should be reduced in scope (e.g. concentrate on State measures in markets wider than national or with cross-border externalities) is a matter of policy choice. To inform this policy choice a more systematic empirical assessment of the harm caused by the "local" cases may be helpful.
8) Overall, **a clarification of the objectives** of European State aid control (welfare criterion and subsidiarity) therefore **is a necessary first step** if the Commission is to achieve a coherent reform.

This paper is divided as follows. Section 2 presents an overview of the existing case-law regarding the selectivity, distortion of competition and effect on trade criteria. Section 3 offers an economic commentary on the case-law and proposes alternative tests to screen aid measures under Article 87(1) EC.

II. State of the art

This section will focus on three conditions of Article 87(1) EC (setting aside the transfer of State resources condition): selectivity, distortion of competition and effect on trade between Member States.

1. The selectivity condition

Pursuant to Article 87(1) EC State aid must favour "*certain undertakings or the production of certain goods*". The Commission inferred from the wording of this provision that only selective measures, i.e. those benefiting specifically certain undertakings or the production of certain goods, fall within its scope (a). A non-selective measure is called a general measure (b). Some

State measures that favour certain undertakings or productions are however not caught by Article 87(1) EC if they are justified by "*the nature and the scheme of the system*" (c). This section reviews how the Commission and the Courts have distinguished selective measures from non-selective measures.

a) Selective measures

The case-law has clarified the selective nature of some types of measures while other types of measures have been subject to different interpretations. Of course, aid provided to a single company on an ad-hoc basis is considered selective. It is for wider schemes that the selective nature has been a matter of discussion. These are reviewed in turn.

aa) Measures that have been deemed selective

– An aid scheme concerning one or several economic sector(s) is selective

The selective nature of sectorial aid is one of the oldest and most obvious lessons in the field of State aid law. As early as 1974, in *Italy v Commission*, the ECJ Stated that: "*the partial reduction of social charges pertaining to family allowances devolving upon employers in the textile sector is a measure intended partially to exempt undertakings of a particular industrial sector from the financial charges arising from the normal application of the general social security system, without there being any justification for this exemption on the basis of the nature or general scheme of this system*".[292]

The Maribel *bis* and Maribel *ter* systems are usually referred to concerning State aid granted to undertakings in sectors exposed to international competition.[293] The Belgian government had taken three decisions concerning the reduction of social security charges for employers hiring manual workers. These measures were called the "*Maribel*" systems. The original Maribel system was the only one not to be considered selective. This first system aimed at reducing employers' charges for all undertakings in Belgium. However, Maribel *bis* and *ter* increased the rebate offered but only to employers active in those sectors most exposed to international competition. The aim of these last two measures was thus to promote exports, through a reduction in wages, in the following sectors: extraction and processing of non-energy materials, chemical, metal-processing, precision instruments, optical instruments, as well as some transport services, for example international road transport.

The examination by the Commission of Irish preferential tax rates constitutes another example of State aid granted to a limited number of economic sectors.[294] In this decision, the Commission took the view that "*the preferential rate is granted only to undertakings in the manufacturing sector and therefore favours undertakings in that sector over those with similar levels of profitability in other sectors*". Concerning the selectivity condition, the Commission

292 Case 173/73 *Italy v Commission* [1974] ECR 709, paragraph 15.

293 Case C-75/97 *Belgium v Commission* [1999] ECR I-3671.

294 OJ [1998] C 395/19.

noted that: "*Although this condition was not regarded as met when the Commission examined the Irish corporation tax system in 1980, it now appears clearly to be fulfilled. The measures impose a lower rate of tax on manufacturing companies than those in other sectors without any justification for this on the basis of the nature or general scheme of the Irish tax system. The reason for the lower rate is rather the attraction of mobile investment in the manufacturing sector to Ireland through the reduction of the sector's costs of production*".

Recently, the Court confirmed that *"The fact that the number of undertakings able to claim entitlement under the measure at issue is very large, or that they belong to different sectors of activity, is not sufficient to call into question its selective nature and therefore, to rule out its classification as State aid"*.[295]

– A national aid scheme concerning a specific region of a Member State is selective

Regional aid, adopted by the central or the federal government, has always been deemed selective. For example, a tax break that was applicable to the entire German territory but, following a decision of the national legislature, was more generous for those undertakings established in one of the new Länder or in Berlin was found to be selective. According to the ECJ: "*It should also be noted that the contested decision classifies the tax concession under Paragraph 52(8) of the EStG as State aid only in so far as it favours certain undertakings situated in the new Länder or West Berlin, which prevents its being a general measure of tax or economic policy*".[296] On the other hand, other types of aid concerning a specific region could be considered non-selective (as discussed below).

– An aid scheme is selective when public authorities enjoy a margin of discretion

Even in cases where a measure is in principle open to all undertakings in a Member State, the process for granting the measure may still provide public authorities with a "*margin of discretion*" such that some undertakings may be more favoured than others. In a *France v Commission* case rendered in 1996, the ECJ took the following view: "*It must also be noted that FNE intervention is not limited sectorially or territorially or by reference to a restricted category of undertakings. However, as the Commission has rightly pointed out, the FNE enjoys a degree of latitude which enables it to adjust its financial assistance having regard to a number of considerations such as, in particular, the choice of beneficiaries, the amount of the financial assistance and the conditions under which it is provided*".[297]

– An aid system that applies only to certain types of undertakings (e.g. large firms or SMEs) is selective

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295 Case C-172/03 *Wolfgang Heiser v Finanzamt Innsbruck* [2005] ECR I-1627, paragraph 42.

296 Case C-156/98 *Germany v Commission* [2000] ECR I-6857, paragraph 23.

297 Case C-241/94 *France v Commission* [1996] ECR I-4551, paragraphs 22-23.

The CFI considered that by restricting the application of a particular tax credit to investments in new fixed assets of over ESP 2,500 million, the Basque authorities reserved the tax concession in question to large undertakings.[298]

bb) Measures whose selective nature may depend on the context

– Are transactions between undertakings and tax or Social Security authorities selective?

A priori, national legislation in this field is deemed legitimate. However, two elements must be verified: the first is whether tax authorities enjoy a margin of discretion; the second is whether such a measure is applied in a non-discriminatory manner. The *DMT* judgment is often referred to in this regard: "*It is for the national court in the main proceedings to determine whether the ONSS's power to grant payment facilities is discretionary or not and, if it is not, to establish whether the payment facilities granted by the ONSS are general in nature or whether they favour certain undertakings*".[299] The Commission considered the suspension of the reimbursement of the debts incurred by Tubacex to be a general measure because it was adopted in the framework of national legislation on insolvency (applicable to all undertakings).[300]

Denis Waelbroeck cites[301] an agreement between the Belgian tax authorities and Umicore, where the Commission considered, in the opening of the formal investigation procedure[302], that the measure was selective because it concerned a single undertaking. As the author notes, "[i]l *semble qu'en examinant si la mesure en question bénéficiait à certaines entreprises, la Commission se soit trompée ici de point de comparaison. En effet, il est évident qu'aucune autre société n'aurait conclu le même accord avec le fisc belge* (…). *L'approche que la Commission aurait dû adopter aurait été de voir si la procédure applicable à Umicore était ouverte à d'autres sociétés se trouvant dans une situation similaire"*, and wonders whether the Commission intends to check whether the same result would have been achieved for every transaction it examines.

– Are aid schemes granted by an infra-State body in accordance with the institutional system of a Member State selective?

Given that decision-making is substantially decentralised in some Member States, it was not clear whether a measure set up by an autonomous region or a federal entity would be *ipso facto* selective. This question has recently tackled the issue in a recent *Portugal v Commission* case

298 Joined Cases T-127,129 and 148/99 *Territorio Histórico de Álava – Diputación Foral de Álava* (T-127/99), *Comnidad Autónoma del País Vasco and Gasteizko Industria Lurra*, SA (T-129/99) and *Daewoo Electronics Manufacturing España*, SA (T-148/99) v Commission [2002] ECR II-1275.

299 Case C-256/97 *Déménagements-Manutention Transport SA* (DMT) [1999] ECR I-3913, paragraph 28.

300 XXVth Report on Competition Policy, paragraph 160.

301 Waelbroeck, "La condition de la sélectivité de la mesure" in Dony and Smits., *Aides d'Etat*, (Ed. de l'Université de Bruxelles, 2005), p. 86.

302 State aid – Belgium Aid C 76/2003 ex NN 69/2003 – Reduction of a VAT debt owed by Umicore SA (formerly Union Minière SA) Invitation to submit comments pursuant to Article 88(2) of the EC, OJ (2004) C 223/2.

where the ECJ stated that "[i]*n order to determine the selectivity of a measure adopted by an infra-State body* […] *it is appropriate* […] *to examine whether that measure was adopted by that body in the exercise of powers sufficiently autonomous vis-à-vis the central power and, if appropriate, to examine whether that measure indeed applies to all the undertakings established in or all production of goods on the territory coming within the competence of that body*".[303] Under the conditions laid down by the ECJ, the regional measure will not be considered selective.

b) General measures

A general tax measure, even if it involves a loss of resources for the State and an advantage for the companies established therein, is not an aid within the meaning of Article 87(1) EC, as it applies indistinctly to all undertakings. Two Commission documents are usually referred to in this regard. The first is the *Notice on the reduction of labour costs*[304] and the second is the *Notice on direct business taxation*.[305]

According to the first of them, "[a] *general, automatic and non-discretionary reduction of non-wage labour costs is clearly not covered by the competition rules relating to State aid*". In this case, it is clearly a general measure. The targeting by other measures does not necessarily imply that these measures concern Article 87(1) EC. It is only *"if targeting favours certain undertakings or the production of certain goods by excluding others (which otherwise are subject to the same objective conditions in relation to general system of social contributions) that the State aid rules enter into play"*.

The Notice on direct business taxation brings, for its part, the following precision:

> *"The fact that some firms or some sectors benefit more than others from some of these tax measures does not necessarily mean that they are caught by the competition rules governing State aid. Thus, measures designed to reduce the taxation of labour for all*

303 Case C-88/03 *Portugal v Commission*, not yet reported, paragraphs 62. Concerning more specifically a regional decision to adopt a tax rate lower than the national rate, in order to be regarded as having been adopted in the exercise of sufficiently autonomous powers, that decision must "*first of all, have been taken by a regional or local authority which has, from a constitutional point of view, a political and administrative status separate from that of the central government. Next, it must have been adopted without the central government being able to directly intervene as regards its content. Finally, the financial consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions or central government*" (paragraph 67). Note that when all the local authorities at the same level (regions, districts or others) have the autonomous power to decide, within the limit of the powers conferred on them, the tax rate applicable in the territory within their competence, there is no selectivity *"because it is impossible to determine a normal tax rate capable of constituting the reference framework"* (paragraph 64).

304 Commission Notice on monitoring of State aid and reduction of labour costs, OJ (1997) C 1/10.

305 Commission Notice on the application of the State aid rules to measures relating to direct business taxation, OJ (1998) C 384/3.

> *firms have a relatively greater effect on labour-intensive industries than on capital-intensive industries, without necessarily constituting State aid. Similarly, tax incentives for environmental, R&D or training investment favour only the firms which undertake such investment, but again do not necessarily constitute State aid".*

It can be noted that the Commission considered that a "*youth-employment*" plan did not constitute State aid.[306] This (Belgian) measure encouraged employers to offer a job to young graduates within six months of the end of their studies. Reductions in employers' contributions were awarded if the supplementary hiring of young graduates represented at least 3% of the personnel. This opportunity was open to all employers of all sectors. According to the Commission, this measure had no selective effect. As noted in point 14 of the Notice on the reduction of labour costs: "*While measures targeted at a particular industry will be regarded as a State aid, the same is not true for measures targeted at certain categories of employees, provided they apply automatically without discrimination between firms*". In this case, young workers were the targeted category and the tax measure was deemed non-selective.

The Commission also accepted that the targeting of the "workers" category in the original Belgian "*Maribel"* system (which entailed a more significant reduction for workers than for employees) was a general measure.[307]

The specificity of a measure is assessed from a national standpoint. In fact, if Articles 87 and 88 EC aim at preventing Member States from unfairly favouring some of their undertakings, they are not designed to prohibit national measures simply because of the disparities created between undertakings in different Member States. These must be abolished through tax harmonisation, following the procedure provided for in Articles 93 to 97 EC.[308]

c) Justification by the nature and the scheme of the system

Several State measures can discriminate between companies and thus could be considered as State aid. However, this will not be the case if such measures are justified by the nature and the scheme of the system.[309] This may seem subtle but it must be stressed that this criteria only comes into play when the tax system as a whole is being examined.

In other words, selective measures may fall outside the Commission scrutiny if the selective *effect* of a measure can be justified on grounds that the measure has an objective inherent

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306 Decision of the Commission of 7 may 2002, C (2002) 1800fin, State aid number NN 129/2000. The assessed measure is to be found in the "Loi du 24 décembre1999 en vue de la promotion de l'emploi, *M.B.*, 27 janvier 2000".

307 Case C-75/97 *Belgium v Commission* [1999] ECR I-3671, paragraph 28.

308 Second Survey on State aid, number 8.

309 See Case C-143/99 *Adria-Wien Pipeline GmbH* [2001] ECR I-8635, paragraph 42: "*According to the case-law of the Court, a measure which, although conferring an advantage on its recipient, is justified by the nature or general scheme of the system of which it is part does not fulfil that condition of selectivity*".

to the tax system, social, labour or environmental policies (e.g. redistribution objectives or labour market policies).[310]

According to Advocate General Darmon in the Sloman Neptun case: *"the only fundamental precondition for the application of Article 92(1) is that the measure should constitute a derogation, by virtue of its actual nature, from the scheme of the general system in which it is set [...] The concept of derogation makes it possible, as I see it, far more than the identification of specific beneficiaries, to distinguish between aid and those general measures of economic and social policy. [...] In my view, a measure constitutes a derogation where it does not apply to all the undertakings or all the sectors of industry which, in view of the nature and the scheme of the system, would be capable of benefiting from it"*.[311]

The assessment relies on a value judgment on the part of the Commission. A specific aspect of a scheme can very well be justified by the nature and the economy of a system, but the Commission can also reject the aim of the system itself. It would be more correct to state that what is possible is "*the justification through the nature and the economy of a system accepted as legitimate by the Commission*". The Commission somehow allows a legitimate system to entail an accessory restriction of competition. Fiscal, social, bankruptcy or *concordat* law schemes are examples of legitimately accepted systems.

The Court said in the Ecotrade case concerning an Italian law on concordat (the so-called "Prodi" law) that *"the possible loss of tax revenue for the State as a result of the application of the system of special administration, on account of the absolute prohibition on individual actions for enforcement and the suspension of interest on all debts owed by the undertaking in question, and the correlated reduction in creditors' profits, does not in itself justify treating that system as aid"*. In fact, such a *"consequence is an inherent feature of any statutory system laying down a framework for relations between an insolvent undertaking and the general body of creditors"*.[312] (in case, the measure was a State aid because it was reserved to large undertakings).

In the *CETM*[313] case, the CFI decided that, in order to limit road pollution, Spain was entitled to encourage the replacement of used lorries by new ones (as long as it was not done only for SMEs and private citizens, which was the added condition in case C-351/98). The fact that the measure favours road haulage contractors is inherent to the environmental objective and does not render the measure selective.

Often, the justification by reference to the nature and the economy of the system comes from a logical reasoning. For instance, British authorities instituted a tax on climate change,

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310 Case C-501/00 *Spain v Commission* [2004] ECR I-6707, paragraph 124: "*However, in this case, in order to justify the contested measures with respect to the nature or the structure of the tax system of which those measures form part, it is not sufficient to State that they are intended to promote international trade. It is true that such a purpose is an economic objective, but it has not been shown that that purpose corresponds to the overall logic of the tax system in force in Spain, which is applicable to all undertakings*".

311 Opinion of Advocate General Darmon delivered in Joined Cases C-72/91 and C-73/91 *Sloman Neptun v Bodo Ziesemer* [1993] ECR I-903, paras. 50, 55 and 58.

312 Case C-200/97 *Ecotrade Srl v Altiforni e Ferriere di Servola SpA* (AFS) [1998] ECR I-7907.

313 Case T-55/99 *Confederación Española de Transporte de Mercancías* (CETM) v Commission [2000] ECR II-3207.

of which commodities used exclusively for non-fuel purposes, commodities used mainly for non-fuel purposes, as well as some competing products were exonerated. According to the Commission, it was in the logic and the nature of an ecological fiscal system to levy the tax on commodities used as fuel, but to exonerate the commodities used exclusively for non-fuel purposes. [314]

The Court has recently developed the notion of *"the nature or the general system"* in the British Aggregates Association[315] case stating that: *"When reviewing the selective nature of a measure, it is the task of the Community Court to determine whether the Commission was right to consider that the differentiation between undertakings, as regards advantages or burdens, introduced by the measure in question, arises from the nature or the general system of the overall scheme which applies. Where such a differentiation is based on objectives other than those pursued by the overall scheme, the measure in question will, in principle, be considered as satisfying the condition of selectivity laid down under Article 87(1) EC"*.[316]

2. Distortion of competition and effect on trade between Member States

According to the case-law, State measures that grant an advantage upon one or more undertakings must distort (or at least threaten to distort) competition and affect trade between Member States to qualify as State aid within the meaning of Article 87(1) EC. These last two conditions of Article 87(1) EC bear some similarities with the requirements in Article 81(1) EC, as already noted in academic literature.[317] Despite these similarities, the case law in both fields has not evolved in the same direction. Some tentative explanations may be put forward to justify the difference in approach. The effect on trade condition under Article 81(1) EC draws the dividing line between Member States' and Community competences.[318] In the field of State aid, such a condition cannot be interpreted in the same way, as Articles 87 and 88 EC concern measures decided by Member States themselves. On the other hand, if the Commission were to clarify the extent of its role as a supranational monitor of governments, the effect on trade condition could draw the line between national measures that require European monitoring as they affect competitors or consumers in other Member States and those excluded because of their predominantly local character.

Article 81(1) EC requires that an agreement between undertakings has as its "*object or effect*" the "*prevention, restriction or distortion of competition*". As long ago as 1966, in *Société Tech-*

314 Commission Decision of 3 April 2002 on the dual-use exemption which the United Kingdom is planning to implement under the Climate Change Levy and the extended exemption for certain competing processes OJ (2002) L 229/15.

315 Case T-210/02 *British Aggregates Association v Commission*, not yet reported.

316 Ibid, paragraph 107.

317 Bellis, "Les critères de la distorsion de concurrence et de l'effet sur le commerce interétatique" in Dony and Smits (Eds.), op. cit., pp. 97-106, at p. 97.

318 For those agreements that do not have an appreciable effect on trade between Member States national competition law may apply, see Whish, *Competition Law* (Butterworths, 2003), pp. 948, at p. 137.

nique Minière,[319] the ECJ ruled that, if the restriction of competition is not the object of an agreement, it is necessary to undertake an economic analysis of the context surrounding its conclusion. Even though Article 87(1) EC also refers to the *"distortion of competition"* of State measures, it draws no distinction between object and effect. In reality, the case law shows that Community case-law has assumed that subsidies entail a distortion of competition by its very object, as they purport to improve the competitive situation of its recipient(s).

a) Interpretation of the two conditions by the ECJ

The position of the ECJ with regard to the distortion of competition and the effect on trade conditions can be traced back to the *Philip Morris* case.[320] Following a Commission decision finding that the measures adopted by the Dutch government were incompatible with the common market, the State aid recipient brought an action against the decision before the ECJ, claiming, *inter alia*, that the institution failed to define the relevant product and geographic markets, thereby violating Article 87(1) EC.

In this case, AG Capotorti[321] proposed a per se approach towards these two conditions. First, he held that *"the wording of Article 92(1) [87(1)] lends itself to being construed as meaning that the distortion of competition should be a consistent and necessary consequence of the benefit given to certain undertakings or the production of certain goods by means of State aid"* and continued by stating that *"*[i]*nterference from outside which is selective cannot but distort the working of competition"*. According to him, it is only under *"exceptional circumstances"* that a subsidy or a similar measure will not distort competition, and used as an example *"the total absence in the common market of products which are identical to or may be substituted for those manufactured by the recipient of the aid"*.[322] Second, AG Capotorti took the view that *"where a financial aid granted by a State strengthens the position of an undertaking [...] in comparison with other undertakings competing in intra-Community trade the latter must be regarded as being affected by the aid"*.

The ECJ followed its AG and simply noted, in point 11 of the judgment, that even though the Commission had not properly defined the relevant market in the contested decision, it still pointed out that the measure put Philip Morris at a "*competitive advantage*". Secondly, the ECJ found that trade between Member States was affected, since a significant amount of output was intended for export to other Member States.

The main conclusion usually drawn from this judgment is that the last two conditions laid down in Article 87(1) EC are almost "*automatically*" fulfilled whenever a measure is deemed

319 Case 56/65 *Société Technique Minière v Maschinenbau Ulm* [1966] ECR 357.

320 Case 730/79 *Philip Morris Holland BV v Commission* [1980] ECR 2671.

321 Opinion of Advocate General Capotorti delivered on 18 June 1980 in Case 30/79 *Philip Morris Holland BV v Commission* [1980] ECR 2671.

322 It is to be noted that the effect on the cost of production for export of the Dutch measure at stake in the *Philip Morris* case amounted to a mere 0.22%.

to be selective, even though the Commission has a formal duty to provide reasons, as required by subsequent case law.[323]

While the recent Altmark judgment[324] appears to have clarified that there are four separate conditions to be fulfilled for a State measure to be deemed State aid,[325] the cases in which the last two conditions (distortion of competition and effect on trade) are in effect analyzed remain rare. We discuss each of these two conditions in greater detail below.

aa) Effect on trade between Member States

Following the *Philip Morris* judgment, the ECJ has systematically rejected[326] any arguments based on the insignificant amount of the measure. In the *Tubemeuse* case,[327] for example, in reply to an argument brought by the Belgian Government, the ECJ held that: "*the relatively small amount of aid or the relatively small size of the undertaking which receives it does not as such exclude the possibility that intra-Community trade might be affected*".

In the *Maribel* case, the ECJ stated that "(…) *when State aid strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade, the latter must be regarded as affected by the aid, even if the beneficiary undertaking is itself not involved in exporting. Where a Member State grants aid to an undertaking, domestic production may for that reason be maintained or increased, with the result that undertakings established in other Member States have less chance of exporting their products to the market in that Member State* (…). *In the case of an aid programme, the Commission may confine its examination to the characteristics of the programme in question in order to determine whether it gives an appreciable advantage to the recipients in relation to their competitors and is likely to benefit essentially undertakings engaged in trade between Member States* (...). *Moreover, in the case of unnotified aid, it is not necessary for the reasoning on which the Commission decision is based to contain an up-to-date assessment of the effect of the aid on competition and on trade between Member States* (…). *According to that case-law, and contrary to what the Belgian Government contends, it is not necessary in this particular instance for the undertakings benefiting from the Maribel bis/ter scheme to be engaged in exporting. They may even operate only at local level"*.[328]

323 Waelbroeck and Frignani, Droit de la concurrence, Megret, Vol. 4, ULB, 1997, at p. 352-353.

324 Case C-280/00, *Altmark Trans GmbH, Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* [2003] ECR I-7747,

325 See also "European Court clarified application of State aid rules to State financing of public service obligations", 29 July 2003, Frédéric Louis and Anne Vallery.

326 As will be seen *infra*, the Commission has issued a de minimis Regulation, which, contrary to the position under Article 81(1) EC, does not find its origin in the case law of the ECJ.

327 Case C-142/87 *Commission v Belgium* (Tubemeuse) [1990] ECR I-959.

328 Case C-75/97 *Belgium v Commission* [1999] I-3671, paragraphs 47 to 49.

More recently, in cases like Heiser or Xunta de Galicia, the ECJ went further and stated that "there is no threshold or percentage below which it may be considered that trade between Member States is not affected".[329]

The following examples may sufficiently show the way in which the ECJ has dealt with the application of the effect on trade condition to date:

– measures benefiting all national producers in a given sector improve their position within the Community and thus affect trade between Member States[330];
– State measures granted to undertakings active in sectors in crisis always affect trade between Member States, as a result of sectoral excess capacity[331];
– the fact that the undertaking is not active in the export market has also been found to be irrelevant[332];
– even when the recipient of the State aid operates locally, trade between Member States has been deemed to be fulfilled, as in *Altmark*[333].

Only in exceptional circumstances will the courts question the findings of the Commission. Some authors usually quote an isolated *Germany v Commission* case,[334] where the ECJ annulled the Commission decision for insufficient motivation.[335]

Only in rare cases has the Commission found that a State measure has no effect on trade between Member States. The *Dorsten* case is an interesting example. It concerned a DM 2 million (EUR 1 million) subsidy granted by the town of Dorsten (Germany) to an undertaking in charge of running the local open-air swimming pool.[336] The Commission found that the measure had no impact on trade between Member States, since the swimming pool was exclusively used by local inhabitants, as opposed to "theme parks", which are also intended for tourists. The same conclusion was reached in the *Brighton Pier* case[337] in 2002 where the Commission considered that "*it could be added that the restoration of existing monuments and landmarks of cultural and historical value does not in itself affect trade between Member States*."

329 Case C-172/03 Wolfgang Heiser v Finanzamt Innsbruck [2005] ECR 1627 and Case C-71/04 Administración del Estado v Xunta de Galicia [2005] ECR I-7419, paragraph 41.

330 Case 173/73 Commission v Italy [1974] ECR 709.

331 Case C-305/89 Italy v Commission [1991] ECR I-1603.

332 Case 102/87 France v Commission [1988] ECR 4067.

333 *Op. Cit*, paragraph 78: "Where a Member State grants a public subsidy to an undertaking, the supply of transport services by that undertaking may for that reason be maintained or increased with the result that undertakings established in other Member States have less chance of providing their transport services in the market in that Member State)".

334 Case C-329/93, Germany v Commission [1996] ECR I-5151. The case is mentioned by Keppenne, *Guide des aides d'Etat en droit communautaire* (Bruylant, 1999), p. 138.

335 A closer look to the case shows, however that the primary reason for the annulment relates to the application of the "market economy investor principle" by the Commission.

336 "On application by Germany, Commission decides that municipal aid for public swimming poll is not State aid", IP/00/1509, 21 December 2000.

337 See letter by the Commission available at http://ec.europa.eu/community_law/State_aid/comp-2001/n560-01.pdf.

In 2003, the Commission adopted a decision, following a complaint by a private party, where it took the view that some measures adopted by the Dutch government in favour of "*non-profit harbours for recreational crafts*" fell outside the scope of Article 87(1) EC.[338] These measures included the sale of land at an abnormally low price and the provision by the municipalities of some services. The Commission concluded in point 55 of the decision that: "*[...] even if some distortion of (local) competition is not excluded, the support (if any) has no effect on trade within the meaning of Article 87(1) EC. In particular, in these cases, also due to the geographical location of the marinas, their relatively small size, and the relatively small amounts of public support involved (in comparison with the number of moorings offered in the marinas), it can not reasonably be expected that this support will lead ship owners from other Member States to use the marinas concerned for mooring (be it fixed or daily) rather than a marina in another Member State".*

Finally, Community case-law has repeatedly accepted that effect on trade between Member States must not be actual, since it can also be potential, as made for example apparent in a recent *Commission v Italy* case:[339]

"(…) the Commission is required to establish, not whether such aid has a real impact on trade between Member States and on competition, but whether that aid could affect that trade. If the Commission had to demonstrate in its decision the real effect of aid already granted, such a requirement would have the effect of favouring Member States which grant aid in breach of the obligation to notify laid down in Article 93(3) of the Treaty, to the detriment of those which do notify aid at the planning stage (Case C-301/87 France v Commission [1990] ECR I-307, 'Boussac Saint Frères', paragraphs 32 and 33)".

bb) Distortion of competition

With regard to this condition, the ECJ has automatically accepted the analysis undertaken by the Commission. In reality, the distortion of competition condition has never been an issue in proceedings before the ECJ. As far back as 1969 it was clear that subsidies could not be used by Member States as a tool of regulatory competition. In *Commission v France*,[340] the French government claimed that the rediscount rate it applied for exports aimed to put local producers at the same competitive level as those established in other Member States. The argument was rejected by the ECJ on the following grounds:

"Neither the fact that the preferential rate in question is applicable to all national products exported and only to them nor the fact that in establishing it the French government may have resolved to approximate the rate to those applied in the other Member countries can remove from the measure in question the character of an aid which is prohibited except in the cases and procedures provided for by the Treaty".

338 Commission Decision of 29 October 2003 on measures in favour of non-profit harbours for recreational crafts OJ (2004) L 34/63.

339 Case C-298/00, Commission v Italy [2004] ECR I-4087, paragraph 49.

340 Joined Cases 9 and 11/69, Commission v France [1969] ECR 523, paragraph 21.

In a different vein, and regarding the "*exceptional circumstances*" where a State aid would not distort competition (as evoked by AG Capotorti in *Philip Morris*), case law has provided very few (if not any) examples. AG Fennelly suggested in a *Belgium v Commission*[341] case that if a Member State decides to extend an advantage to all undertakings throughout the Community such measure would not be caught by Article 87(1) EC.[342]

3. General comment regarding the two conditions

It must be noted that the two abovementioned conditions are usually scrutinised by both the Commission and the ECJ as one and the same. The CFI has recalled that « (…) *in matters relating to State aid, the two conditions for the application of Article* [87(1) EC]*, namely that trade between Member States must be affected and competition distorted, are as a general rule inextricably linked. In particular, where State financial aid strengthens the position of an undertaking as compared with other undertakings competing in intra-Community trade, the latter must be regarded as affected by that aid (Alzetta v Commission, paragraph 81, and the case-law cited therein)*"[343].

The Commission *Vademecum* on State aid[344] presents both conditions under the same heading ("effect on competition and trade") and confirmed the *per se* approach by stating that "*[i]t is sufficient if it can be shown that the beneficiary is involved in an economic activity and that he operates in a market in which there is trade between Member States*".

In this same vein, it can be noted from the case law that many of the arguments put forward by the ECJ to support the proposition that trade between Member States is affected by a particular measure are also used to uphold that a given measure distorts competition. For example, the fact that a sector is characterised by structural overcapacities is usually taken into account when examining whether the measure entails a distortion of competition.[345]

Recent developments seem to be hinting at a change in the assessment of both conditions by the CFI. In *Le Levant v Commission*[346] and *Italy v Commission (Wam)*[347] cases, the CFI annulled two Commission decisions on the grounds that the institution had not provided suffi-

341 Opinion of Advocate General Fennelly delivered on 28 September 1995 in Case C-56/93 Belgium v Commission [1996] ECR I-723.

342 According to AG Fennelly "*a commercially unjustifiable preferential price (i.e. an aid) might, however improbably, be extended to ammonia producers throughout the Community on equal terms before breaching Article 92(1)* [87(1)] of the Treaty because there would be no threat to trade or competition within the Common Market". AG Fennelly's opinion is mentioned in Evans, European Community Law of State aid (Oxford University Press, 1997), pp. 484, at p. 86. For a similar idea, see Keppenne, op.cit, p. 123.

343 Case T-288/97 Regione autonoma Friuli Venezia Giulia v Commission [2001] ECR II-1169, paragraph 41.

344 Vademecum – Community rules on State aid, available at: http://ec.europa.eu/comm/competition/State_aid/others/vademecum/vademecumen2003_en.pdf.

345 Case 310/85 Deufil GmbH & Co. KG v Commission [1987] ECR 901. A complete catalogue of the arguments relied upon by both the Commission and the ECJ with regard to this condition can be found at Evans, *op. cit.*, at pp. 79-91.

346 Case T-34/02 EURL Le Levant v Commission [2006] not yet reported.

347 Joined Cases T-304/04 and T-316/04, Italy v Commission (Wam) [2006] not yet reported

cient evidence that trade between Member States would be affected and competition would be distorted. The first of the cases concerned a subsidy granted to an undertaking established in Saint-Pierre-et Miquelon, a French *territoire d'outre mer* that is outside the boundaries of the EC. The second case concerned a series of tax breaks granted by the Italian government to undertakings willing to penetrate markets in the Far East (Japan, South Korea and Taiwan). It is difficult to draw any definitive conclusion from these two cases, which remain isolated and both present a very particular set of facts, in the sense that State aid in both cases was granted for activities taking place outside the EU.

In any event, following the *Wam* case, some of the conclusions outlined above are now open to question. The CFI required in that case that specific motivation is devoted to the effect on trade and distortion of competition conditions. Surprisingly, the CFI considered that a finding by the Commission that the undertaking is put at an advantageous position by the granting of the aid is not sufficient to establish the fulfilment of these two conditions, for it is simply, in the CFI's view, the natural consequence of State aid.[348] The fact that the undertaking is engaged in intra-Community trade is not sufficient either, according to the CFI.[349] In line with the ECJ in Altmark, the *Wam* case seems to confirm, contrary to what stems from previous cases, that the effect on trade and distortion of competition conditions are independent from one another.[350]

III. Economic Commentary on current case-law

1. What is the link between economic advantage and selectivity?

a) Defining selectivity and economic advantage

Despite the abundant case law presented in Section 2, it is quite interesting to see that the conditions under which Article 87(1) EC is fulfilled have only recently been clarified by the *Altmark* judgment, and even so, there is still some confusion as to whether there are four or five conditions.[351]

While the issue may be semantic, a clarification of the respective roles of the concepts of selectivity and economic advantage seems useful. Selectivity and economic advantage may be interpreted as being two conditions that must be jointly satisfied or as a unique criterion – in the sense that selective measures always confer an economic advantage or that a measure

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348 Joined Cases T-304/04 and T-316/04, Italy v Commission (Wam), quoted supra, at para. 67.

349 Joined Cases T-304/04 and T-316/04, Italy v Commission (Wam), quoted supra, at para. 74.

350 It is interesting to note that CFI took the view, in paragraph 74 of the judgment, that the participation of an undertaking in intra-Community trade does not suffice to establish the effect on trade and distortion of competition conditions. Therefore, one may imagine that in a case similar to Wam the distortion of competition may be established, if sufficiently motivated (as a consequence of the participation in intra-Community trade) but the effect on trade condition may not be fulfilled, if subsidies only concern trade outside the Community.

351 Annex I presents a selection of quotes listing the four or five conditions of Article 87(1) EC.

conferring an economic advantage is always selective. The latter intuition holds true in most cases, and the question whether an advantage is granted is answered by having regard to the selective nature of the measure. However there are at least two cases where it becomes apparent that "*advantage*" and "*selectivity*", as defined by the current case law, are in reality two different concepts, even though they are presented by the ECJ as part of one and the same condition. In particular, selective measures do not necessarily confer an economic advantage, and can be excluded from State aid control despite their selective nature. This is the case in at least the two following situations:

when the State measure compensates for a particular burden on the recipient(s) (like an SGEI or a structural disadvantage, imposed by the State); or

when the a market economy investor would have provided the measure under the same conditions.

In these cases, the selective measures (as defined under Article 87(1) EC) would not confer any economic advantage and would therefore be deemed "non-aid".

b) Critical assessment of the current interpretation of the selectivity criterion

The review of the case law in Section 2 indicates that, in the past, the selectivity criterion has generally taken the form of a discrimination test, which asks whether all undertakings in the granting Member State are eligible for a measure involving State resources (e.g. tax benefits or subsidy). As a consequence, the test bears, at least at first sight, similarities with discrimination tests that also apply in the context of Internal Market provisions, such as Article 28 EC. This may be due to the fact that a system of State aid control is complementary to the establishment of the Internal Market. Some authors have indeed put forward the idea that the rules on State aid "*share more chromosomes with internal market rules than antitrust rules*".[352] In this regard, it must be pointed out that, indeed, when a customs union is established, its members may feel tempted to treat more favourably those firms or industries with a competitive disadvantage. This interpretation may explain why Article 87 EC is concerned with measures that favour "*certain undertakings and the production of certain goods*" and leaves outside its scope general measures.

As a consequence, the Commission and Community courts currently assess whether, prima facie, a State measure applies to all undertakings (i.e. whether all undertakings are in principle *eligible* for the measure).

There are however exceptions: in the *Commission v Italy* case, the ECJ upheld the Commission finding that a seemingly general measure sought to favour *de facto* the textile industry (the measure was aimed to promote female employment) and thus was selective.[353]

Yet, it stems from past practice that the Commission will not look systematically at the asymmetric effects of measures that appear to be general. In the Notice on direct business

352 Jose Luis Buendia Sierra, "The refined economic approach seen from a legal point of view – some sceptical remarks", The European State aid Law Institute, p.31.

353 Case 203/82, Commission v Italy [1983] ECR 2525.

taxation, also referred to supra, the Commission made this clear when it stated that "*measures designed to reduce the taxation of labour for all firms have a relatively greater effect on labour-intensive industries than on capital-intensive industries, without necessarily constituting State aid*".

In recent studies, economists have identified the problem of asymmetric effects of seemingly general measures. The previous Chief Economist at DG Comp and his co-authors observed that:

> "Measures which are de jure not selective may de facto have a highly divergent economic impact on firms, sectors or regions".[354]

Likewise, the OFT, in its recent study on the effect of public subsidies, also considered that:

> "A subsidy may be asymmetric in effect even if it is not selective in terms of its eligibility criteria. For example, a subsidy which is available to firms in a market in a particular region may be asymmetric, because it will only affect firms that have yet to decide where to locate, or those that can move relatively low cost. A subsidy for a particular type of technology may also be asymmetric in effect, as firms which have already invested in the technology will not benefit. Finally, a subsidy could be asymmetric in effect if it favours a particular business model. For example, a subsidy for training could assist a firm with a labour intensive production process more than a competitor with a more automated process".[355]

While these arguments focus on the fact that a test based on eligibility may lead to under enforcement, we would like to emphasise that the alternative is also true. Currently, the Commission would not conclude that an aid measure is excluded from State aid control if only a subset of undertakings in a relevant jurisdiction are eligible and if no asymmetric effect is to be expected. However, from an economic perspective there is no asymmetric effect if all competing firms are affected in a similar way though there may well be other undertakings in other relevant markets (which may or may not be eligible) where the effect differs. For example, measures affecting one sector, one region or only a group of firms might be excluded from further scrutiny if *competing* firms all benefit (in similar ways) from the measure. One such example could be the change in the VAT status applicable to medical services in Austria (*Heiser* case[356]) as this modification would affect all dentists and doctors based in Austria in a similar way (i.e. it would not be expected a priori to favour some dentists/doctors more than others).

The asymmetric effects approach would therefore also exclude measures that are deemed selective under the current case law. From this perspective, an effects based approach could

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354 See Friederiszick H., Röller L-H. and Verouden V, *op.cit*

355 Public Subsidies, A Report by the OFT, November 2004 (OFT750), at para. 3.38.

356 *Op.cit.*

therefore also reduce the number of State aid measures to be scrutinised by the Commission.

These arguments seem to argue in favour of the introduction of an effects-based approach that departs from the past focus on eligibility. However, there is concern that in practice moving in that direction may be impractical and costly to implement. Indeed, a literal application of an effects based approach would imply that the selectivity condition would be of quasi-automatic fulfilment for most general measures, as Nicolaides, Kekelekis and Buyskes have commented:

> *"Given the fact that not all undertakings operate under identical conditions, in principle there is no such thing as a general scheme that can apply equally to all undertakings. The Commission and the Court, however, do not attempt to examine the precise ex post effects of a general scheme on company competitiveness. They consider instead whether in principle it applies to all sectors of the economy (i.e. whether it discriminates a priori between sectors) and whether any company may, in theory, be eligible to benefit from it"*[357].

Thus, the question is clear: are the cost of implementation and the practical difficulties of moving to an effects based approach so prohibitive that the Commission should remain with the eligibility test despite the under or over enforcement it may entail?

The *Commission v Italy* judgement, which departs from the pure assessment of selectivity predominantly based on eligibility, nicely illustrates the tension between conceptual purity and practicality.

Thus, one interim finding of our discussion is as follows:

An effects-based approach is preferable as it is conceptually sounder but it is practically more difficult to implement than a test based on eligibility.

The current Commission practice focuses on eligibility but case law allows for an assessment of the effects of a measure (see *Commission v Italy*).

In this context, should we push for more effects-based analysis? There are controversial views on this issue within the group. On the one hand, it is easy to construct scenarios where such a move is inadvisable: a full-fledged effects based analysis would require an assessment of whether a general measure affects in an asymmetric way competing firms in numerous relevant markets. Thus, read literally, it would require market definition exercises within the Article 87(1) procedure for potentially a large number of cases. On the other hand, the current state of affairs is uncertain and a move to a pure discrimination test would lead to obvious under and over enforcement (moreover the current situation is unclear as asymmetric effects can be considered but on a very unsystematic basis).

While the optimal approach may ultimately require a more detailed analysis of the effectiveness of the rules for the bulk of the cases that the European Commission looks at (a task beyond the scope of this paper), we are tempted to presume that the optimal approach should

357 Nicolaides, Kekelekis and Buyskes, *State aid Policy in the European Community* (Kluwer, 2005), p. 25.

try to identify only those cases where (1) not all undertakings in the relevant jurisdiction are eligible but the lack of asymmetric effects are obvious (in which case selective measures could be exempted under Article 87(1)EC) or where (2) all undertakings are eligible but the asymmetric effect is highly probable and sizeable (i.e. when general measures are designed to target specific groups).

Such an approach would provide a more systematic tool to identify measures that confer an a relevant economic advantage to some firms vis-à-vis their competitors. It would also ensure that general measures are not specifically designed to favour certain sectors or more importantly, certain undertakings. This seems to be the reason why the Courts have suggested that the actual effects of general measures should be looked at (see *Commission v Italy*). Indeed, it seems that asymmetric effects of general measures are only looked at in those cases where the allegedly general measures are likely to favour, "*with a high degree of probability*" certain undertakings. In all other cases, the Commission would be satisfied so long as the measure is not discriminatory.[358] This seems a reasonable approach given the costs associated with implementing literally the asymmetric effects approach to general measures affecting all undertakings in a Member State.

To make things more complicated, under current case law some measures that favour certain undertakings are deemed non selective insofar as they are justified by the "nature and the economy" of a system. The application of this criterion is often criticised for being applied on a case by case basis. The concept of "nature and the economy of a system" seems to have been implemented mainly to exclude selective measures that pursue specific policy objectives deemed worth pursuing despite their potential for selective effects (e.g. environmental objectives). Also, general measures may have asymmetric effects when general measures in one Member State have no asymmetric effect amongst local firms but have a selective effect on local firms *vis-à-vis* their competitors in other Member States (e.g. if corporate tax is reduced or labour charges reduced). Both aspects are discussed in the next section.

c) Should general measures or selective measures "justified by the system" be excluded from State aid control?

The exclusion of so-called "general measures" (generally fiscal measures affecting all operators located in one country) from State aid control is justified by the broader policy consideration that DG Comp should not be involved in pursuing tax harmonization objectives. From an economic point of view this approach also makes sense.

As discussed above, case law has given significant prominence to the selective form of State measure (e.g. are all undertakings in a country eligible?).

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358 Nicolaides, "Fiscal State aid in the EU: The Limits of Tax Autonomy", *World Competition*, vol. 27, n. 3 (2004), pp. 365-396, at p. 373. In the Commission v Italy case mentioned above the selective nature of the measure was supported by further evidence (Italy excluded certain branches of the industry). In other cases, the selective effects of supposedly general measures were rather obvious. In Case 169/84, Cdf Chimie AZF [1990] ECR I-3083, for instance, the eligibility criteria could only be satisfied by a sector.

In many situations, the selectivity of an aid instrument is a good proxy for the selectivity of its effect. However, from an economic perspective, asymmetric effects should be taken into account and economic analysis can play a role in assessing such asymmetries. Where the relevant State aid markets are international, seemingly general schemes (e.g. taxation of competing firms located in different countries) may become selective in their effect, and thus affect trade and distort competition in the sense of Article 87(1) EC.

Hence, there should *a priori* be no economic argument to exclude such measures from EC scrutiny: general tax competition could have the same effects as State aid races. However, while conceptually not very distinct from State aid, there are arguments to exclude general tax measures from State aid control. Besley and Seabright actually argue that tax competition issues differ fundamentally from State aid control for two main reasons: there is no clear evidence that lower tax regimes in one country create negative cross-border externalities in the same way that subsidies can; and tax competition tends to reduce the overall level of public spending when subsidies increase it.[359] Within the European Commission, general tax regimes are covered by DG Internal Market, and therefore issues raised by tax competition fall outside the scope of State aid control. Excluding general tax regimes can therefore be justified on economic grounds.

From an economic point of view the relevant screening criterion should be whether aid confers a selective economic advantage with reference to the relevant market, irrespective of whether the measure is general or not. However, the exclusion of general fiscal measures from the Article 87(1) EC prohibition may be justified despite the fact that seemingly non-selective measures may have selective effects on competing rivals. This view is in accordance with the legal architecture of the EC Treaty: distorting effects of general measures are to be tackled not under the provisions on State aid, but under the provisions dealing with tax harmonisation (Article 93 EC), which require unanimity by the Council, and, more generally, under the provisions relating to approximation of laws (Articles 96 to 97 EC).

d) Beyond the current approach to selectivity: an effects-based approach

Our discussion suggests that, rather than relying on the *nature* of the aid to determine selectivity and advantage, an economic approach would advocate to start by identifying the set of competing firms (i.e. define the market) and evaluate whether the measure grants a "selective advantage" to one or some of the competing firms on that market (including potential entrants).

Measures that confer a "selective advantage" would cover measures with asymmetric effects despite their non-selective nature (as defined by the case-law) and would also be consistent with case law regarding measures that are selective but deemed not to grant an economic advantage (i.e. in *Altmark* and *Combus*). Also, as indicated above, there are reasonable grounds to also exclude general measures or measures justified by the "*nature of the system*" (i.e. national tax schemes, regulations, social or labour laws) from the scrutiny of State aid control.

359 Besley and Seabright, Discord over Harmony, European Economic Perspectives, February 1999.

A systematic approach to determine whether a measure confers a selective advantage constitutes a meaningful starting point for the assessment of the effect on competition and trade and the economists propose the following approach in which each of these five questions should be addressed[360]:

1) Does the measure lead to a benefit for the recipient (i.e. is the recipient better off because of the measure?)?[361] If the answer is "No", the aid does not confer a selective advantage.
2) Would a market economy investor have provided the same benefit? If the answer is "Yes", the aid does not confer a selective advantage.
3) Does the benefit provided exceed any relevant costs due to a burden imposed on the recipient? If the answer is "No", the aid does not confer a selective advantage.
4) Is the resulting benefit relative to a situation without aid (and without the burden) selective? i.e. not provided to all firms in the relevant market or selective in its effect. If the answer is "No", the aid does not confer a selective advantage.
5) Does the selective effect arise from measures justified by the "nature or general scheme of the system"? If the answer is "Yes", the aid does not confer a selective advantage.

Determining whether a measure confers a selective advantage as defined above is important for screening purposes: when a measure does not give a selective advantage, no distortion of competition should arise, unless the cost to taxpayers is taken into account, and no effect on trade should arise (with the exception of cases that are screened out in step (5)).

However, if this first step indicates that a selective advantage is being granted it does not automatically entail that the measure will "distort competition" or have an "effect on trade". Further screening should be undertaken – as discussed below.

e) Beyond the current approach to selectivity: some implications for State aid policy

As already said, the "effects-based" approach presented in the previous section constitutes a clear departure from the current system as it requires a systematic identification of competitors and the way in which the measure affects the recipient(s) and its rivals. As a consequence, it would have serious implications for State aid policy. If, for instance, the relevant market is national or local in scope, and all undertakings benefit from the aid in the same way, the State measure would be found to be non-selective. From a legal point of view, this would lead to unjustified "false positives", as sector-specific aid could fall outside Article 87(1) EC when the relevant market is national or local. The fact that the relevant market is national or local in

360 Annex 2 presents these questions in diagram form.

361 Of course, most State measures are likely to provide some benefit to the recipient(s), otherwise they are just entirely wasteful and ineffective.

scope has never excluded the application of Article 87(1) EC, as the ECJ has constantly taken the view that State aid may contribute to the foreclosure of national or local markets.[362]

Where the relevant State aid markets are international, general measures may become selective under the test that economists would advocate. However, as acknowledged above, the distorting effects of general measures should be examined under Articles 90 to 93 and/or 96-97 EC.

It is also submitted that the justification of selective measures by the "nature or general scheme" of the system are only workable when selectivity is applied with regard to other companies within the Member State. Another interesting topic is raised by the recovery of State aid in the case of general measures. If general tax measures are found to be caught by Articles 87-88 EC, what would be the applicable recovery measure? It is submitted that, in practice, such an extension of the scope of Article 87(1) EC would necessarily lead to tax harmonisation (or other approximation of laws).

With regard to the rest of the conditions laid down in Article 87(1) EC, an effects-based approach to selectivity may lead to an overlap with the distortion of competition condition. As already mentioned above, the selectivity criterion aims to ascertain whether the State has singled out one or more undertakings. From a legal standpoint, this criterion cannot deal with undertakings beyond the boundaries of the Member State, as these boundaries are necessarily the limits of the legislative powers of the State. It is under the distortion of competition and the effect on trade conditions that the Commission and the Courts ascertain whether the measure has effects on other undertakings established beyond the boundaries of the granting Member State. The architecture of Article 87 itself would also favour this interpretation.

From a legal perspective, the idea of moving towards an effects-based approach to selectivity would involve, rather than defining the relevant market to identify the "competing firms", transposing some ideas that currently apply in the context of internal market law. Under Articles 28 and 90 EC, objective criteria have been accepted as valid justifications for discriminatory regimes.[363] The same principles could apply to assess whether two undertakings can be considered as being "competing firms" and whether the measure entails asymmetric effects on the basis of objective. For instance, the "*business models or production technologies*" used could be considered as objective criteria. Such an approach would be closer to the current interpretation of the selectivity criterion by the ECJ. In his opinion in the *Adria-Wien Pipe-*

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362 See for instance Case 102/87 France v Commission [1988] ECR 4067 and Case C-303/88 Italy v Commission [1991] ECR I-1433.

363 See in particular Case C-106/84 Commission v Denmark [1986] ECR 833, paragraph 20, and Case C-196/85 Commission v France [1987] ECR 1597, paragraph 6 quoted in Opinion of Advocate General Mischo delivered in Case C-132/88 Commission of the European Communities v Hellenic Republic, [1990] ECR I-01567, paragraph 17: *"at its present stage of development Community law does not restrict the freedom of each Member State to lay down tax arrangements which differentiate between certain products, even products which are similar within the meaning of the first paragraph of Article 95, on the basis of objective criteria, such as the nature of the raw materials used or the production processes employed . Such differentiation is compatible with Community law if it pursues objectives of economic policy which are themselves compatible with the requirements of the Treaty and its secondary legislation, and if the detailed rules are such as to avoid any form of discrimination, direct or indirect, in regard to imports from other Member States or any form of protection of competing domestic products ".*

line case,[364] the Advocate general Mischo raised a similar idea when he stated that the different treatment reserved for the primary and secondary sectors does not constitute derogation from the normal application of a general system.[365] He took this opportunity to present the risks of such approach. In his opinion, *"the doors are opened wide to all kinds of abuse. Consequently, tomorrow, a Member State could raise the general level of its social charges with impunity and increase them even more in the services sector."* The equilibrium between the Member States and the common market is threatened.

Whether a legal or an economic perspective is preferred in the shaping of an effects-based approach to selectivity, it is important that such an approach is based on precise and predictable rules so as to avoid the risks of legal uncertainty. It must be pointed out that this new solution may not necessarily lead to increased legal uncertainty, if account is taken of the fact that the scope of the notion of selectivity remains unclear. On the other hand, there is scope for increasing legal certainty under the current approach to selectivity. However, the use of economic tools may not contribute to increasing legal certainty.

2. Devising a screening test to exclude cases with limited effect on competition

According to case-law (see Section 2), measures that lead to a selective advantage have so far been identified as distorting competition and affecting trade provided that (a) the beneficiary was engaged in an economic activity (required for the effect on competition) and (b) firms in other Member States are (potentially) affected by the measure.

In other words, it is sufficient to prove that a measure confers a selective advantage to conclude that Article 87(1) EC applies and the State aid can only be authorized if compatible with Article 87(3) EC. It is also sufficient to prove the absence of a selective advantage to warrant a "non-aid" decision (i.e. the measure is unlikely to distort competition and affect trade). Is such an interpretation of Article 87(1) EC valid from an economic perspective? Or should the "distortion of competition" condition be subject to additional analysis in order to screen out selective measures less likely to distort competition? And are there non-selective measures likely to distort competition?

Overall, a measure conferring a selective advantage to its recipient, relative to its competitors is likely to distort competition. However, the strong presumption that the distortion will be automatic is not justified. The appropriate screening to distinguish distorting aid from non-distorting aid will depend on the welfare objective. As the previous Chief Economist and his co-authors put it:

"The first step to a more refined economic approach is to define a relevant policy standard in the assessment of State aid measures. (…). The crucial question is what interpretation should be given to the concept of common interest, i.e. what is the relevant standard for assessing whether an aid measure is in the common interest?"[366]

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364 Case 143/99, Adria- Wien Pipeline v Finanzlandesdirektion, ECR [2001] pI-08365.

365 Ibid, para. 49.

366 *Op.cit*, page 26.

The identification of the policy standard is necessary to determine which State measures can be screened out under Article 87(1) EC and it is necessary to guide the compatibility assessment of measures under Article 87(3) EC. Once the policy standard is established (e.g. maximisation of consumer welfare, rival profits or total welfare), it is possible to identify which type of measures can be safely excluded from the Commission's scrutiny as they are unlikely to distort competition. It is important to clarify that economists assess a "distortion of competition" on the basis of whether the policy standard is negatively affected by the aid measure under consideration. Under a rivals' profit standard, a "distortion of competition" would arise if the profits of the recipient(s)' *rivals* are negatively affected by the aid measure. Under a total welfare standard, a "distortion of competition" would arise if the sum of consumer surplus, taxpayers surplus, the recipient(s)' and competitors' profits is negatively affected. Under such a standard, if the benefit to the recipient and customers *exceeds* the cost to taxpayers and reduction in rivals' profits, then there is no "distortion of competition". Hence, it is easy to see that conclusions (and hence, screens) may differ substantially depending on the standard ultimately defined as the objective to pursue.

a) Welfare Criterion: effect on rivals

When subsidies affect the recipient firms' behaviour, rivals' profits are likely to be affected. Standard economic models suggest that aid measures that are not explicitly tied to a given behaviour and that do not lead to a marginal cost reduction do not change firm behaviour (although these may affect entry/exit decisions or investment decisions). The idea is that a firm's optimal market behaviour is *independent* of transfers of lump sums of money. Only if there are capital market imperfections, will the level of financial resources a firm command influences its behaviour (e.g. by allowing predatory strategies).

Although there is agreement among economists that capital markets are not perfect, there is no clear consensus on the importance of the imperfections, which will depend on the case analysed. Thus, while discussions about the role of capital market imperfections are unsettled, there may well be aid measures unlikely to result in a change of market behaviour (for example, aid measures leading to lump sum payments for early retirement schemes or other measures that are not linked to firm behaviour). On the other hand, aid measures to firms in difficulty will affect market behaviour (because in such cases, measures will directly affect the decision to exit) and are therefore likely to distort competition.

If the firm behaviour is affected and if the welfare criterion is rivals' profits, a measure that confers a selective advantage will be likely to distort competition. Proving that a measure confers a selective advantage that would lead to a material change in behaviour by the recipient(s) should therefore require a detailed investigation under Article 87(3) EC.

Economists and other competition authorities have researched the possibility to design further screens to exclude from scrutiny measures that provide a selective advantage but are still unlikely to distort competition (when rivals' profits is the welfare measure). For example, such analysis of the circumstances in which State aid "distorts competition" (in the sense that rival profits are reduced) was undertaken by Garcia and Neven (2005).[367] Their paper suggests that the effect on rival profits depends on the type of aid, the firm behaviour likely to be affected by the aid (aid affecting marginal cost, aid affecting fixed costs and aid affecting quality). For all types of aid, distortions will tend to increase with the degree of concentration. However, the degree of substitution between the firm's products on differentiated markets will affect rival profits in different ways depending on the type of aid and the location of firms (i.e. domestic vs. foreign).

Market concentration was also identified as a screening factor in the study by Frontier for the OFT.[368] In particular, if market concentration is extremely low (or in fact if the market is fully monopolised) before the subsidy is granted, competition distortions are less likely.[369] Yet, even with low market concentration, subsidies could be distortive unless the subsidy is "*not so large*" so as to prevent rivals from competing.[370]

Overall, the results of these studies do not offer simple rules to devise an across-the-board screening of aid measures that confer a selective advantage. The proposed screens suggest combinations of selectivity criteria (whether the aid offers a selective advantage), the type of aid, the effect of the aid on the firms' behaviour, the degree of market concentration and the level of aid. The OFT proposals of November 2005 indicate that any robust "Phase I" screen should include some analysis of market failure.[371] In their 1998 report for DG-III (now DG Enterprise), Besley and Seabright[372] proposed a policy rule to assess compatible aid measures covering 7 steps (which involved looking at market concentration, net negative cross-border externalities, market failures, …). However, their proposal implicitly referred to the compatibility assessment under Article 87(3) EC as they presume that the first screen just involves identifying whether the measure constitutes an aid that treats one or a group of firms more favourably than others in the same jurisdiction (i.e. broadly following the definition of "selective advantage" under the current case-law).

Overall, the various attempts at identifying appropriate screens to reduce the number of cases to be notified under Article 87(1) EC do not provide simple screens. Apart from giving more prominence to the behaviour of the firm that would be altered by the aid, State aid control does not lend itself to a set of screens to clear subsidies that confer a selective advantage without further analysis of the type of aid, the market circumstances and the market failure that is targeted.

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367 Garcia J. and Neven D., State aid and Distortion of Competition: A Benchmark Model, HEI Working Paper No 06/2005.

368 Frontier Economics, The Effect of Public Subsidies on Competition, A report prepared for the Office of Fair Trading, November 2004.

369 However, even if the market is monopolised, one would have to consider the effect of subsidies on potential entrants and any distortion arising from subsidised prices in the relevant market (which may affect substitution away from other products).

370 Frontier Economics, *Op. Cit.*, Page 28.

371 European State aid Control, November 2005, OFT (OFT821). In Diagram 4.2 the OFT proposes a screening test that requires looking at market failures, selection criteria and market shares.

372 Besley T and Seabright P, 1998, The Effects and Policy Implications of State aid to Industry: An Economic Analysis, Report to DG-III of the European Commission, page 42.

Market concentration is one good example to illustrate this point. There will be no linear relationship between market shares and the likely distortion of competition generated by State aid.[373] Aid provided to a monopoly would in theory have no distortive effect (as there are no competitors, and yet, entry decisions by potential entrants could be affected) Aid provided to one firm or a small group of firms in an unconcentrated market might on the other hand distort competition if the product is homogeneous, the aid affects operating costs of the recipients and production is transferred from competitors to the recipients of the aid (if the recipients of the aid are less efficient than competitors, this would be particularly distortive). If the aid is targeted towards specific investments, such as R&D, the impact of the aid should be assessed with respect to the position of the firms in the innovation "market" (rather than their position on the production markets).

When "distortion of competition" relates to the effect of a subsidy on "rivals' profits", economic theory therefore predicts that subsidies granting a selective advantage (as defined by the five-step approach advocated above) tend to harm rivals *if the recipient's behaviour is significantly affected*. If the behaviour is marginally altered, then even measures that confer a selective advantage should be cleared (as should all measures that do not confer a selective advantage). Additional screens (such as the level of subsidy (in absolute or percentage terms), the type of aid or market concentration) would require a more thorough review of the circumstances of each case, including identifying the market failure targeted by the aid. Such analysis would – under the current architecture – be undertaken under Article 87(3) EC.

In the current context, it is therefore concluded that identifying a "selective advantage" and the effect on the recipients' behaviour are the most appropriate screening tests to identifying likely "distortion of competition" under a rival's profit policy standard.

b) Welfare criterion: effect on rivals, consumers and taxpayers (total welfare)

If total welfare is the relevant standard to assess competition distortions, the previous conclusions are altered to a significant extent. In fact, under a total welfare criterion, the "selective advantage" criterion may be a poor screening instrument.

In particular, if the aid confers no selective advantage (for example if no selective effect is identified and one aid measure affects all competing firms in similar a way), distortions of competition may still arise *if total welfare is reduced when accounting for consumer and taxpayer's surplus*.

Also, when State aid does not change the market behaviour of the recipient or the market structure (i.e. it does not prevent entry or exit), a loss to taxpayers may still arise and reduce total welfare. In such circumstances, a measure could therefore distort competition and be subject to further scrutiny, even if does not confer a selective advantage or affect market behaviour. As discussed above, under a rivals' profits standard, such measures should be allowed and exempted from further scrutiny.

373 Note that even in a more settled area such as merger control, the relationship between market shares and competitive harm is not straightforward in markets with differentiated goods or bidding markets.

Under a total welfare standard, the impact of a measure on consumers, taxpayers, the recipients and its rivals needs to be taken into account. In such context, the “selective advantage” screen is not suited to identify potentially distorting measures. Under a total welfare approach screening should involve checking whether the aid is targeted to address a significant market failure. This requires individual thresholds and analysis depending on the nature of the market failure. With this approach potentially a large number of cases can be screened out but it is currently only applicable under Article 87(3) EC.

Under a total welfare criterion, devising a single screen for all types of aid would be extremely difficult because the market distorting effect will depend to a large degree on the type of aid but also on the type of market failure that the aid is supposed to remedy. This point is reminiscent of the approach advocated by the OFT and would require a major shift in the application of Article 87(1) EC. Alternatively, this may once again imply that Article 87(3) EC may be more suited to undertake the assessment of the market distorting effect of the measure.[374] In this context, market-failure specific block exemptions are actually likely to better achieve the screening of aid measures unlikely to distort competition.

c) Conclusions on the scope for refining the “distortion of competition” condition

The “selective advantage” criterion is an appropriate screen under Article 87(1) to exclude aid measures that are unlikely to distort competition under a rivals profit standard. Further refinements could be brought under the “distortion of competition” with an additional step to analyse the extent to which the market behaviour of the recipient would be altered.

Under a total welfare standard, the current architecture of defining “State aid” based on selective advantage is not appropriate (as it directly tackles the effect on rivals but does not provide any insights on the relative effect of the measure on the recipients’ profits, customers and taxpayers). A more direct analysis of the market failure targeted by the aid measure would have to be undertaken. Overall, a complete overhaul of the current practice for defining State aid under Article 87(1) EC would have to be considered if total welfare is the relevant standard,

Without further research (empirical in particular) of the extent to which the current architecture (or a screening based on the “selective advantage” approach suggested in 3.2 (b)) excludes clearly harmful aid measures from the Commission’s scrutiny, it might be advisable to pursue the first screening of aid measures based on a “selective advantage” type criterion (with some refinements) and undertake a more thorough analysis of the impact on total welfare, including an analysis of market failures, under Article 87(3) EC– if total welfare is ultimately the objective pursued under State aid control.

We now turn to the “effect on trade” criterion and discuss how this criterion could be refined and given a more prominent role in the analysis under Article 87(1) EC.

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374 Note however that there will be a tension between arguing for non-aid (i.e. MEIP is satisfied) and arguing that the measure corrects a market failure.

3. When is trade affected by measures conferring a selective advantage?

As discussed in Section 2, case-law has not interpreted the effect on trade criterion relative to a relevant market or with reference to the existence of cross-border externalities. On the contrary, the "effect on trade" criterion has been interpreted widely given that selective aid measures are deemed to affect trade between Member States (independently of whether the product in question is traded or not). In fact, even aid measures which have strong effects on competition can have only limited or no effects on other Member States. If the relevant market is local, the effects on foreign rivals (and potential foreign entrants) may well be limited. The main question is the following: is there a rationale for investigating aid measures affecting Dutch zoos or German swimming pools? Some commentators argue that the Commission should not deal with such cases.[375]

Determining whether such cases should be analysed by the Commission and designing a screen that excludes such cases will hinge on the extent of the role that the European Commission is expected to play as a supranational supervising authority.

Supranational control of national subsidies may have several objectives. Depending on the objectives assigned, the interpretation of the "effect on trade" should cover a wider or narrower range of subsidies.

Most commentators would agree that in the presence of cross-border externalities (when State measures in one country negatively affect companies or customers in another country), supranational control should be implemented.[376] Governments will tend to take into account the interest of national companies and consumers, without taking into consideration the impact that State aid granted to local firms may have on consumers and competing companies in other countries. In this context, too much aid will be granted and supranational control may be necessary. The "effect on trade" criterion , as interpreted so far, certainly covers State measures that generate cross-border externalities. The issue is the extent to which the criterion goes beyond this rationale.

The interpretation of the "effect of trade" condition under Article 87(1) EC covers a much wider range of measures (i.e. measures that are unlikely to have cross-border externalities such as subsidies affecting Austrian dentists). For years, the Commission has been investigating subsidies that may distort competition at a local level but certainly do not affect trade in any significant way (as discussed before, the Brighton West Pier and the Dorsten swimming pool are rare examples where the Commission adopted a narrower approach to the "effect on trade" criterion).

Should the Commission be worrying about subsidies granted locally by national governments when such subsidies are unlikely to affect rivals or consumers in other countries? The answer will depend on whether European State aid control has an additional rationale: controlling national "regulatory failures" (where governments grant aid even though it distorts competition locally – whichever the welfare criterion that is applicable). When local governments

375 See Frédéric Louis, Presentation on 14 June 2005 at the seminar on EC State Control: the case for reform.

376 Besley, Timothy; Seabright, P. , *op cit*.

cannot resist pressure groups, or grant subsidies conferring short run benefits but leading to dynamic inefficiencies,[377] control by a supranational body may resolve national inefficient decision-making by governments.

To date, European State aid control seems to have served these wide purposes: intervention against State measures that generate cross-border externalities and monitoring inefficient national subsidies. If the "effect on trade" criterion serves these two purposes, then it has been appropriately defined by the case-law – though the wording of "effect on trade" is misleading and has been stretched to give the Commission the right to overview subsidies with very limited effects on other Member States. Indeed, if the supervisory role of the Commission extends to all measures that may distort competition (even if competition is only distorted locally), the actual role left to the "effect on trade" criterion becomes extremely limited (as the past practice illustrates).

However, if the view is that the European Commission should not deal with State measures affecting swimming pools, zoos, local bus services or dentists (irrespective of whether these measures distort competition), a more prominent role for the "effect on trade" criterion is warranted and economic analysis can provide guidance.

A revised "effect on trade" criterion was developed in a recent study for the European Commission.[378] It is aimed at identifying (and then excluding from the Commission's scrutiny) those cases where the net welfare effect on the non beneficiary Member States is positive so that there is no strategic-trade-type incentive to provide excessive aid. Thus, the analysis would only continue if other Member States are likely to carry the burden (due to distortions of competition) while the aid giving Member State benefits (e.g. by favouring national firms).[379] The screen consists of asking two questions:

1. question 1: is the definition of the relevant State aid market national or local?
2. question 2: is there no indication of likely anticompetitive behaviour by the recipient (e.g. predatory behaviour or foreclosure) and are the other Member States jointly not significant net-exporters?

If either of the two questions is answered with yes, the State measure should not be qualified as State aid since it is unlikely to significantly harm welfare, assuming that Member States' State aid decisions are in the best interest of their citizens.

Such a screen could filter out cases like those mentioned above: Local transport, swimming pools and local services like dentists. This approach would be contrary to current practice in which aid to firms that operate in clearly national or local markets is investigated by the European Commission.

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377 In their paper, Friedrichszick, Röller and Verouden provide some examples.

378 Nitsche R. and Heidhues P., Study on methods to analyse the impact of State aid on competition, Report to DG ECFIN, December 2005.

379 A similar suggestion is proposed by Pietro Crocioni, a UK senior economist at OFCOM. See "Can State aid Policy Become more Economic Friendly?", World Competition, 29(1), 89-108, 2006.

Two cautionary remarks, however, are due. They both relate to the concept of market definition in the context of State aid cases.[380]

First, where bidding markets (for local services) are international (as they usually should be) aid to local bidders may distort competition and harm foreign rivals without any compensating benefit to foreign consumers. Second, where there are complementary inputs or downstream goods, the analysis must cover these markets as well. While the market for a branded consumer good may be national due to national advertisement activities and distribution networks, a selective subsidy may affect the producers of the goods, which may be based in other countries.

With these caveats in mind, the subsidiarity view would offer a potentially powerful filter to screen out cases where it can be easily shown that there is either no effect or a positive effect on other Member States.

IV. Annex 1: The article 87(1) EC criteria

This annex presents a number of sources that define the conditions of Article 87(1) EC in varying ways.

For example, the Commission's own website lists the criteria of Article 87(1) EC in two different ways. On the **DG Comp State aid page**, the criteria are defined as follows:

"As a first step, it has to determine whether a company has received State aid, which is the case if the support meets the following criteria:

1. *there has been an intervention by the State or through State resources which can take a variety of forms (e.g. grants, interest and tax reliefs, guarantees, government holdings of all or part of a company, or the provision of goods and services on preferential terms, etc.);*
2. *the intervention confers an advantage to the recipient on a selective basis, for example to specific companies or sectors of the industry, or to companies located in specific regions;*
3. *competition has been or may be distorted;*
4. *the intervention is likely to affect trade between Member States"*

– Source: http://europa.eu.int/comm/competition/State_aid/overview/what.html

380 For an extensive discussion of the differences compared to the definition of relevant markets in other areas of competition policy see Section 4.5 in Nitsche R. and Heidhues P. (op. cit.) and the paper by Fingleton, J., Ruane, F., and Ryan, V, "Market Definition and State aid Control", in European Economy Reports and Studies Number 3, Directorate-Generale for Economic and Financial Affairs, 1999.

The 2003 Vademecum on State aid rules also lists 4 conditions, but the effect on competition and trade are under the same heading while economic advantage and selectivity are defined separately:

1. *transfer of State resources;*
2. *economic advantage;*
3. *selectivity*
4. *effect on competition and trade.*

– Source: http://europa.eu.int/comm/competition/State_aid/others/vademecum/vademecumen2003_en.pdf
– In the Altmark Judgment (2003), the Court of Justice indicated that four conditions are to be fulfilled (paragraph 75):

"Article 92(1) of the Treaty lays down the following conditions. First, there must be an intervention by the State or through State resources. Second, the intervention must be liable to affect trade between Member States. Third, it must confer an advantage on the recipient. Fourth, it must distort or threaten to distort competition. "
– Source: http://curia.europa.eu/jurisp/cgi-bin/gettext.pl?lang=en&num=79969275C19000280&doc=T&ouvert=T&seance=ARRET&where=()

In one of its recent studies on public subsidies, the OFT lists the conditions in the same way as the DG Comp website (i.e. separating the effect on trade and distortion of competition criteria and retaining a "selective advantage" criterion):

"*The Treaty defines State aid as any government intervention that fulfils four criteria:*
– *A transfer of State resources – either a cost or loss of revenue,*
– *Conveys an economic advantage to some firms – i.e. is selective in availability,*
– *Distorts or threatens to distort competition – even a limited advantage is likely to raise a risk of distortion, and*
– *Affects trade between member States – i.e. the product or service is or could be subject to intra-Community trade.*"

– Source: Public Subsidies, November 2004, paragraph 4.2.

In their paper, DG Comp's previous Chief Economist and his co-authors discuss four conditions and the complementary role of selectivity.

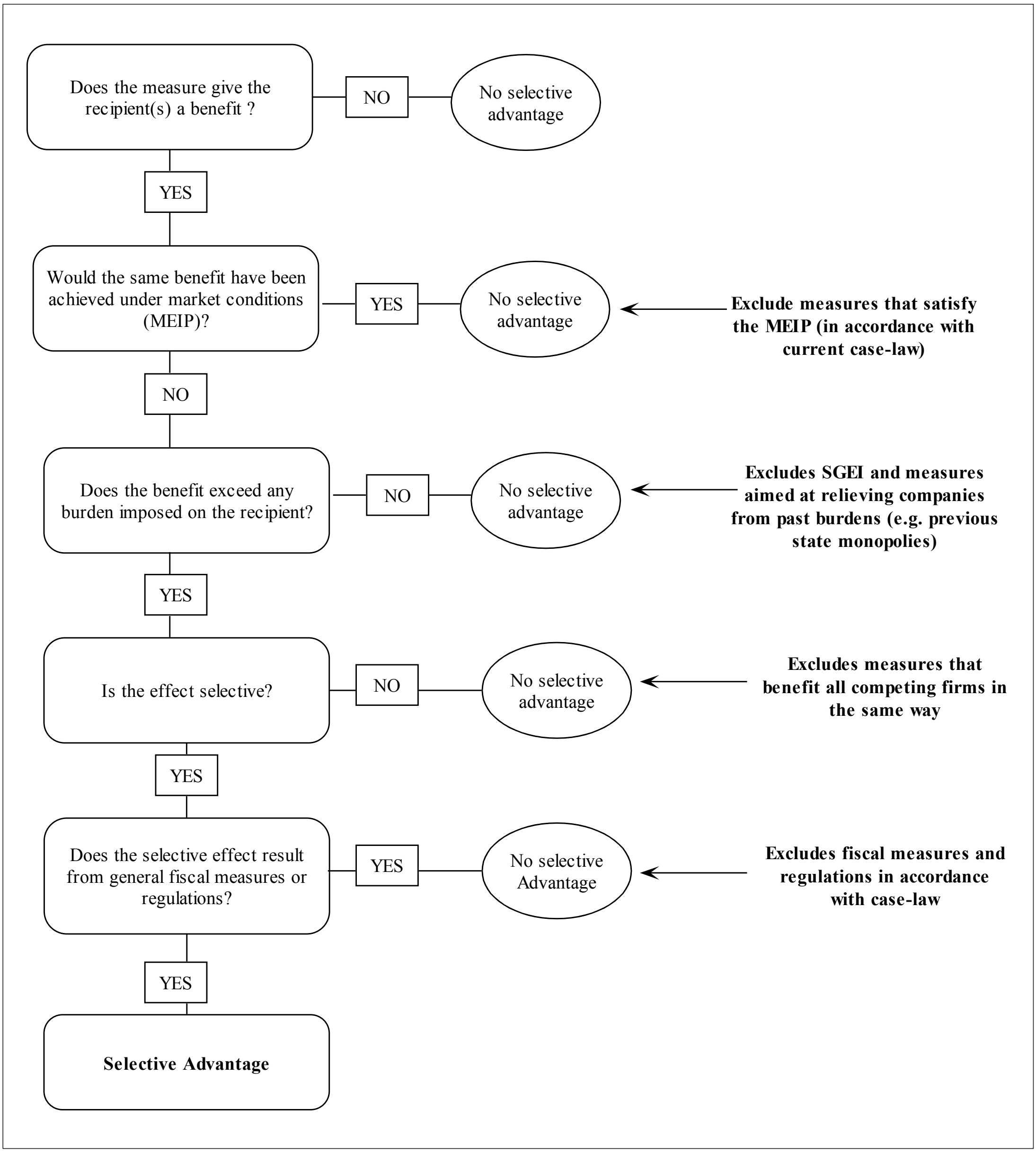
"*The case law identifies four conditions to be fulfilled jointly for a measure to constitute State aid in the meaning of Article 87(1) EC:*
(i) Transfer of State resources – there must be an intervention by the State or through State resources;
(ii) Economic advantage – it must confer an advantage on the recipient;
(iii) Distortion of competition – it must distort or threaten to distort competition;

(iv) Effect on trade – it must be liable to affect trade between MS.
It is interesting to note that in most cases the last two criteria are considered to be fulfilled if the measure is "selective" in terms of granting an advantage."
– Source: http://ec.europa.eu/comm/dgs/competition/esac.pdf

Finally, in a recent Global Competition Law Review publication, two authors, Drakakakis and Anestis, list five conditions:

"*The concept of aid as found in Article 87(1) EC consists of five cumulative elements: (i) transfer of State resources; (ii) grant of an advantage; (iii) selectivity; (iv) distortion of competition; and (v) effect on trade between member States*."
– Source: http://www.howrey.com/docs/Stateaid.pdf

V. Annex 2: Determining measures that confer a selective advantage (based on an effects-based approach)



Comments on the paper "Selectivity, economic advantage, distortion of competition and effect on trade"

Vittorio Di Bucci*

I. Introduction

Any comment on the notion of State aid should be based on a proper assessment of the rationale of the relevant Treaty rules and on a good understanding of their function within the system of the Treaty. More than fifty years after it was drafted, the Spaak report still provides some interesting reading in this respect[381].

Two lessons are particularly important for our purposes. First, the Treaty rules on competition in general and even more those concerning State aid were conceived as a complement to the creation of a common market and aimed, in particular, at ensuring an optimum allocation of economic activities. State aid control was thus meant to be a specific and exceptionally powerful instrument allowing the Commission to ensure that Member States do not engage in a race to subsidies to attract new investment, do not foster penetration of their firms on other national markets and do not shelter their national market by subsidising certain firms or certain sectors. State aid could only be authorised if it contributed in an effective and proportionate way to the attainment of an objective of common interest, as recognised by a central and independent body.

Second, the Founding Fathers established a clear distinction between distortions of competitions arising from "artificial advantages" granted by Member States to certain undertakings and certain sectors, on the one hand, and other distortions caused by national legislative and regulatory measures, and in particular by their disparity, on the other hand. While the former were deemed to be particularly dangerous and were to be submitted to a prior scrutiny by the European Commission, the latter could be left to further scrutiny and, as the case may be, to harmonisation measures to be decided by the Council. The idea behind this distinction is that Member States are generally allowed to compete with each other by shaping their general

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381 Comité intergouvernemental créé par la Conférence de Messine, Rapport des Chefs de Délégations aux Ministres des Affaires Etrangères, Brussels, 21 April 1956.

economic environment in different ways, but should not create niches of privilege for specific firms and sectors. State aid control was considered essential because of the gigantic size of national budgets within the Community and of a well-established tradition of State intervention in the economy at least in some Member States.

These features of State aid rules may explain that they do not fit easily within economic standards, be it total welfare, consumer welfare or rival's profit. Total welfare must be taken into account when assessing the compatibility of a State aid measure with the common market, but cannot be considered as a relevant standard for deciding whether a national measure qualifies as State aid, unless we want to entrust the European Commission with a veto power on all aspects of national economic policies. Consumer welfare, while equally relevant for deciding whether a given aid should be declared compatible, is obviously not a viable option as a policy standard for identifying State aid measures, given that public subsidies generally increase consumer welfare, at the expense of the taxpayer. Finally, rival's profit is certainly closer to the idea expressed in the Spaak Report that « une des garanties essentielles qui doivent être données aux entreprises, c'est que le jeu ne risque pas d'être faussé par les avantages artificiels dont bénéficieraient leurs concurrents ». However, it does not fully capture the logic of State aid control, and in particular the distinction between general measures and selective advantages.

II. Selective advantage

The essential element in the notion of State aid is precisely the requirement of selectivity, or of a selective advantage. Indeed, whether the measure constitutes an advantage for the recipient and whether this advantage is selective can be assessed together, as proposed with the five-step approach. However, it must be clear that the selectivity requirement does not concern the identification of the *selective impact on competing firms*, but rather a comparison between the beneficiaries of the measure and the situation of the other undertakings within the same Member State. In other words, it is linked to the idea that there should not be niches of privilege within a national system and not to the idea of asymmetric effects within a given market. Therefore, the test cannot be aimed at "excluding measures that benefit all competing firms in the same way", as proposed in step 4 of the five-step approach.

This being said, I concur with the panel report in considering that there is scope for improving the application of the selectivity criterion by considering in a more systematic way *de facto* selectivity. A measure should certainly be considered as selective even when the eligibility criteria are set in an apparently neutral way, but its effects are likely to focus on specific sectors or groups. The Commission practice is somewhat hesitant in this respect, generally considering, for instance, that a tax relief granted beyond a given threshold of energy consumption is selective[382], but refraining from applying the same logic in the case of tax advantages for research activities that are concentrated in specific sectors of the economy. A more consistent

382 See also Opinion of Advocate General Jacobs in Case C-368/04 *Transalpine Ölleitung in Österreich* [2006] ECR.

approach would be welcome, but in my view it should not be distorted by the application of purportedly objective justifications based on business models or production technologies, as envisaged in the panel report.

A more rigorous application of the selectivity criterion will probably lead to increase the number of national measures that qualify as State aid. The opposite view expressed in the panel report, with reference to the *Heiser* case[383], seems to be wrongly based on an assessment of asymmetric effects, rather than on a proper application of the selectivity criterion. The fact that a measure benefits all Austrian dentists and doctors in a similar way does not mean that it is not selective; quite the contrary, given that only dentists and doctors benefit from it, while all other sectors are excluded.

However, a slight increase in the workload of the European Commission should not be particularly worrying. If one considers that State aid control is justified, the resources devoted to this activity are in any event minimal compared with the scale of the European economy.

Let me now turn briefly to the other aspect of the test, concerning the existence of an advantage. I believe that the third limb of the five-step approach is expressed in rather confusing and dangerous terms. "*Does the benefit exceed any burden imposed on the recipient?*" is not a relevant question, because the so-called notion of a "*net advantage*" has no place in the assessment of a national measure as State aid, as convincingly shown by Advocate General Léger in *Altmark Trans*[384]. Save in very exceptional cases, State aid is linked to some counterparts from the beneficiary undertakings that constitute a burden for them. Nevertheless, the full amount of the advantage granted by the State qualifies as aid, while the counterpart will be taken into account in order to assess its compatibility. The *Altmark* judgement itself confirms this approach, by stating that even when an undertaking must carry the particular burden arising from public service obligations, any compensation normally qualifies as aid, unless four cumulative conditions are fulfilled.

In particular, it seems to me that there are no good reasons to take into account "*past burdens*" weighing upon former State monopolies, as proposed in step three. In the transition from a legal monopoly to a market system the former monopolist will carry over both advantages, linked to the existing infrastructure, to its market presence, its goodwill and so on, and disadvantages linked, in particular, to its cost structure. It would be artificial to isolate these disadvantages and allow Member States to provide compensation by escaping any State aid control. Such compensation should qualify as State aid, but if there are good reasons to justify it, it can be declared compatible with the common market.

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383 Case C-172/03 *Heiser* [2005] ECR I-1627.

384 Opinion in Case C-280/00 *Altmark Trans* [2003] ECR I-7747.

III. Effect on trade and distortion of competition

Concerning distortion of competition, the report appropriately quotes the seminal opinion by Advocate General Capotorti in *Philip Morris*[385]: "*the wording of Article 92(1)* [now 87(1)] *lends itself to being construed as meaning that the distortion of competition should be a consistent and necessary consequence of the benefit given to certain undertakings or the production of certain goods by means of State aid*". In other words, the Treaty establishes a *iuris et de iure* presumption that State aid distorts competition, so that distortion of competition should not be considered as a separate requirement, but rather as the necessary consequence of a measure that fulfils the other requirements.

This construction does not always appear very clearly in the case-law, but it explains why the effect on intra-Community trade and the distortion of competition are generally examined jointly and the latter is deemed to be present when there is an effect on trade. Of course, the nature and size of the distortion should be duly considered and balanced with the alleged benefits when assessing compatibility: a small contribution to an objective of common interest may justify a State aid measure that produces a small distortion of competition.

One should then focus on effect on trade. The report correctly recognises that this requirement, as laid down in Article 87(1), cannot be interpreted in the same way as the similar notion in Article 81(1). The reason is not only that, unlike Article 87(1), Article 81(1) draws the dividing line between Member States' and Community competences. More fundamentally, Article 81(1) is concerned with the effect of a particular agreement or practice, while Article 87(1) must address the overall effect of the measure on the entire activity of the beneficiary. Therefore, well-established case-law rightly considers that an advantage given to an undertaking that is active (also) in a sector where intra-Community trade takes place is likely to affect trade between Member States, because it may influence patterns of trade or investment choices.

The internal market function of State aid rules thus justifies a very wide approach to effect on trade, notwithstanding the limited amount of the measure, or the fact that the beneficiary is only active in a national or local market, provided only that firms from other Member States are able to compete on that market. Once a sector is liberalised and cross-border trade actually takes place, a selective advantage granted by the State will inevitably affect trade between Member States, save in exceptional cases such as the *Dorsten* swimming pool, which can be explained by the local nature of the service provided.

In this context, it is submitted that recent judgments such as *Le Lévant*[386] and *Wam*[387] do not mark a new approach and must be explained – if at all – by the very special features of these cases.

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385 Opinion in Case 30/79 *Philip Morris Holland* v Commission [1980] ECR 2671.

386 Case T-34/02 *Le Lévant and Others* v Commission [2006] ECR.

387 Joined Cases T-304/04 and T-316/04 *Italy and Wam* v Commission [2006] ECR. An appeal before the ECJ is pending.

IV. Conclusion

State aid rules are and have always been based on effects, not form. Therefore, an economic analysis is certainly necessary when applying them. However, it seems necessary to recognise that, because of their particular nature and function, State aid rules do not always lend themselves to the kind of analysis that is generally performed in other areas of competition law. In particular, the notion of State aid and, above all, the requirement of selectivity must be properly understood if the economic analysis is to provide a useful contribution. In any event, such a contribution will probably be more limited in the application of Article 87(1), because of the way the State aid notion is defined. On the contrary, as recognised in the State aid action plan, economic analysis will become extremely important in all issues concerning compatibility under Article 87(3), be it the design of general rules in frameworks and in block exemption regulations or the assessment by the Commission of large cases under those rules.

Compatibility of State aid and the balancing test: its role in the architecture of the system of State aid control

Phedon Nicolaides*

I. Introduction

One of the objectives of the State aid Action Plan is to introduce a refined economic analysis of State aid. The purpose of this paper is to consider how the balancing test fits in the architecture of State aid control.

The "refined economic analysis" of the SAAP is embodied in a so-called "balancing test" which so far has been elaborated in the R&D&I Framework, the Guidelines on Risk Capital in SMEs and the guidelines on environmental protection. The balancing test consists of three stages, each answering the following respective questions:

1. Is the aid measure aimed at a well-defined objective of common interest? For State aid to be exempted it must pursue one of the policy objectives which are defined in Article 87(3) [or (2)].
2. Is the aid well designed to deliver the objective of common interest; i.e. does the proposed aid address the market failure or other objective? This in turn is broken down into three subsidiary questions:
   i. Is State aid an appropriate policy instrument? There may be other instruments that do not involve subsidies and which are equally good or even better at achieving the desired policy objectives.

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ii. Is there an incentive effect; i.e. does the aid change the behaviour of firms? For aid to be exempted it must be capable of inducing firms to do things they would not otherwise do without government intervention.
iii. Is the aid measure proportional; i.e. could the same change in behaviour be obtained with less aid?
3. Are the distortions of competition and effect on trade limited, so that the overall balance is positive? Even if the aid is appropriate and proportional, it may still generate significant distortions of competition that may harm other member states. These harmful effects have to be taken into account.

The balancing test adopted by the Commission has been criticised for a number of reasons: legal [primarily that Article 87(3) supposedly does not allow for this kind of analysis], economic [primarily that the test is too narrow] and procedural [primarily that the complexity of the test reduces legal certainty].

Addressing the first two criticisms is outside the scope of this paper. Given that the purpose of this paper is to appraise the role of the balancing test in the system of State aid control, the third criticism has to be considered at the outset.

Any test that is not applied mechanically is bound to raise uncertainty. This is even more so where the test does not depend on procedural criteria but on an assessment whose results are not known in advance. However, this is not necessarily a negative development. Legal certainty is not the only concern in State aid control, nor the most important one. The most important concern is to prevent distortion of trade and competition. Certainly, it is desirable that prevention of distortion of competition can be achieved with procedures that afford a high level of legal certainty to national authorities and undertakings. At the same time, however, a small reduction of legal certainty for the sake of avoiding misallocation of resources is a trade-off worth making.

The criticism about the complexity of the test is also largely misplaced. Attempting to remedy market failure through State aid is a difficult task. The public authority that grants the aid must somehow be able to predict the behaviour of market players. In essence, it asks how they are likely to behave with and without government intervention. Since these are two alternative states of the world, if one occurs, the other necessarily does not. The alternative state can never be known with absolute certainty. Moreover, there is a degree of endogeneity in government intervention because market players lobby in favour or against it and because they react accordingly.

Refusing to acknowledge these difficulties which are inherent in public policy and criticising the complexity of the balancing test is the policy equivalent of hiding one's head into the sand. If assessing the impact of State aid is as difficult as critics claim, then they must explain why it is legitimate for governments to grant aid without actually knowing what its impact may be and whether it will achieve its objectives. The argument that the economic assessment of State aid is difficult is more of an indictment of the laxity and ineffectiveness of current procedures. However, as is argued in this paper, there can be improvement in the way that the test is applied so that it fits better in the architecture of the system of State aid control.

The paper first reviews how the test has been elaborated in the R&D&I Framework, the Risk Capital Guidelines and the draft Environmental Guidelines. Indeed it is important to understand how it has been elaborated because it is the only way to form an opinion about how tough or easy the test is likely to be. This is because one of the aims of the SAAP is to "reduce and better target" State aid and because in broader terms an objective of the system of State aid control in the EC is to guide member states to design State aid measures that are likely to be approved by the Commission. After that, the paper reviews some recent cases where the Commission applied the balancing test. The paper concludes with an evaluation of its likely contribution to the system of State aid control and how it may be improved so that its role can be strengthened.

II. The balancing test in State aid for R&D&I[388]

Not all aid cases of State aid to R&D&I will be subject to the balancing test. It is assumed that for most cases, compliance with the criteria and ceilings laid down in the Framework [and a future block-exemption regulation] will also satisfy the conditions of the test. This means that, in practice, most aid granted to SMEs or for research far removed from the market will not have to undergo the balancing test. Aid will be subject to a more detail assessment only when it exceeds EUR 5 million [although this amount is not yet fixed].

In addition, degree of the Commission's assessment will be proportional to the risk of distortion of competition. This means that the detailed assessment will not necessarily require that all the criteria be verified; the scope of the analysis will depend on the nature of each case.

The starting point of the balancing test is the identification of market failure that hampers R&D&I. The Commission expects proof of knowledge spillovers, imperfect and asymmetric information or coordination failures. Member states can illustrate the existence of market failure through benchmarking showing that other regions, markets or sectors experience higher levels of R&D&I. To show that State aid is an appropriate instrument, the Commission wants proof of the advantages of using a selective instrument such as State aid over other possible policy responses.

The next important step is to determine whether the aid has an incentive effect. The Commission considers that as a result of aid, R&D&I activity should be increased in size, scope, amount spent or speed. Where aid is granted to large firms or when the aid is closer to the market raising more competition concerns, the incentive effect will have to be identified by counterfactual analysis, comparing the levels of intended activity with aid and without aid.

At the same time, aid must be proportional; i.e. even if aid is necessary and has an incentive effect, it must not exceed the minimum amount required to carry out the R&D in question or it must not result in excessive distortion of competition. The amount of required aid is linked to the degree of market failure.

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388 Accessed at http://ec.europa.eu/comm/competition/state_aid/others/action_plan/rdi_frame_en.pdf

The essence of the balancing test is that the negative effects of aid (distortion of competition) must be limited. These effects can be categorized in the following:

i. Disruption of the dynamic incentives of undertakings and crowding out of private investment.
ii. Support of inefficient production.
iii. Encouragement of exclusionary practices and enhancement of market power.
iv. Impact on trade flows between member states.

There are three distinct ways in which R&D&I aid can distort competition in product markets:

i. R&D&I aid can distort the dynamic incentives of market players to invest (crowding out effect). In its analysis, the Commission takes into consideration the following elements:
    i. Aid amount. The significance of the aid amount will be measured with reference to total private R&D expenditure in the sector, and the amount spent by the main players.
    ii. Closeness to the market / category of the aid
    iii. Open selection process
    iv. Exit barriers
    v. Incentives to compete for a future market
    vi. Product differentiation and intensity of competition.
ii. R&D&I aid can create or maintain positions of market power. The Commission is unlikely to identify competition concerns related to market power in markets where each aid beneficiary has a market share below 25% [still to be confirmed] and in markets having a market concentration with Herfindahl-Hirschman Index (HHI) below 2000 [still to be confirmed]. In its analysis, the Commission takes into consideration the following elements:
    i Market power of aid beneficiary and market structure.
    ii. Level of entry barriers.
    iii. Buyer power.
    iv. Selection process.
iii. R&D&I aid can maintain an inefficient market structure. The Commission considers whether the aid is granted in markets featuring overcapacity, in declining industries or in sensitive sectors.

Once the foreseeable positive and negative impacts of the State aid are identified, the final step is to compare them. For this purpose the Commission has said that it will not use the criteria set out above mechanically but will make an overall assessment based on the proportionality principle. It will attach different weights to the different criteria depending on the facts of each case.

III. The balancing test in State aid for Risk Capital[389]

As in the case of aid to R&D&I, the measures that fall below the thresholds defined in the Guidelines are presumed to satisfy the compatibility test. A more detailed compatibility assessment will be necessary for risk capital measures which do not satisfy all the conditions laid down in the Guidelines, notably investments exceeding EUR 1.5 million. The analysis of compatibility of the measures will be based on a number of positive and negative elements. No single element is determinant, nor can any set of elements be regarded as sufficient on its own to ensure compatibility.

The Commission considers that there is no general risk capital market failure in the Community. It does, however, accept that there are market gaps for some types of investments at certain stages of enterprises' development. These gaps result from an imperfect matching of supply and demand of risk capital and can generally be described as an equity gap.

The Commission considers that the main source of market failure relevant to risk capital markets, which particularly affects access to capital by SMEs and companies at the early stages of their development and which may justify public intervention, relates to imperfect or asymmetric information.

Imperfect or asymmetric information may result notably in:

i. Transaction and agency costs: potential investors face more difficulties in gathering reliable information on the business prospects of an SME.
ii. Risk aversion: investors may become more reluctant to provide risk capital to SMEs.

Evidence of market failure must be based on a study showing the level of the equity gap with regard to the enterprises and sectors targeted by the risk capital measure. The relevant information concerns the supply of risk capital and the fundraising capital, as well as the significance of the venture capital industry in the local economy. The evidence could also include the following elements:

(a) development of the fundraising over the past five years, also in comparison with the correspondent national and/or European averages;
(b) the current overhang of money;
(c) the share of government aided investment programs in the total venture capital investment over the preceding three to five years;
(d) the percentage of new start-ups receiving venture capital;
(e) the distribution of investments by categories of amount of investment;
(f) a comparison of the number of business plans presented with the number of investments made by segment (amount of investment, sector, round of financing, etc.).

The Commission considers that State aid to risk capital measures may constitute an appropriate instrument within the limits and conditions set out in these guidelines. However, risk capital provision is essentially a commercial activity involving commercial decisions. In this

389 Accessed at http://ec.europa.eu/comm/competition/state_aid/others/risk_capital_guidelines_en.pdf

context, more general structural measures not constituting State aid may also contribute to an increase in the provision of risk capital, such as promoting a culture of entrepreneurship, introducing a more neutral taxation of the different forms of SME financing (for example new equity, retained earnings and debt), fostering market integration, and easing regulatory constraints.

Where member states have considered other policy options and the advantages of using a selective instrument such as State aid have been established and submitted to the Commission, the measures concerned are considered to constitute an appropriate instrument.

State aid for risk capital must result in a net increase in the availability of risk capital to SMEs, in particular by leveraging investments by private investors. The lack of incentive effect means that some enterprises funded through publicly supported measures would have obtained finance on the same terms even in the absence of State aid (crowding out). The Commission considers that aid in the form of risk capital satisfying the conditions laid down in these guidelines ensures the presence of an incentive effect. The need to provide incentives depends on the size of the market failure related to the different types of measures and beneficiaries. Therefore different criteria are expressed in terms of size of investment tranches per target enterprise, degree of involvement of private investors, and consideration of notably the size of the company and the business stage financed.

Therefore, the Commission will also take into account the following additional criteria showing the profit-driven character of investment decisions and the commercial management of the measure, where relevant:

i. Commercial management.
ii. Presence of an investment committee.
iii. Size of the measure/fund [the budget for investments into target SMEs should be of a sufficient size to take advantage of economies of scale in administering a fund and the possibility of diversifying risk via a pool of a sufficient number of investments].
iv. Presence of business angels.

The need to provide incentives depends on the size of the market failure related to the different types of measures, beneficiaries and development stage of the SMEs. A risk capital measure is well-designed if the aid is necessary in all its elements to create the incentives to provide equity to SMEs in their seed, start-up and early stages. State aid will be inefficient if it goes beyond what is needed to induce more risk capital provision. In particular, to ensure that aid is limited to the minimum, it is crucial that there is significant private participation and that the investments are profit-driven and are managed on a commercial basis.

The Commission will consider that the following elements positively influence the assessment of proportionality as they represent a best-practice approach:

i. Open tender for managers.
ii. Call for tender or public invitation to investors.

When deciding whether to authorise the grant of public funds for measures designed to promote risk capital, the Commission will seek to limit as far as possible the following categories of risk:

i. The risk of crowding out: The presence of publicly supported measures may discourage other potential investors from providing capital. This could, over the longer term, further discourage private investment in young SMEs and thus end up widening the equity gap, while at the same time creating the need for additional public funding.
ii. The risk that advantages to the investors and/or investment funds create an undue distortion of competition in the venture capital market relative to their competitors that do not receive the same advantages.
iii. The risk that an oversupply of public risk capital for target enterprises not invested according to a commercial logic could help inefficient firms stay afloat and could cause an artificial inflation of their valuations, making it all the less attractive for private investors to supply risk capital to these firms.

IV. The balancing test in State aid for environmental protection[390, 391]

The positive effects of environmental aid depend on the following factors.

Existence of a market failure

The Commission will in general not question that there are negative externalities related to environmental protection, but verify whether the State aid measure has a substantial impact on environmental protection.

Appropriate Instrument

In its compatibility analysis, the Commission will in particular take account of any impact assessment of the proposed measure which the Member State may have made, including considerations of using other policy options than State aid, and take account of justifications that the polluter-pays principle (PPP) will be respected.

Incentive effect and necessity of aid

Aid cannot be considered necessary solely because the level of environmental protection is increased. The advantages of new investments or production methods are normally not limited to their environmental effects.

390 Draft Community guidelines for State aid for environmental protection – 10 May 2007. Accessed at: http://ec.europa.eu/competition/state_aid/reform/guidelines_environment_en.pdf.

391 For ease of presentation, I ignore here that part of the explanation of how the balancing test may be applied to tax exemptions.

In addition to the calculation of extra costs, the Commission will take account of the following elements in its analysis:

a) Expected change: At least one of the following elements must be demonstrated, taking into account the normal behaviour of an undertaking in the sector concerned:
   i) Increase in scope: reduction of a specific type of pollution that would not be reduced without the aid;
   ii) Increase in size: reduction of a specific type of pollution to a further extent due to the aid;
   iii) Increase in speed: reduction in pollution starting at an earlier point in time due to the aid.
b) Production advantages: If there are other advantages linked to the investment in terms of increased capacity, productivity, cost reductions or quality, the incentive effect is normally lower.
c) Advantages linked to image: Indications that the undertaking or the relevant sector can benefit from advantages linked to a better environmental image will normally reduce the incentive effect.
d) Advantages linked to the labelling of production method: If undertakings in the industry/sector concerned are able to differentiate environmentally friendly products from conventional products and thereby set higher prices for the environmentally friendly products, the incentive effect of aid is normally lower.
e) Possible future mandatory standards: If there are negotiations at Community level to introduce (higher) mandatory standards which the measure concerned would seek to target, the incentive effect of aid is normally lower.
f) Level of risk: If there is a particular risk that the investment will be less productive than expected, the incentive effect of aid will normally be higher.
g) Level of profitability: If the level of profitability of the action pursued is negative over the time horizon by which the investment is fully depreciated or the operating aid is intended to be in force, taking account of all the advantages and risks identified in this point, aid will normally have an incentive effect.

Proportionality of the aid

The Member State should provide evidence that the aid is necessary, the amount is kept to the minimum and that the selection process is proportional. In its analysis the Commission will consider the following elements:

a) Selection process: the selection process should be conducted in a non-discriminatory, transparent and open manner, without unnecessarily exclude companies that may compete with projects to address the same environmental objective. The selection process should lead to the selection of beneficiaries that can address the environmental objective using the least amount of aid or in the most cost-effective way.
b) Aid limited to the minimum: Member States shall demonstrate that the aid intensity which is linked to the calculation of extra costs does not lead to an aid amount exceeding the expected lack of profitability when taking into account all the advantages and risks.

Analysis of the distortion of competition and trade

If the aid is proportional, notably if the calculation of the extra investment or operating costs has taken into account all advantages to the undertaking, the negative impact of the aid is likely to be limited. However, a profit-seeking undertaking will normally only increase the level of environmental protection beyond mandatory requirements if it considers that this will result at least marginally in some sort of advantage for the undertaking.

Dynamic incentives/crowding out

State aid for environmental protection may have as a result that aid beneficiaries refrain from investing in environmentally-friendly technologies beyond regulatory standards and simply wait for the State to intervene.

In its analysis, the Commission will consider the following elements:

a) amount of aid: The higher the amount of aid, the more likely it is that part of the aid can be used to distort competition. This is in particular the case if the aid amount is high compared to the size of the general activity of the beneficiary.
b) frequency of aid: If an undertaking receives aid repetitively, it is more likely that this will distort dynamic incentives.
c) duration of the aid: If operating aid is granted for a long period, this is more likely to distort competition.
d) gradual decrease of aid: If operating aid is reduced over time, the undertaking will have an incentive to improve efficiency; therefore, the distortion of dynamic incentives will be reduced over time.
e) readiness to meet future standards: , if the aid will enable the undertaking concerned to meet new Community standards expected to be adopted in the foreseeable future, the aided investment will reduce the costs of investments that the undertaking would have had to make in any event.
f) level of the regulatory standards and/or taxation in relation to the environmental objectives: the lower the level of mandatory requirements, the higher is the risk that aid to go beyond mandatory requirements is not necessary and will crowd out investments or be used in a way that distorts dynamic incentives.
g) risk of cross-subsidisation: Where the undertaking produces a wide range of products or produces the same product using a conventional and an environmentally friendly process, the risk of cross-subsidisation is higher.
h) technological neutrality: Where a measure focuses on one technology only, the risk of distorting dynamic incentives is higher.

Maintaining inefficient firms afloat

State aid for environmental protection may be justified as a transitory mechanism to move towards a full allocation of environmental negative externalities. It should not be used to grant unnecessary support to undertakings, which are unable to adapt to more environmentally friendly standards and technologies because of their low levels of efficiency.

In its analysis, the Commission will consider the following elements:

a) nature and type of beneficiaries: Where the beneficiary has a relatively low level of productivity and is in poor financial health, it is more likely that the aid will contribute to artificially maintaining the undertaking in the market.
b) overcapacity in the sector targeted by the aid: In sectors where there is overcapacity, investment aid risks to sustain the overcapacity and maintain inefficient market structures.
c) normal behaviour in the sector targeted by the aid: If other undertakings in the sector have reached the same level of environmental protection without aid, it is more likely that the aid will serve to maintain inefficient firms in the market.
d) level of mandatory standards: If there are no standards or if the mandatory standards are relatively low compared to the actual level of environmental protection, there is a higher risk that the aid will generate or maintain inefficiencies.
e) duration of the aid: The longer the duration of the aid, the higher is the risk that the aid will serve to maintain inefficient undertakings in the market.
f) investment costs or aid amount in form of tax reduction/exemption in proportion of the beneficiary's turnover: the higher the cost, or the aid amount, compared to the activity of the beneficiary, the more likely it is that the aid will lead to inefficiencies.

Market power/exclusionary behaviour

The Commission will assess the market power of the beneficiary concerned before the aid is granted, and the change in market power which can be expected as a result of the aid. Aid for environmental protection given to a beneficiary with substantial market power may be used by this beneficiary to strengthen or maintain its market power, by further differentiating its products or excluding rivals. The Commission is unlikely to identify competition concerns related to market power in markets where each aid beneficiary has a market share below 25% and in markets having a market concentration with Herfindahl-Hirschman Index (HHI) below 2000.

In its analysis, the Commission will consider the following elements:

a) Market power of aid beneficiary and market structure: Where the recipient is already dominant on the affected market, the aid measure may reinforce this dominance by further weakening the competitive constraint that competitors can exert on the recipient undertaking.
b) New entry: where the aid concerns product markets or technologies that compete with products where the aid recipient is an incumbent and has market power, the aid may be used strategically to prevent new entry or substitution towards more environmentally friendly products offered by competitors.
c) Product differentiation and price discrimination: the aid may have as a negative effect to facilitate product differentiation and price discrimination by the aid recipient, to the detriment of consumers.
d) Buyer power: The market power of an undertaking may be limited by the market position of the buyers. The presence of strong buyers can serve to counter a finding of market power if it is likely that the buyers will seek to preserve sufficient competition in the market.

e) Selection process: Aid measures which allow undertakings with market power to influence the selection process, such as by having the right to recommend undertakings in the selection process or influencing the environmental project in a way which disfavours alternative projects on unjustified grounds, are liable to raise the Commission's concern.
f) Conditions of competition in the affected markets and importance of price competition between the various competitors: the more competition is based on price, the greater the risk that it is affected by aid in form of tax reduction/exemptions. If by contrast, products are highly differentiated and competition is not primarily based on price, the impact of the aid in form of tax reduction/exemption is likely to be less important.

Effects on trade and location

State aid for environmental protection may result in some territories benefiting from more favourable production conditions, notably due to comparatively lower production costs as a result of the aid, or due to higher production standards achieved through the aid. This may result in companies re-locating to the aided territories, or to displacement of trade flows towards the aided area.

Balancing and decision

In the light of these positive and negative elements, the Commission will balance the effects of the measure and determines whether the resulting distortions adversely affect trading conditions to an extent contrary to the common interest.

The Commission may raise no objections to the notified aid measure without entering into the formal investigation procedure or, following the formal investigation procedure laid down in Article 6 of Regulation (EC) No 659/1999, decide to close the procedure with a decision according to Article 7 of that regulation. Where it takes a conditional decision within the meaning of Article 7(4) of that regulation, it may for instance consider attaching the following conditions, which must reduce the resulting distortions or effect on trade and be proportionate:

a) Lower aid intensities than the maximum intensities allowed or lower level of tax reduction.
b) Separation of accounts in order to avoid cross-subsidization from one market to another market, when the beneficiary is active in multiple markets.
c) Additional requirements to improve the environmental effect of the agreements concluded as counterpart for tax reduction.
d) No discrimination against other potential beneficiaries (reduce selectivity).

It is worth pointing out that the balancing test in the environmental guidelines, which is the most recent, is significantly more elaborate than the previous applications to R&D&I and risk capital. This probably reflects the complaints voiced by member states that the Commission had not given them sufficient guidance on how to comply with the balancing test.

V. Applications of the balancing test

First of all it is necessary to remark on an apparently ignored aspect of the balancing test. That is the fact that the test is not really new. The Commission has always used a version of the balancing test to assess State aid granted outside any of the regulations and guidelines. It has had to base its assessment directly on Article 87(3)(c). This Article has always required that exempted aid is shown to have incentive effect, that it is proportional and that it is in the common interest. The only difference between the practice of the Commission until 2005 and the practice since the publication of the SAAP in 2005 is that now there are more detailed and explicit criteria which also serve to help member states design aid measures that can be exempted by the Commission.

During the past few years the Commission has systematically applied the balancing test to numerous cases concerning aid to the construction and operation of broadband networks.[392] In all cases but one it has found aid to be in the common interest [for promoting Lisbon objectives] and necessary [because private operators tend not to supply broadband services in rural areas due to the high costs of building networks in sparsely populated areas]. Given that public contracts for the construction and/or operation of such networks are in most cases awarded following public procurement procedures, the Commission normally finds that competitive tendering minimises the amount of State aid and therefore fulfils the criterion of proportionality. As far as distortion of competition is concerned, the construction of networks in rural areas promotes rather that weakens competition, so the Commission also finds that the distortion of competition is minimal.

In this connection, it is worth noting the differences in the Commission's analysis of the impact on competition in Article 87(1) and Article 87(3)(c). In the view of the Commission, public funding of broadband networks normally constitutes State aid because, among other things, state intervention confers an advantage to the network operators causing a distortion of competition in the meaning of Article 87(1). However, the Commission also finds that in the case of networks in rural areas, the expansion of supply of broadband services strengthens competition so there is no undue distortion in the meaning of Article 87(3)(c).

The one case where the Commission concluded that aid to broadband did not satisfy the criteria of the balancing test and therefore was declared to be incompatible with the common market concerned the Dutch city of Appingedam. In case C 35/2005, the Commission examined municipal funding for the expansion of the town's network. It found that the measure lacked incentive effect because the market already provided significant amount of services. The aid was not necessary and was banned.

Outside the broadband cases, the balancing test resulted in negative decisions in two instances. In the case concerning the introduction of digital terrestrial tv in Berlin-Brandenburg, the Commission concluded in Decision 2006/513 that aid was not an appropriate instru-

392 See Monika Hencsey et al, State aid Rules and Public Funding of Broadband, Competition Policy Newsletter, 2005, no. 1, pp. 8-15; Lambros Papadias et al, Public Funding for Broadband Networks – Recent Developments, Competition Policy Newsletter, 2006, no. 3, pp. 13-18.

ment. The issue was prompt switch from analogue to digital tv and this caused a coordination problem between broadcasters. The Commission's view was that the coordination problem could be better resolved through regulatory measures that would manage both the timing of the switch and the frequency spectrum that would be released. Moreover, given the existence of rife competition between different platforms, the Commission found that aid channelled to certain broadcasters would distort competition in favour of specific technologies without economic or scientific justification. The measure was banned.

Another similar case concerned Italian funding of digital decoders to boost demand for digital tv so that terrestrial broadcasters would switch from analogue to digital signals. In its Decision 2007/374, the Commission prohibited the measure because it failed the balancing test. The aid was not an appropriate instrument because, just like in the Berlin case, regulatory intervention could address more effectively the coordination issue. More importantly, by limiting the beneficiaries to terrestrial broadcasters, the Italian authorities caused undue distortion of competition. Cable and satellite broadcasters were unjustifiably excluded.

In all three cases the Commission reached its negative conclusion without having to carry out a quantitative economic assessment of the costs and benefits of those measures.

VI. Purpose of State aid control

To appreciate the role of the balancing test in the architecture of State aid control in the EC, it is first necessary to define the aims of that control. I believe it has two broad aims. The first is to support the achievement of a truly integrated internal market; i.e. to prevent distortions to trade and competition. It protects the interests of competitors who do not receive State aid. Since neither the Treaty, nor economic theory require an absolute prohibition of State aid, its control has to be selective. Indeed the role of the Commission is to determine the kinds of aid that are compatible with the objectives and criteria laid down in the Treaty.

The second aim of the system of State aid control is to guide member states to design their policies and State aid measures in such a way so that the Commission will be in a position to approve them. The results of this guidance are to afford a reasonable degree of legal certainty both to national authorities and undertakings and to prevent waste of administrative resources.

It has been suggested that the cost of designing and implementing State aid measures for public authorities represents about 5% of the amount of State aid granted.[393] Another 5% is spent by undertakings in applying for State aid and complying with the conditions imposed by the Community and national authorities. These are significant amounts and indicate that the value of that guidance has to be seriously taken into account by any assessment of the system of State aid control.

393 See the assessment of regional subsidies in the report by the National Audit Office, Regional Grants in England, (London: Stationery Office, 2003).

VII. Evaluation

The balancing test begins by asking whether aid has a legitimate purpose. This is absolutely correct because if aid is not intended to remedy some kind of market failure or promote some other kind of well-defined policy objective then there is hardly any justification for the government to intervene in the economy. And if the government intervenes without any well-defined purpose, then it is likely that the intervention is motivated by short-term political objectives of doubtful value for the long-term interests of the economy as a whole.

In this connection, it should be noted, however, that the balancing test is quite accommodating. The test uses a broad criterion because it refers to "policy objectives of common interest". The reason is that aid which is exempted under Article 87(3) may serve objectives other than the remedying of market failure. However, in the R&D&I Framework and the Risk Capital Guidelines the emphasis is, correctly, on market failure because it is not possible or efficient to attempt to raise R&D&I or encourage investment of risk capital in SMEs by giving aid, for example, to employment, and vice versa.

The next step of the balancing test is to ask whether State aid is an appropriate instrument. Although this is a legitimate question it should not necessarily form the second step of the test. Priority should have been given to another question – whether there is a significant impact on competition and cross-border trade. Since State aid control in the EU is intended to protect the uninterrupted functioning of the internal market, the interests of the other member states and those of the Community in general, it makes sense to have a "filter" to identify the most problematic cases for the common interest.

In fact, this consideration could be taken a step further. This kind of filter should operate at the very first stage of economic analysis of State aid. Aid that is granted only to companies with insignificant market share or which are unlikely to engage in cross-border trade, should not be subject to Community scrutiny, irrespective of whether that aid is granted for a legitimate objective or not or whether it constitutes an appropriate policy instrument or not. If member states waste their public money on ineffectual policy instruments it is their problem as long as they do not cause any negative cross-border spillovers.

There is another, probably more important, reason why I believe that the balancing test should start with well-defined thresholds to determine cases of Community concern. The reason is that markets hardly ever function perfectly. This does not mean that government intervention is always legitimate. On the contrary, it reveals the magnitude of the difficulty of designing intelligent public policies. But the point here is that if member states will have to prove market failure, it will be rather easy for them to do so. In this respect, the balancing test does not really impose any onerous burden on member states, nor will it result in rejections of any significant number of State aid measures.

The same consideration applies to whether State aid is an appropriate instrument and whether it has an incentive effect. The Economic Advisory Group on Competition Policy, in their commentary on the R&D&I Framework, observe that there many other things that government can do besides granting aid, such as improving scientific training.[394] The Commission also identifies a number of alternative policy responses to market failure such as strengthening the culture of entrepreneurship. In principle, these views are valid. But this kind of measures take time to design, implement and gestate. I believe that member states will have little difficulty arguing that the State aid they wish to grant is an appropriate instrument for generating short-term results given its immediate impact on market players.

With respect to the incentive affect, it is clear that aid lacks such an effect whenever it is granted after the project starts or the investment takes place or when it aims to subsidise the every day operations of beneficiary firms, including their normal product development activities. In other cases, applicant firms are unlikely to have difficulty showing that their planned investment cannot be profitable without aid. This is simply because they can add costs to raise the quality of the product or can add time to the minimum length of time that is needed for a project to be completed or can identify all sorts of risks ranging from competitors' reaction to technological changes.

My conclusion is that proof of market failure, the appropriateness of State aid and incentive effects will be rather easy obstacles for member states to surmount. They will not be decisive in rejecting proposed State aid measures. Therefore, they should be given less significance and should be at a later stage of the test. Again, if member states want to grant poorly designed State aid, it is their problem as long as they do not impose any burden on the rest of the Community. Therefore, more attention should be given at the outset to defining thresholds that identify cases where there is serious Community concern.

After determining the necessity and proportionality of aid, the balancing test seeks to assess the trade and competition impact of aid. They all look at factors such as market shares, the degree of market concentration, the existence of entry barriers, the extent of product differentiation, etc.

The Commission in its balancing test is explicit that the specific weights that will be attached to the various factors will change from case to case. This leaves national authorities with considerable degree of uncertainty as to whether the aid under investigation can be approved or not. This is a different uncertainty than that which emanates from the ex ante unknown outcome of the competition assessment and which depends on market conditions which are external to the assessor, i.e. the Commission. Here the uncertainty is caused by the subjective use of different weights by the assessor. Perhaps it is impossible to define with any precision before hand the relative importance that the Commission will attach to the various factors. But as it has done in the case of Article 81(3), it should provide examples that can illuminate its policy preferences and make its approach more transparent.

It is instructive that the latest elaboration of the balancing test in the draft environmental guidelines is so more detailed about the various factors that will be taken into account in the assessment of aid. This shows that the Commission is responsive to member state requests for more guidance and also that the Commission adds to the test as it gains experience from its use.

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394 EAGCP, Commentary on the European Commission's Draft Community Framework for State aid for Research, Development and Innovation, 3 July 2006. Accessed at http://ec.europa.eu/comm/dgs/competition/eagcp.pdf

This experience, as revealed by the actual Commission decisions, is also instructive. Despite its name, in reality the "refined *economic* approach" or the "*balancing* test" does not perform either a fully fledged economic analysis or a weighting of the positive and negative effects of State aid. The three Commission decisions reviewed earlier demonstrate that the Commission follows in State aid the same approach as with Article 81(3). I have argued else where that in reality the enforcement of Article 81(3) is not based on true economic analysis.[395] Rather the Commission puts the practice under investigation through a "screening" process and if the practice fails specific elements of that process, it declares the practice to fall within the prohibition of Article 81(1).

The same appears to happen with Article 87(3)(c). If a measure fails any of the factors that are deemed to be important, then the measure cannot be exempted. There appears to be no attempt to quantify the positive and negative elements of an aid measure and certainly no attempt to determine whether the net effects are positive or negative.

VIII. Conclusion

A more refined economic analysis of State aid is much needed in the system of State aid control of the EU. The Commission has adopted a test that purports to balance out the positive and negative effects of State aid.

This test will contribute to the control of distorting aid not by asking whether State aid is a well-designed policy but by offering guidance to member states on the kinds of aid that are more likely to harm intra-Community competition. For this purpose, more explicit thresholds of Community interest should be developed, the assessment of the impact of aid on competition should be elaborated and this assessment should come earlier in the test rather than last.

If the Commission does not elaborate further the procedure that will follow to assess the competition impact of State aid there will be a risk that member states will challenge before the Court of Justice every negative decision of the Commission. Indeed the Court has acknowledged that the Commission enjoys wider discretion in applying Article 87(3) than 87(1). However, the Court has also annulled a significant number of Commission decisions for failure to provide adequate reasoning.

The balancing test must be tough if it is to contribute to achievement of the SAAP aims. But a tough test must be transparent as well. In fact the screening approach that the Commission follows in practice is more transparent than a fully-fledged economic test.

395 P. Nicolaides, The Balancing Myth: The Economics of Article 81(1) & (3), Legal Issues of Economic Integration, 2005, vol. 32(2), pp. 123-145.

Procedure

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State aid in EC competition law is in the midst of recent reform efforts, and such opportunities for change should not be lost. Targeted areas of reform should include facilitating the use of enhanced economic analysis, and particularly in this regard, the cohesive strengthening of the crucial information gathering process for the assessment of State aid.

Indeed, State aid has not escaped the general tendency towards the use of economic tools as a means to obtain better implementation of competition policy. This movement, contemporaneous with the end of the *per se* rule, has already affected the enforcement of Article 81 EC and the EC merger control rules, and should also impact the application of Article 82 EC.

This trend is more than just a passing admiration for mathematical models. It reflects, in fact, a desire to create a more enlightened, more adapted and also more responsible use of the competition rules so as to enhance a market-based economy. This economy itself has met considerable change, due to such factors as the deregulation of utilities, the increasing significance of services, and the digitalization and subsequent dematerialization of all forms of communications associated with the globalization of all sectors.

The Lisbon Summit of March 2000, destined to address all these challenges, specifically mentioned the necessity to re-define the goals and operation of EC State aid policy[396]. Building on such mandate, the Commission published in June 2005 the State aid Action Plan[397] (SAAP), which offers certain remedies and proposals for reform aimed at achieving the modernization mentioned in the Lisbon conclusions.

Less, but better-targeted, State aid is at the core of the reform[398]. This fundamental objective should, in turn, be supported by two main goals affecting both the substance and procedure of EC State aid control: the use of a refined economic approach and implementation of more efficient procedural rules.[399]

The present study focuses on the interaction of these two goals, via a questioning of the contribution and limits of economic analysis in relation to State aid procedural rules. The core issue raised by this interaction concerns the appropriate means which are already available and those which should be designed to efficiently gather and treat the relevant economic data required by use of a refined approach of State aid. More specifically, the strengthened economic approach necessarily implies that additional and more complex information be collected, treated and provided to the competent authority or judge entitled to decide, *inter alia*, on (i) the characterization of the contentious State measure, (ii) its compatibility with the common market, and (iii) requests for compensation to remedy the damage incurred by victims of illegal (*i.e.*, non-notified) or incompatible State aid granted. For this reason, the paper will not examine the issues related to the recovery of State aid. In addition, as the current study focuses on EC law, the private enforcement of State aid rules will also be set aside.

396 European Council of Lisbon, 23-24 March 2000, Conclusions of the Presidency, DOC/00/8, paragraph 17; Communication from the Commission to the Council and the European Parliament, Common Actions for Growth and Employment: The Community Lisbon Programme COM(2005) 330 final of 20 July 2005, pp. 4, 6 and 10.

397 State aid Action Plan, Less and better targeted State aid: a roadmap for State aid reform 2005-2009, COM(2005) 107 final.

398 See paragraphs 14, 15, 17 and 18 of the SAAP.

399 See paragraphs 18, 21-23 and 48 *et seq.* of the SAAP.

The purpose of this paper is therefore to assess where we stand in terms of the means to collect relevant data supporting a sound assessment of State aid, what is contemplated by the SAAP in this regard and, above all, how innovative changes in the procedural framework of State aid might be instrumental in reaching the intended objectives. Innovation is, however, not unlimited, as the scope of the planned reform only extends to the rules implementing Articles 87 and 88 EC, not the EC Treaty itself.

Thus, after describing the current State aid procedural framework and its shortcomings in terms of the information gathering process (1), we will closely examine the remedies envisaged by the SAAP (2). Based on the rather meager proposals made by the SAAP, we will set forth the procedural changes that we believe could be made without modifying the content of the EC Treaty, with a view to enhancing our market based economy, which remains the best guarantee for improving living conditions in the European Union (3).

I. Inefficient information gathering system under the current State aid procedural framework

The current State aid procedural framework derives, in large part, from the content and application of EC Regulation 659/1999[400], which lays down detailed rules for the application of Article 88 EC, and thus provides the framework governing the Commission's powers in the State aid field. This framework is clearly flawed, as it does not permit the efficient gathering of pertinent information (in particular of an economic nature) to support a sound assessment of State aid.

This inefficient information gathering process has two main causes: (i) the limited powers granted to the Commission, which is the main actor in the current centralized State aid control system, and (ii) the inappropriate and unbalanced roles given respectively to the Member State concerned and interested parties, particularly with respect to beneficiaries.

1. Limited powers of the Commission to gather the relevant information in a procedure mainly centralized at the European level

The Commission has exclusive jurisdiction to decide on the compatibility of State aid and, in practice, very little power is granted to national authorities. Only national judges, because of their duty to apply EC law as first degree jurisdiction, may be involved in State aid proceedings[401]. Even in this context, national jurisdictions have a role limited to specific issues, since

400 Council Regulation (EC) No 659/1999 of 22 March 1999, laying down detailed rules for the application of Article 93 of the EC Treaty, OJ (1999) L 83/1. This text was adopted on the basis of Article 89 EC whereby the Council may take appropriate measures (*e.g.*, adopt any implementing regulation) for the application of Articles 87 and 88 EC.

401 Article 14 (3) of EC Regulation 659/1999; Notice on cooperation between national courts and the Commission in the State aid field, OJ (1995) C 312/8.

they only decide on (i) the repayment of illegal and incompatible State aid, and (ii) claims for damages. National competition authorities are totally excluded from the State aid field.

In spite of its prominent position in State aid control, the Commission has rather limited powers under the current procedural framework to gather relevant information.

This is the case, first of all, for its investigative powers. The Commission can only send requests for information to the Member State concerned[402], but no legal basis is available to effectively implement this power against either the interested parties or any other relevant source of information to soundly assess State aid. In addition, the Commission can deliver an information injunction to force a Member State concerned to answer a request for information[403]. However, this power can only be applied in case of unlawful State aid (and not for gathering information to assess the compatibility of a duly notified measure)[404].

Furthermore, no direct sanctioning power has been granted to the Commission against the Member State concerned. In particular, such a Member State is not subject to any sanction if failing to comply with the aforementioned information injunction.

2. Inappropriate and unbalanced roles granted respectively to the Member State concerned and the interested parties create hindrances to the information gathering

The current State aid procedural framework is based on the axis of the Commission-Member State concerned. It is the second main feature of this framework. A distinction is drawn between, on the one hand, the "real parties", *i.e.*, the Commission and the Member State concerned, and, on the other hand, the so-called "parties concerned" or "interested parties", *i.e.*, the beneficiary, all competitors, the complainant(s), various industry or consumer associations, as well as trade unions and institutions representing work personnel, that may be affected by the State aid granted[405].

This distinction appears artificial and inappropriate, principally with respect to the status of the beneficiary. The beneficiary is indeed the entity likely to suffer most from a negative decision (based on an illegal or incompatible State aid), as it will have to repay amounts which, more often than not, have been or still are critical to its development[406]. However, its power

402 Articles 5 and 10 (2) of EC Regulation 659/1999.

403 Article 10 (3) of EC Regulation 659/1999; see, for example, Joined Cases T-304/04 and T-316/04 Italian Republic v Commission [2006] not yet reported, point 11.

404 Article 10 (3) of EC Regulation 659/1999.

405 The „*parties concerned*" referred to in Article 88 (2) EC mirror the "interested parties" mentioned in the implementing EC Regulation 659/1999. Both relate, i.a., to the State aid beneficiaries, their competitors and all other "person, undertaking or association of undertakings whose interests might be affected by the granting of aid". See Article 1 (h) of EC Regulation 659/1999; Case T-34/02 EURL Le Levant 001 v Commission [2006] not yet reported, points 77 et seq.; Case T-69/96 Hamburger Hafen- und Lagerhaus a.o. v Commission [2001] ECR II-1037, point 40; Case 323/82 SA Intermills v Commission [1984] ECR 3809, point 16.

406 See, in particular, the European Parliament Report on State aid reform 2005-2009 (2005/2165(INI)) A6-0009/2006 final of 27 January 2006, paragraph 48, whereby the European Parliament „[e]*xpresses its discontent that sanctions for non-notification are currently enforced only against beneficiaries and not against Member States*".

to influence the conduct of the procedure, and ultimately the decision to be adopted by the Commission, is rather limited. The beneficiary has no right of access to the file, and no right to be heard. Its sole possible impact derives from its limited right to submit comments on the letter sent by the Commission to the Member State, which announces the opening of the procedure, following its publication in the Official Journal of the European Union[407].

This obviously represents a very limited intervention and minor opportunity to provide the Commission with the relevant information the beneficiary may possess to better assess a State measure under review and, therefore, limit the potential adverse consequences of the Commission's control[408]. This insufficient involvement in the State aid procedure constitutes a major inefficiency, since the beneficiary is best placed to provide evidence on the effects of State aid and, in some instances, to demonstrate to the Commission the positive impact of such measure.

By contrast, the Member State concerned is given a much more comfortable position. It is the true correspondent with the Commission, and is in charge of answering the various questions raised by the Commission, and of commenting on the most important elements of the file. Paradoxically, the Member State cannot be really coerced into answering, in a full and straightforward manner, the queries sent by the Commission:

> First, while Article 10 (3) of EC Regulation 659/1999 grants the Commission the decision-making power to obtain information from the Member State concerned through information injunctions, no sanction is available which could allow the Commission to force the Member State to comply with that decision. In case it does not, the Commission may only end the administrative procedure on the basis of the only information given.
>
> Second, the Member State has no obligation to involve the beneficiary when providing the Commission with all necessary information in order to the enable the latter to make a decision.

As far as the situation of the other interested parties is concerned, these parties are granted the same opportunities as those given to the beneficiary to provide the Commission with the relevant information they may have, without, however, incurring the same risks. In short, interested parties benefit from a more favorable status than beneficiaries. Indeed, they retain not

407 Articles 6 (1) and 20 (1) of EC Regulation 659/1999.

408 In addition, the current situation does not provide the beneficiary with adequate rights of defense. See, for instance, Linklaters' Submissions on European Commission's State aid Action Plan Less and better targeted State aid: a roadmap for State aid reform 2005-2009, paragraph 22; Herbert Smith Gleiss Lutz Stibbe's Position paper on State aid reform, p. 5; Competition Law Association's Comments on the European Commission consultation document on the State aid Action Plan: a roadmap for reform 2005-2009, p. 5; Comments of AFEC on the State aid Action Plan of the Commission, paragraphs 46-48.

only the same limited rights as those granted to the beneficiary[409], but are also entitled to file a complaint to the Commission and seek recourse before national jurisdictions where an illegal or incompatible State aid has caused them damage[410]. However, unlike the beneficiary, these other interested parties are likely to be less immediately impacted financially by a decision characterizing State aid as illegal or incompatible[411].

Although the unfortunate division outlined above between "real parties" and the "interested parties" has been endorsed by the Court[412], it cannot be put forth as the logical and necessary consequence of the terms of Articles 87 and 88 EC. Arguably, the wording leaves enough room for any implementing regulation to define more precisely and enlarge the rights of the parties concerned, including the State aid beneficiary.

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409 Article 6 (1) of EC Regulation 659/1999. See also Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001, regarding public access to European Parliament, Council and Commission documents, OJ (2001) L 145/43. It seems that EC Regulation 1049/2001 may also constitute a means for the interested parties to be granted an access, albeit limited, to the file. Still, in practice, such opportunity has been scarcely used in the State aid proceedings. This can be explained, *i.a.*, by Article 4 (5) of EC Regulation 1049/2001, whereby "[a] Member State may request the institution not to disclose a document originating from that Member State without its prior agreement".
However, for a recent access to the file partially granted by the Commission to the complainant in State aid proceedings on the basis of EC Regulation 1049/2001, see the decision of the European Ombudsman of 11 July 2006, on complaint 3531/2004/(BB)TN against the European Commission, available on the European Ombudsman website: http://www.euro-ombudsman.eu.int/decision/en/043531.htm.

410 For a discussion on that particular point, see M. Sousse, „La situation du concurrent du bénéficiaire d'une aide d'Etat devant les juridictions nationales", Petites Affiches, 1er août 2000, p. 11.

411 Nevertheless, State aid may have caused financial loss to competitors. However, while the State aid recovery has a direct and immediate impact on the beneficiary, the damage suffered by the competitor for the illegal/incompatible State aid granted is, at least, more spread over a period of time allowing, in particular, such competitor to adapt/change its strategy.

412 See Case T-354/99 Kuwait Petroleum (Nederland) BV v Commission [2006] not yet reported, points 80-82; Joined Cases T-228/99 and T-233/99 Westdeutsche Landesbank Girozentrale a.o. v Commission [2003] ECR II-435, points 122-125; Joined Cases C-74/00 P and C-75/00 P Falck SpA a.o. v Commission and Italian Republic [2002] ECR I-7869, points 80-83; Joined Cases T-371/94 and T-394/94 British Airways plc a.o. v Commission [1998] ECR II-2405, points 59-60; Case 323/82 Intermills, points 16-19.
Adde: Case C-276/03 P Scott SA v Commission [2005] not yet reported. The ECJ, through rather far-reaching and somewhat inconsistent reasoning, narrowed down once again the rights of the interested parties and, in this case, those of the beneficiary. Its rights of defense were swept away as a result of the application of Article 15 of EC Regulation 659/1999, which grants the Commission the power to recover State aid within a limitation period of ten years. In casu, the Commission attempted to recover a State aid granted more than nine years before. The time limitation period was interrupted by a request for information sent to the Member State less than 6 months before the action was time barred. This request interrupted the limitation period which started running anew. The beneficiary was not informed, and his attempt to rely on the rights of defense, when the recovery of State aid was finally initiated, was useless. For a good illustration of the reasoning, and in particular the discrepancies with the approach taken by AG Jacobs in his Opinion for this case, see Hanns Peter Nehl, "The Imperfect Procedural Status of Beneficiaries of Aid in EC State aid Proceedings", European State aid Law Quarterly, 1/2006, p. 57.

II. Insufficient proposals of the SAAP on the establishment of an efficient information gathering system

The SAAP addresses only part of the issues raised by the shortcomings of the current State aid control framework. The proposals clearly appear insufficient to allow an efficient information gathering process, and thus effectively contribute to the use of a refined economic analysis. Some of these proposals could even potentially conflict with the objective of adopting an enhanced economic approach to State aid.

1. Failure to address the core issue of the reformed interested parties' rights as a means to improve the current information gathering system

The SAAP fails to address the main issue which could have helped reinforce the economic approach to State aid. Indeed, no proposal has been made regarding a strengthening of the rights of State aid beneficiaries' and, more broadly, of the interested parties[413]. This seems to suggest that the Commission is unwilling to change anything in the current axis of the Commission-Member State concerned.

The Commission simply limits its wish to increase "advocacy about State aid policy to allow undertakings, the academic world, competition specialists, consumers and the broader public to get involved and act against unlawful aid, in particular before national judges"[414]. But the SAAP considers that the burden of providing the Commission with the necessary evidence supporting a refined economic analysis should remain with the Member State concerned[415], and that beneficiaries should continue to bear the entire risk that such Member State fails to provide all required and relevant information before the deadline fixed by the Commission[416].

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413 See the Results of the consultation on the State aid Action Plan (SAAP) – Detailed Summary (09/02/2006), p. 26: „16 respondents (the majority from the private sector) commented on a subject, which was not mentioned in the SAAP: the need to increase rights for the beneficiaries of aid and other third parties"; Competition Law Association's Comments on the European Commission consultation document on the State aid Action Plan: a roadmap for reform 2005-2009, p. 5: "Crucially, […] we think that the Commission has omitted the main area where we would wish to see a change to its practices and procedures […] – that area is the rights of the recipient of aid"; Comments of AFEC on the State aid Action Plan of the Commission, paragraphs 46-48; Response of the Law Society of England and Wales' EU Committee's on the European Commission's State aid Action Plan, paragraphs 25-26.

414 Paragraph 17 of the SAAP. See also paragraph 18, third and fourth indents, of the SAAP.

415 Paragraph 19, in fine, of the SAAP: „It is for Member States to provide the necessary evidence in this respect, prior to any implementation of the envisaged measure".

416 Paragraph 58, first indent, of the SAAP.

2. Insufficient proposals on subsidiarity and the powers of the Commission to improve the current information gathering system

a) Insufficient proposals on subsidiarity

First, the SAAP recommends establishing a network of State aid authorities or contact points so as to «facilitate the flow of information and exchange of best practices»[417]. Unfortunately, no specific details are given about this network and, in particular, its components, its mandate, or its mode of operation.

*Second, the SAAP suggests an enhanced role for the national jurisdiction "*in controlling whether measures deemed to fall under a block exemption or under the de minimis thresholds, and which have therefore not been notified to the Commission, actually fulfil the necessary criteria"[418]. *Consistency in the enforcement of the State aid rules requires that control of the application of a block exemption regulation to a given State aid also be based on a refined economic analysis. National jurisdictions should therefore also be granted powers to efficiently collect and treat the relevant economic data. However, even though this issue resorts to the Member States' domestic law, the SAAP suggests nothing in relation to this matter.*

Third, it seems that all other proposals on decentralisation do not concern the collection and treatment of the relevant economic information that is helpful to decide on the State aid compatibility, but rather relate to recovery or private enforcement, which are not at stake here.

In particular, the SAAP proposes granting some powers to "operationally independent monitoring authorities"[419] and the national courts of auditors. However, the role assigned to these authorities and courts is loosely defined, and the involvement of said authorities and courts in the collection and treatment of the refined economic data is not expressly envisaged. Rather, the role of such "operationally independent monitoring authorities" appears more geared at enhancing the cooperation between the Commission and the Member States, and helping the former on (i) the detection and provisional recovery of illegal State aid, and (ii) execution of the recovery decisions[420].

As far as the national courts of auditors are concerned, their role in a recast procedural framework is limited to that of (i) advisor to assist the Member State to design the most appropriate measure that it plans to grant[421], and (ii) whistleblower in recovery and private enforcement actions[422]. Here again, nothing is suggested in the SAAP to involve the courts of audi-

417 Paragraph 53, second indent, of the SAAP.

418 Paragraph 56 of the SAAP.

419 Paragraph 51 of the SAAP.

420 *Ibid.*

421 Paragraph 54 of the SAAP: „The Commission will […] encourage Member States to engage in benchmarking to verify that State aid is achieving the objective and is the best type of state intervention for any given objective. This could be done in partnership with national Courts of Auditors".

422 Paragraph 55 of the SAAP.

tors in the data gathering and treatment process, or to grant them the power to provide the Commission with such data.

b) Insufficient proposals on increasing the Commission's powers

*The SAAP suggests a «*shared responsibility between the Commission and Member States; [since] the Commission cannot improve State aid rules and practice without the effective support of Member States and their full commitment to comply with their obligations to notify any envisaged aid and to enforce the rules properly"[423]. *To reach this objective, the Commission proposes an increase in its powers towards the Member States*[424]. *Some of these enhanced powers could undoubtedly facilitate the use of a refined economic analysis by improving the information collection system. Unfortunately, what is proposed remains rather vague.*

First, the Commission could be granted additional investigative powers to (i) consult the market participants, and (ii) gather relevant sectoral information[425]. In particular, the SAAP considers that "Member States should engage more actively to ensure that the conditions for the exemptions are fully respected and that necessary information is kept in accordance with the relevant rules, in order to enable the Commission to verify the compatibility in case of doubts or complaint"[426]. This proposal, which could clearly help the Commission improve its economic approach of State aid, must be approved as a clear legitimate target. However, more details should have been provided in order to show how it could be efficiently implemented.

Second, the Commission is seeking to enhance the Member States' commitment regarding "their obligation to enforce State aid rules"[427] and, in particular, to comply fully with the notification requirement[428]. In doing so, it is willing to more systematically use the information injunction provided by Article 10 (3) of EC Regulation 659/1999[429]. This measure may certainly represent an efficient tool to collect the relevant economic data, provided, however, that enforcement means are granted to the Commission vis-à-vis the Member State concerned. However, the SAAP does not suggest (i) any direct sanction for the Member State failing to comply with such injunction, and/or in such case, (ii) an increase in the State aid beneficiary's rights[430]. As a result, the proposed renewed application of the information injunction is likely to remain as inefficient as the current one.

423 Paragraph 18, last indent, of the SAAP.

424 In particular, the SAAP intends to increase the Commission's *ex post* control on the Member States' compliance with the compatibility decisions subject to conditions (paragraph 54 of the SAAP) and the national jurisdictions' recovery decisions (paragraph 53 of the SAAP).

425 Paragraph 58, third indent, of the SAAP.

426 Paragraph 52 of the SAAP (emphasis added).

427 Paragraph 17 of the SAAP.

428 Paragraph 58 of the SAAP.

429 Paragraph 50 of the SAAP.

430 A more intensive use of the non-compliance action provided by Articles 88 (2), 226 and 228 EC is recommended by the SAAP, but only in case of (i) absence of notification (paragraph 58, second indent, of the SAAP), and (ii) non-execution or improper execution of recovery decisions (paragraph 53, first indent, of the SAAP).

Third, the Commission "*encourage[s] Member States to engage in benchmarking to verify that State aid is achieving [its] objective[s] and is the best type of state intervention for any given objective'*[431]. While such benchmarking could indeed require a more careful economic analysis of the measure that the Member State concerned intends to grant, the SAAP merely suggests that "[t]his could be done in partnership with national Courts of Auditors"[432]. There again, no concrete means of action is proposed to help these courts of auditors to carry out this benchmarking.

3. Potential conflicts between certain proposals and the establishment of an efficient information gathering system

Last, but not least, some of the SAAP proposals could conflict with the establishment of an efficient information gathering system, and therefore with the objective of using a refined economic analysis for State aid.

In particular, it is questionable whether a more sophisticated economic approach, supported by such efficient information gathering system, necessarily fits with the declared aim to have a more transparent and, above all, user-friendly procedure[433]. Greater complexity will necessarily be associated with an increased use of economics to define State aid and assess its compatibility. Indeed, such use requires that more complex information be collected and treated and, as a consequence, that more people and authorities intervene in the proceedings.

In addition, recourse to a refined economic analysis should mean more time to collect, treat, and therefore transmit, the relevant data to the competent authority or jurisdiction. In this context, streamlining the timetable of the State aid procedure might be a difficult goal to achieve[434].

Finally, due to the increased complexity that necessarily derives from the use of economics, the objective of reducing bureaucracy/administrative burden in general does not seem realistic[435]. What is no longer done by the Commission (and the Member States) will be done by others. The reform could therefore lead to an overall increased administrative burden for other actors, such as the beneficiaries and other interested parties which, under the new scheme, could be called upon to provide relevant economic data.

In conclusion, the SAAP proposals on State aid procedural reform remain too vague, theoretical, and insufficient to ensure the creation of an efficient information gathering system to secure a refined economic approach to State aid. A more ambitious reform of the State aid control procedure must therefore be envisaged.

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431 Paragraph 54 of the SAAP.

432 Ibid.

433 See paragraphs 18, third indent, and 58 of the SAAP.

434 See paragraph 57 of the SAAP.

435 See paragraph 17 of the SAAP.

III. More ambitious proposals for the establishment of an efficient information gathering system

The Commission's suggestions should be completed and/or developed so as to contribute to the establishment of an efficient information gathering system. In particular, State aid reform on such procedure should lead to (i) extended rights for interested parties, (ii) significant involvement of national sources of information in a State aid network, and (iii) additional responsibilities and powers for the Commission to efficiently gather and treat relevant information.

1. Extended rights for interested parties

Enhancing the legal and economic analysis, as advocated by the SAAP, means having access to greater specificity about both the positive and negative impacts of the concerned measure. However, Member States are neither best placed, nor the best equipped technically, to provide valuable information on either aspect of such impact. Thus, more diverse and reliable sources of information should be relied upon. This may necessitate the adoption of a revamped procedural regulation, which would accord enhanced rights to the various interested parties[436]. A distinction should, however, be drawn between State aid beneficiaries and other interested parties.

a) Extended rights for State aid beneficiaries

Beneficiaries are undoubtedly best placed to demonstrate the positive impact of a State measure to the Commission. First, they are best equipped to supply information on the main features of the market on which they operate. Second, it is their own accounts (presuming their accuracy and transparency) that will provide the appropriate information to allow measurement of the impact of State aid on their costs and price structure. Third, beneficiaries have the available knowledge to allow the Commission to make an accurate determination of the incentive/seminal value of State aid.

Thus, beneficiaries should be fully involved in the proceedings with the Commission, once the latter has given notice to the Member State concerned of the opening of the procedure, and, for that reason, beneficiaries should be clearly identified in the decision to open the procedure[437]. In other words, the possibility mentioned in Article 88 (2) EC for them "to submit

436 This would not mean modifying the EC Treaty. No doubt, Article 88 (2) EC is silent on the meaning of „*parties concerned*". At the same time, this provision is extremely laconic on their rights and responsibilities (it merely mentions the right for these parties "to submit their comments"). Examples are numerous where, in similar situations, the European institutions (i.e., not only the ECJ and the CFI) have shown themselves capable of appropriately supplementing the EC Treaty, without undergoing the extreme challenge of an actual amendment process (see, e.g., the adoption of EC merger control rules in 1989 and the Modernization Package implementing Articles 81 and 82 EC in 2004). A thorough reform of the procedural rules laid down in EC Regulation No 659/1999 could be the response needed.

437 Case T-34/02 Le Levant, points 82-91.

their comments" should be interpreted broadly in the revamped EC Regulation 659/1999, to enable them to provide the Commission with all relevant information in their possession that is deemed appropriate to communicate.

A distinction should, however, be made between the beneficiaries of individual State aid and beneficiaries of State aid schemes.

aa) Extended rights for the beneficiaries of individual State aid

Without being accorded the status of party (which would imply a reform of the EC Treaty), beneficiaries of individual State aid should be among the official recipients of the letter opening the procedure. They should also receive a copy of all requests for information sent by the Commission to the Member State concerned. In addition, the Member State replies to these requests should also be signed by the beneficiary, as proof of appropriate cooperation between the Member State concerned and the beneficiary. In this regard, the revamped EC Regulation 659/1999 would codify the current cooperation which, in practice, must take place between the beneficiary and the Commission.

Furthermore, the beneficiary should normally be de plano entitled to attend all meetings between the Commission and the Member State concerned. In addition, and in certain cases, the Commission should be entitled to hold separate meetings with the beneficiaries[438].

bb) Extended rights for the beneficiaries of State aid schemes

The above-mentioned proposed cooperation between beneficiaries and the Member State concerned may, however, prove difficult to implement in practice where beneficiaries are numerous. This is the case, for instance, of beneficiaries of State aid schemes.

Thus, such beneficiaries' rights should at least comprise, if so requested, the right of access to the non-confidential version of the file, and a right to be heard by the Commission.

b) Extended rights for other interested parties

As actors in the relevant market, competitors are also quite well placed to know such market and supply the Commission with accurate information on the characteristics of the market likely to be impacted by the State aid. The same can be said for other well-informed agents, such as consumer associations, trade unions, institutions representing work personnel, economic experts, etc. which may also possess relevant economic data. In this regard, inspiration can

438 Certain beneficiaries may be almost institutionally deprived of sufficient independence from their Member State where the latter intervenes, for example within the general framework of a government control/administrative supervision akin to what is known as „*la tutelle*" in France, which in turn may cause all types of reverential fears or even Government reprimands and resulting unwanted restraint on the part of said beneficiaries.

be sought in the involved parties' and third persons' rights granted by the EC merger control procedural rules[439].

A different approach, however, should be adopted regarding (i) complainants (especially those who compete with the beneficiary), and (ii) ordinary competitors (i.e., as opposed to the complainants) and the aforementioned other well-informed agents. The former should be granted additional rights as compared to the latter.

aa) Extended rights for complainants

Complainants can undoubtedly provide the Commission with the best possible economic information on the «negative side effects» of State aid, *i.e.*, its harmful impact on competition, especially when they compete with the beneficiary on the same market.

For this reason, complainants should be granted rights equivalent to those given to the beneficiary of a State aid scheme. As a result, they should benefit from automatic access to the non-confidential version of the file when requested. This access "rewards" complainants for drawing the Commission's attention to a violation of the law, which otherwise may have gone unnoticed and therefore unpunished[440]. In addition, the complainants should benefit from a right to be heard by the Commission, if requested.

When anonymous complaints are filed, it could be suggested that the Commission automatically lift anonymity as a condition for granting access to the file to the complainant. However, one may consider that, in exceptional (and fully justified) circumstances, the complaint should remain anonymous, *e.g.*, when the complainant is an actual or potential client or supplier of the State aid beneficiary.

bb) Extended rights for ordinary competitors and other well-informed agents

In its pursuit of strengthened economic analysis, the Commission should also consider giving an enhanced role to ordinary competitors and other well-informed agents, such as consumer associations, economic experts willing to intervene for the benefit of competition, or trade unions and other institutions representing employees[441], etc., as they may also undoubtedly help the Commission to better understand the market.

In this regard, such interested parties could also be granted access to the file in order to assist them in commenting on the planned State aid. However, as with "other involved parties" in the EC merger control procedure, such access would only be granted where sufficiently

439 Article 18 of Council Regulation (EC) No 139/2004 of 20 January 2004, on the control of concentrations between undertakings, OJ (2004) L 24/1; Articles 14, 16 and 17 of Commission Regulation (EC) No 802/2004 of 7 April 2004, implementing Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings, OJ (2004) L 133/1.

440 See Competition Commissioner Neelie Kroes, „Reforming Europe‘s State aid Regime: An Action Plan for Change“, Wilmer Cutler Pickering Hale and Dorr/ University of Leiden Joint conference on European State aid Reform, Brussels, 14 June 2005, SPEECH/05/347, whereby Competition Commissioner Kroes recalls that „*private complainants may be* [the Commission's] best friends".

441 For instance, in the case of an industrial reshuffle such as in the *Alstom* case which may involve thousands of jobs, the representatives of the employees could certainly represent an invaluable source of information on the positive or negative (social) consequences of maintaining, withdrawing or amending a State aid.

motivated (*cf., i.a.,* (i) quality and quantity of the information that these informed agents can provide to the Commission, and (ii) if jobs are at stake (especially when access to the file is requested by trade unions)). Such access would, of course, be restricted to non-confidential documents of the file.

Ordinary competitors and other well-informed agents could also be granted a right to be heard, but again provided that the request to be heard is sufficiently motivated.

2. Significant involvement of national sources of information in a State aid network

Reliance on subsidiarity should take on a more significant role in the recast State aid control framework. Indeed, while the current legal framework is based on a Commission-Member State axis, neither the Commission (given its lack of resources), nor the concerned Member State (given both its distance from the market and its own vested interests) are the best-placed entities for having access to and analyzing the most relevant information on the market from a State aid perspective. However, there may be alternative (and still unused) ways of utilizing the capacities of the Member States to assist the Commission in conducting stronger economic analysis.

One of these alternatives can be found in the mandate granted to members of the European network of State aid authorities or contact points, which is rather loosely envisaged in the SAAP[442]. This network could, indeed, directly facilitate, accelerate, and better process the information necessary to support a refined economic State aid control analysis. However, the elements of this network must still be clearly defined, as well as its specific mandate and mode of operation.

a) Components of the State aid network

The SAAP does not clearly identify the "State aid authorities or contact points"[443] composing the State aid network. Furthermore, a better use of national resources may require the involvement of the national competition authorities and the national courts of auditors in the information gathering and treatment process. It therefore appears advisable that the State aid network should involve (i) the Commission, (ii) national competition authorities, and (iii) the national courts of auditors[444]. The SAAP's broad wording would seem to permit such involvement.

442 See paragraph 53 of the SAAP.

443 *Ibid*.

444 One may fear that national competition authorities and courts of auditors provide biased information to the Commission. However, things have started to change for the better in many Member States (*e.g.*, in France), where these national authorities and courts have started to adopt a much more objective posture and have clearly shown that they accept and recognize the (positive) impact of competition. Furthermore, the risk that national competition authorities and courts of auditors offer biased data could be counterbalanced with the new opportunity for the Commission to collect more and better information from additional sources, such as the interested parties other than the beneficiaries.

As far as the "State aid authorities" are concerned, it is unclear whether the Commission assimilates these authorities to the so-called "independent monitoring authorities"[445] to be set up in each Member State[446]. Indeed, the exact contours of such monitoring authorities remain rather vague. In particular, it should be considered whether these authorities are to be settled ex nihilo, or whether they could be an emanation of the national competition authorities, or, more simply, if these national competition authorities could be appointed as "independent monitoring authorities".

Clearly, instead of creating ad hoc national authorities entrusted with powers in State aid control, it would be more sensible to entrust such powers with existing national competition authorities, or specific divisions of these authorities. Such authorities are, indeed, significantly versed in the analysis of economic information in antitrust and merger cases and already well-equipped to conduct, if necessary, the appropriate investigations to collect this kind of information. In particular, these authorities may be in a good position to provide valuable analysis on their national markets and develop better evidence on how State aid measures may lead to distortions in competition.

As for the "contact points" involved in the State aid network, this broad notion could comprise, i.a., the national courts of auditors[447]. These courts could be kept easily informed of State aid proceedings initiated against their Member State, upon publication of the letter to initiate these proceedings in the Official Journal of the European Union. Once informed of such proceedings, they could help the Commission better to understand and use the refined economic information supporting an assessment of the compatibility of a given State aid.

b) Mandate given to the various components of the State aid network

aa) Mandate given to State aid authorities/national competition authorities

The mandate given to State aid authorities/national competition authorities, with a view to facilitating the use of a refined economic analysis, could first consist of advising the Commission. Once the Commission commences a review of a State aid measure (either upon the notification proceedings, or in the course of proceedings against illegal State aid), these authorities could supplement the Commission's assessment by providing market information and/or previous competition assessment that they may have undertaken on the same market (exist-

445 Paragraph 51 of the SAAP.

446 However, pursuant to paragraph 51 of the SAAP, these independent monitoring authorities are deemed to „play a role as regards facilitating the task of the Commission in terms of State aid enforcement (detection and provisional recovery of illegal aid, execution of recovery decisions)". Their involvement in the collection and treatment of the relevant information necessary to assess the compatibility of State aid is therefore not envisaged.

447 See the European Parliament Report on State aid reform 2005-2009, paragraph 45: the European Parliament „[s]trongly supports the idea of forming a closer network of supervisory authorities, such as courts of auditors, in the Member States, which could facilitate the objective of consistency in the application of State aid rules".

ence of market failures, existence of barriers to entry, market shares, level of innovation, maturity of the market, etc.).[448]

Second, and beyond submitting any available information, these authorities could also conduct investigations on behalf of the Commission in State aid matters and, for example, be entrusted with the power to request information from Member States, from State aid beneficiaries and from other interested parties.

It should further be considered whether such authorities should also be entrusted either with an *ex officio* power to conduct sector inquiries in their national territory (like the Commission pursuant to Article 17 of EC Regulation 1/2003), or to perform such inquiries on the basis of a mandate given by the Commission. EC guidelines or Best Practices could urge Member States to reform their domestic law accordingly.

bb) Assignment given to the contact points/national courts of auditors

As suggested by the SAAP, the national courts of auditors could act as (i) advisors to Member States in order to assess the compatibility of State aid, as well as (ii) whistleblowers when aware of illegal or potentially incompatible State aid granted by their Member State[449].

The effective enforcement of the second of these powers may require enabling the courts of auditors to use the *ex officio* investigation powers granted by their domestic law. EC guidelines could provide a reminder of such possibility.

Such guidelines could also deal with the broader issue of cooperation between the Commission and the national courts of auditors.

Finally, said guidelines should provide that the national courts of auditors could act as advisors/*amicus curiae* of the so-called State aid authorities (whether these emanate from the national competition authorities or not) and of the national judges when deciding on State aid matters.

c) Mode of operation of the State aid network

The mode of operation of the contemplated State aid network remains unclear. Inspiration could certainly be sought in the European competition network (ECN) and its related enforcement of Articles 81 and 82 EC[450] (however, the purpose of the State aid network would be limited here to efficiently gathering relevant information and granting the Commission exclu-

448 The State aid authorities could also advise the concerned Member State at the pre-notification stage, when it plans to grant a State aid. These authorities could assist in structuring a less restrictive scheme for competition. They could also be given a systematic right of review to ensure that the notification is made in an appropriate format and includes the kind of information useful/necessary for the Commission to issue an enlightened decision. To the extent that this issue refers to national law, the EC guidelines or Best Practices could at least encourage the State aid authorities to assist their Member State.

449 See paragraphs 54-55 of the SAAP.

450 Articles 11, 12 and 22 of Council Regulation (EC) No 1/2003 of 16 December 2002, on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, OJ (2003) L 1/1; Commission Notice on cooperation within the Network of Competition Authorities, OJ (2004) C 101/43.

sive jurisdiction to determine the compatibility of State aid, and would not include the allocation of State aid cases, as in the ECN).

3. Additional obligation and powers granted to the Commission to efficiently gather and treat relevant information

Finally, the effective use of a refined economic analysis calls for increased Commission investigatory powers to gather relevant information, as well as an additional obligation on the Commission to clarify/better target the information it requests. Unfortunately, no additional enforcement powers can be granted to the Commission against the Member State concerned, without amending the EC Treaty.

a) Additional investigatory powers for the Commission

The Commission should, first, be entrusted with the power to request information from the beneficiary, competitors, or any other person or entity it deems appropriate, with a view to collecting pertinent data.

In addition, it should also be entitled to investigate, i.e., consult market participants and gather economic information, in the various sectors of the economy, and thus improve its economic competition analysis. Such power could mirror that granted to the Commission under Article 17 of EC Regulation 1/2003.

Finally, the scope of application of the information injunction could be extended to the assessment of notified State aid and no longer be limited to unlawful State aid.

b) Additional obligation to clarify the information requested

The Commission should also clarify the information it may request from the Member State concerned and the interested parties, if the latter are becoming more implicated in the reformed State aid procedure[451]. The Commission's questions should therefore be better targeted[452]. This additional obligation to clarify the information requested seems all the more necessary that economic data is concerned by the Commission's requests.

Taking an economic approach for State aid cases means balancing market failures against distortions of competition. For the latter, other areas of competition policy could serve as a potential basis for detailing information requests. In particular, a systematic parallel could be made with the analysis of the effect of anticompetitive practices on competitors. Indeed, just as in the case of predatory behaviour for example, one is worried here not about the short-term effect on consumers but on its longer-term effect, due to hardship imposed on competitors.

451 Results of the consultation on the State aid Action Plan (SAAP) – Detailed Summary (09/02/2006), p. 23.

452 In particular, the requests for information sent to the Member States concerned should always enclose questions enabling the Commission to assess whether the four conditions set forth by Article 87 (1) EC are fulfilled. See in this regard, Case T-34/02 Le Levant, points 109 *et seq*.

As for market failures, this can be inherently complicated, since they can arise in a variety of context (they can relate to credit-market failures, to intellectual-property-right failures, etc.). However, guidelines on the various categories of State aid can help systematize information requests for individual cases[453]. This is important if one wants to help 'organize' the process of evaluation of State aid requests.

c) *No additional enforcement powers can be granted to the Commission against the Member States concerned without reforming the EC Treaty*

The effective use of improved economic analysis would appear to require giving the Commission enforcement powers to require Member States to provide the Commission with all the relevant economic data requested and, in particular, to comply fully and promptly with the information injunctions they receive[454].

Indeed, an efficient enforcement system should enable the Commission to impose (i) procedural fines on the State concerned[455] in case of failure to completely, correctly and/or promptly respond to the requests for information addressed to it, and (ii) periodic penalty payments[456] to a Member State that fails to comply with an information injunction.

However, in order to impose a genuine duty of compliance with the Commission's injunction and/or real means to ensure the efficiency of the State aid administrative procedure, a mere re-working of EC Regulation 659/1999 might turn out to be insufficient and may call for an actual reform of the EC Treaty.

At present, the Commission's only enforcement mechanism is the existing action for failure by the Member States to fulfil its EC obligations. However, this judicial remedy is not the appropriate tool in this case:

First, direct referrals to the ECJ for Member States' non-compliance with their obligations concern only cases of failure to comply with (i) non-compatibility decisions[457], and (ii) suspension and recovery injunctions[458]. For this reason, Article 23 of EC Regulation 659/1999 cannot be extended to direct referrals to the ECJ for cases of Member State non-compliance with procedural decisions and, in particular, with information injunctions.

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453 See, for instance, Draft Community framework for State aid for research and development and innovation, 8 September 2006, paragraph 6.1, whereby „*Member States are invited to provide all the elements that they consider useful for the assessment of the case. The Member States are, in particular, invited to rely on evaluations of past State aid schemes or measures, impact assessments made by the granting authority, risk assessments, financial reports, internal business plans that any company should realise for important projects, expert opinions and other studies related to R&D&I.*"

454 See the European Parliament Report on State aid reform 2005-2009, paragraph 48, whereby the European Parliament „supports the Commission […] in exploring new deterrent mechanisms with a view [to] addressing the incorrect implementation of the State aid rules by Member States, and invites the Commission to provide for appropriate sanctions in this regard".

455 Such as those applying pursuant to Article 23 (1) of EC Regulation 1/2003.

456 Such as those applying pursuant to Article 24 (d) of EC Regulation 1/2003.

457 Article 88 (2) EC.

458 Article 12 of EC Regulation 659/1999.

Second, recourse to Articles 226 and 228 EC against Member States failing to comply with information injunctions would be inappropriate and over-burdensome.

Various hurdles clearly exist against a true reinforcement of the Commission's sanctioning power. Nonetheless, closer involvement of the State aid beneficiaries (at least when granted an individual State aid) could lead to more rapid and complete responses to Commission requests for information. As advocated in this paper, this could be achieved through enhanced cooperation between these beneficiaries and the Member State concerned.

A comparison of WTO subsidy and EU State aid rules

Antoine Winckler, David Little*

In theory, it would be in the interests of a free global trading arena, if a single body of trade laws, the rules and legal principles of the World Trade Organisation (WTO) were uniformly applicable to all, creating an economically efficient global system. Rules of international trade would be economically neutral and all decisions would be adopted only on the basis of relative advantage, with special strategic or protectionist intervention by the State kept to a minimum. The reality of world trade is of course somewhat different; individual states, and regional organisations such as the European Communities (EC), have developed their own principles of international trade, which depart to a greater or lesser degree from the rules of the WTO.[459] One of the key areas of international trade law where Member States are apt to differ in their approaches is subsidies. Subsidies remain a central political instrument, and although at times they may play a useful corrective role, *e.g.*, in case of market failure, as a general rule subsidies are a wasteful use of public resources, alter market behaviour negatively (*inter alia* by creating "moral hazards") and protect inefficient industrial management.[460] In this context, it is useful to compare the rules of the WTO on subsidies with those applied by the institutions of the EU to State aid. While the latter apply to trade within the EU and trade with third states

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459 See, e.g., Case T-55/99 – *Confederacion Espanola de Transporte de Mercancias (CETM)* v Commission [2000] ECR II-3207, paragraphs 40 *et seq*. . "the concept of subsidy within the meaning of the WTO Agreement on Subsidies and Countervailing Measures has, as the Commission submits, no relevance whatsoever to the classification of the measure in question as State aid within the meaning of Community law". See also, Commission Decision of 30 March 2004, on the aid scheme which the United Kingdom is planning to implement as regards the government of Gibraltar Corporation Tax Reform, (2005/261/EEC), at paragraph 117.

460 See e.g., Comment by Walther, in Bourgeois, *"Subsidies and International Trade, A European Lawyers' Perspective"* (1991); See also Alessandrini, "*Subsidies, Strategic Trade Policies and the GATT*", Id.

covered by the EEA and EUROMED accords, the former apply to trade between the EC and third parties that are signatories of the WTO agreement.[461]

There are, of course, many areas that merit consideration and which throw up interesting contrasts between the two systems. However, for the purposes of our discussion, we would like to consider three examples in particular. In the first instance, we will examine the substantive issue of how the WTO and EC approach the questions of material and regional selectivity (I). We will then consider how the procedural systems developed by each organisation compare, and how they might contribute to differing substantive approaches to subsidies (II). The WTO rules, perhaps inevitably given the draftsmen's need to build a consensus position, are not exhaustive and contain many loopholes. It is one of these loopholes, namely the failure to extend the rules on subsidies to cover services as well as goods, which may have created regulatory distortions. One example of such a distortion is the EU "matching clause" inserted in its R&D&I framework. We will examine this matching clause in the final part of our discussion (III).

The EU provisions governing subsidies are a combination of primary and secondary legislation. Article 87 EC sets out the initial rules governing the activities of Member States in providing State aid. The Commission draws a distinction between "selective measures" and "general measures". General measures are deemed to not constitute aid and therefore are not governed by Article 87(1) of the Treaty. A measure is considered general within the meaning of article 87(1) where: (i) there is no specificity or selectivity in terms of sector, region or category (for instance SMEs), (ii) the eligibility for the aid is based on objective criteria, without any discretionary power of the authorities, and (iii) the measure is in principle not limited in time or by a predetermined budget. Articles 88 and 89 EC empower the Commission to determine whether a particular aid is compatible with the Treaty and to make regulations setting out the procedures for making this determination and categories of aid that are exempt from the procedure. The Commission has supplemented these dispositions with further legislation relating to the granting of subsidies by third countries, of which the most important for our purposes is Council Regulation No 2026/97 (the "Regulation").[462] The Commission has also recently published various consultation documents related *e.g.* to R&D&I, which will be considered in further detail in our discussion of the so-called "matching clause".[463] Other institutions, including the Council, have been active in expanding upon the body of legal texts governing the provision of State aid, and we should mention in passing the Council procedural regulation for the application of Article 88 EC, which has done much to improve legal certainty, setting important time limits for State aid decisions and enabling the Commission to force Member States to suspend unlawful subsidies.

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461 See, for a more detailed discussion of jurisdictional questions, Dr. Till Müller-Ibold, "*Ausfuhrförderung aus der Sicht der Europäischen Gemeinschaft*", in Rechtsfragen der Ausfuhrförderung (2003).

462 Council Regulation No 2026/97 on protection against subsidised imports from countries not members of the European Community [1997] O.J. L 288, pages 1-33.

463 Draft Community Framework on State aid for research and development and innovation of April 20, 2006; Draft Memorandum on the Community Framework on State aid for research and development and innovation of May 4, 2006; COM(2005)436, Consultation Document on State aid for Innovation.

Within the framework of the WTO, subsidies are governed by the rules laid down in the GATT, at Articles VI and XVI, and in the Agreement on Subsidies and Countervailing Measures (the "ASCM"), drawn up at the Uruguay Round of negotiations concluded in 1994. The ASCM defines three categories of subsidies: prohibited, actionable and non-actionable subsidies. Prohibited subsidies are contingent upon export performance, *e.g.*, require the recipient to meet certain export targets or to use domestic goods instead of imported goods. They can be challenged under the WTO dispute settlement procedure, which may eventually lead to withdrawal of the subsidy, or the application of a countervailing duty, without the complainant needing to demonstrate injury. In the case of actionable subsidies, the complainant must demonstrate that the subsidy has an "*adverse effect*" on its interests. Unquestionably, there are similarities in both the language and the effect of the WTO and EU rules in particular in respect of the principle of specificity/selectivity which is one of the key considerations under both systems in defining a subsidy/State aid (see below).

It is interesting to note in passing that the EU rules on State aid are given the express aim of avoiding the distortion of competition. By contrast, the ASCM is not assigned a stated object or purpose, and much of the responsibility for the overall aim of the rules has evidently been left to the WTO's *ad hoc* dispute settlement bodies and the Appellate Body. The absence of a stated aim is probably attributable to the inability of WTO members to reach a consensus on the issue during the Uruguay Round. The very concept of subsidy control under the GATT and under the Treaty of Rome differs, in that the GATT has traditionally focused on the effects of subsidies on trade in order to avoid injury, whereas the EU rules on State aid are, as we have mentioned, oriented towards preventing distortions of competition. Arguably, the focus on the competitive process rather than on trade flows overlap to a large extent. There is however a difference to the extent that the EU aims at preserving competition among the players on the market rather than trade relations among states. As a result, while the WTO rules are primarily reparative in nature, making extensive provision for the application of remedies but with limited focus on the actual prohibition of subsidies[464], the EU rules on State aid seek, through the pre-emptive administrative agency of the Commission, the abolition of all unlawful subsidies.[465]

464 Compare, by way of example, the detailed procedural mechanism established in Article 4 of the ASCM, with the cursory prohibitions of Article 3. See also, Comment by Walther, in Bourgeois, "*Subsidies and International Trade, A European Lawyers' Perspective*" (1991).

465 "The EC Treaty pronounces the general prohibition of State aid. The founders, however, saw of course that in some circumstances, government interventions are necessary for a well-functioning and equitable economy." For further information on the aims of the Commission in relation to State aid, see http://ec.europa.eu/comm/competition/state_aid/overview/.

I. The selectivity criterion

For all the similarities between the EU rules and those of the WTO, their practical application has differed considerably, in particular with regard to the criterion of material and regional "selectivity".

1. Comparison of the tests for material selectivity

Substantive similarity of legislation. According to the EU rules, in order to be considered unlawful under Article 87, a State aid must favour certain undertakings or the production of certain goods. By way of example, aid schemes that give favourable treatment to particular sizes of companies[466], or only to companies that manufacture goods, can constitute unlawful State aid.[467] Conversely, Article 87 does not apply to general measures applicable to all undertakings in a Member State that meet objective and non-discriminatory requirements.[468] These rules are reflected by the Regulation, which provides for the identification of both *de iure* and *de facto* material selectivity, at Article 3(2). Article 3(2) covers those clear cases where the subsidising entity, or the legislation pursuant to which the subsidising entity operates, explicitly limits access to that subsidy to specific enterprises. Article 3(2) also captures those instances where subsidies are *prima facie* general and non discriminatory, but in practice are limited to a particular number of undertakings.[469] Unsurprisingly, these provisions mirror very closely Article 2 of the ASCM, which also applies to cases of *de iure* and *de facto* material selectivity. The WTO considered the breadth of Article 2 in *Subsidies on Upland Cotton*. The Panel, having acknowledged the openness of the disposition, concluded: "The plain words of Article 2.1 indicate that specificity is a general concept, and the breadth or narrowness of specificity is not susceptible to rigid quantitative definition. Whether a subsidy is specific can only be assessed on a case-by-case basis."[470]

Practical differences of application. However, if the rules on selectivity are substantively similar, some authors have criticised the implementation of the EC rules by the Commission

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466 See, concerning large enterprises, Case C-200/97 *Ecotrade SRL v Altiformi e Ferriere di Servola Spa* [1998] ECR 1-7907, paragraphs 39-41. See also, concerning SMEs, Case T-55/99 – *Confederacion Espanola de Transporte de Mercancias (CETM)* v Commission [2000] ECR ii-3207, paragraphs 40 *et seq*.

467 Case C-143/99 *Adria-Wien Pipeline GmbH and Others* [2001] ECR 1-8365, paragraph 50.

468 See Cases C72-73/91, *Sloman Neptun* [1993] E.C.R. I-887. According to the Advocate General Darmon, the measure in question must constitute a derogation from generally applicable rules which benefit or otherwise favor a particular sector or enterprise.

469 For an example of *de facto* material specificity, see e.g., Council Regulation (EC) No. 1891/97 imposing a definitive countervailing duty on imports of *Farmed Atlantic Salmon originating in Norway*, O.J. [1997] L267/19, at 21. The choice of Article was perhaps surprising given that the infringement was identified by virtue of the fact that in practice almost all the employees the social security contributions of whom were being examined lived in the same zone as the employer.

470 DS267, Panel Report of September 8, 2002, United States – *Subsidies on Upland Cotton* – Request for Consultations from Brazil, paragraph 7.1142.

as unnecessarily restrictive. By way of example, with reference to the calculation of countervailing subsidies, the Commission allows minimal scope for making deductions to the subsidy amount stipulated in Article 7(1) of the Regulation,[471] and has often systematically categorised accelerated depreciation as a grant-style subsidy rather than a lawful method of tax deferral.[472]

Returning more specifically to the issue of selectivity, we might consider as an example of a similar application of the subsidy rules by the Commission and the WTO, the *Stainless Steel Wire* case.[473] In *Stainless Steel Wire*, the Commission investigated a complaint lodged by the European Confederation of Iron and Steel Industries alleging unlawful subsidisation of stainless steel wire imported into the Community from Korea and India. In particular, the Commission considered a number of export-financing loans provided by EXIM, a Korean State-owned bank. The Commission held that dispositions of Korean tax law governing Overseas Investment Loss, despite being available to any company based in Korea with foreign investments, were materially specific since in practice only those Korean companies choosing to invest abroad would benefit from the tax reserve. It appeared that the legislation at issue in *Stainless Steel Wire* was intended in practice to benefit a limited number of companies, all of which held investments abroad. A similar conclusion could have derived from the application of the ASCM. However the absence of direction in the ASCM as to the correct method of calculating the amount of subsidy in terms of benefit to the recipient has left this area susceptible to contrasting and protectionist interpretations by WTO members.[474] The provisions of Article 14 of the ASCM are "*too limited to provide any meaningful clarifications on exact calculation methods to be used*".[475]

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471 For an example of the differences between WTO members on the issue of deductions from subsidy amounts, see e.g., DS330, Request for Consultations of April 29, 2005, *Argentina – Countervailing Duties on Olive Oil, Wheat Gluten and Peaches*. The EC alleged a failure on the part of the Argentine authorities to both provide an adequate and reasoned explanation that the amount of any alleged subsidy is calculated in an appropriate manner and to carry out an assessment of the facts on the record in an objective and unbiased manner.

472 See e.g., Waer and Vermulst, "*EC Anti-Subsidy law and practice after the Uruguay Round*" [1999] Journal of World Trade, page 19 at page 42. The Commission's strict approach is undoubtedly influenced by its desire to examine the legality of an alleged countervailing subsidy within the narrow investigation period at issue. However, this does not exclude that the Commission might on other occasions examine instead the effect of an accelerated depreciation scheme over the entire duration of its application. In such a case, the Commission would be more likely to accept that the accelerated depreciation scheme constituted a non-specific measure (provided it had been made available to applicants on an objective basis).

473 Commission regulation (EC) No. 619/1999 of 23 March 1999 imposing a provisional countervailing duty on imports of stainless steel wire having a diameter of less than 1mm originating in India and the Republic of Korea [1999] O.J. L79/60, at page 70.

474 See, e.g., DS299, Panel Report of June 17, 2005, *European Communities – Countervailing Measures on DRAM chips from Korea*, paragraph 7.2.20 *et seq*. The Panel approved the EC application of Arts. 1.2 and 2.1 of the ASCM, the EC having inferred *de facto* material specificity from the limited use of a subsidy by a small number of companies, and the disproportionate use of the funds by one company in particular.

475 Waer and Vermulst, "*EC Anti-Subsidy law and practice after the Uruguay Round*" [1999] Journal of World Trade, page 19 at page 42.

2. Comparison of the tests for regional selectivity

The difference between the WTO subsidy laws and the Commission's application of EU State aid rules is particularly clear in the case of regional selectivity. Arguably, the stringent EU scrutiny of State aid measures makes it more difficult for Member States to construct a differential tax system; in essence, all tax rules not equally applicable to all taxpayers throughout the territory of that Member State risk prohibition.[476]

Article 3(3) of the Regulation deals with regional selectivity, i.e., those State aid limited to a designated geographical region within the jurisdiction of the granting authority. The key recent EU cases considering regional selectivity under Article 87 EC are the *Gibraltar Case*[477]and the *Azores Case*.[478] Both cases demonstrate that the notion of regional selectivity is currently evolving from a "mechanical" (and sometimes simply wrong) application of Article 87 by the Commission, to a more sophisticated legal concept of regional selectivity, taking into account the constitutional, political and economic realities in the Community.

The Gibraltar case. In April 2002, the Government of Gibraltar announced that it would introduce an entirely new corporate tax regime for all companies in Gibraltar.

The situation of Gibraltar is unique in the Community, and the case was therefore less than ideal as a test ground for the Commission to develop a theory on regional selectivity: Gibraltar is not a region of the UK. It is not part of the UK for the purpose of Gibraltar law or UK law. It is fiscally and economically separate from the UK. It is a dependent territory with its own tax powers derived from the Gibraltar Constitution (and not derived from, or based on, UK law).[479]

Nevertheless, in a decision adopted on March 30, 2004, the Commission considered the Gibraltar tax reform regional selective. It did not take into account the constitutional and fiscal autonomy of Gibraltar (as outlined above). It held that, "*by providing for a system of corporate taxation under which enterprises in Gibraltar are taxed, in general, at a lower rate than those in the United Kingdom, the reform confers a selective advantage on enterprises in*

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476 See, Arhold, European State aid Law Quarterly 2005, page 188. See also, Schoce/Arhold, European State aid Law Quarterly 2002, page 49. EU State aid case law on tax systems continues to develop. See, e.g., 2003/216/EC Commission decision of Jan 15, 2002 on State aid granted by France to Crédit Mutuel [2003] O.J. page 39 at paragraph 150. The Commission's method of calculating the profitability of an initiative for the purposes of assessing State aid will be tailored to the activity in question. In assessing whether Crédit Mutuel's "Livret Bleu" savings account scheme constituted an unlawful State aid, the Commission introduced a "*cost of own funds*" concept, in order to devise a hypothetical "*normal margin*" from the activity concerned.

477 Commission decision 2005/261/EC of 30 March 2004 on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform.

478 Case C-88/03 Action brought on 27 February 2003 by Portuguese Republic against the Commission of the European Communities [2003] O.J. C 112, page 11. See also, Commission Decision 2003/442/EC of 11 December 2002 on the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous region of the Azores which concerns reduction in the rates of income and corporation tax [2003] O.J. L 150, page 52.

479 Gibraltar is a British overseas territory. As a matter of UK law, British overseas territories do not form part of the United Kingdom. This is consistent with the status of "colonies" generally under public international law and notably under the United Nation Charter of 1946.

Gibraltar".[480] The Commission's decision is currently under appeal before the Court of First Instance.

Interestingly, the United Kingdom had substantiated its arguments by reference to the provisions of the ASCM, in particular its Article 2.2, which states that "the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to be a specific subsidy for purposes of the rules prohibiting the grant of such subsidies". Interestingly, the Commission rejected the UK argument (without comparing the two sets of rules in substance) as follows:

"The parallels that the United Kingdom draws with the WTO agreement on subsidies are not relevant, as the legal order within the European Union is quite distinct from any international law provided for by WTO agreements, the regime of State aid control in a single market must obviously be stricter than the rules applicable to subsidies laid down in a world agreement and the fact that a measure might not be considered to be a specific subsidy under the Agreement on subsidies cannot cut down the scope of the definition of aid in Article 87(1) of the Treaty."

The Azores Case. It was clear, however, that the Commission's approach to regional selectivity, as expressed in the Gibraltar case, would not stand judicial scrutiny. Irrespective of Gibraltar's unique situation, the Commission's approach disregarded the legal, fiscal, and political realities in many Member States, where some regions enjoy substantial autonomy from the central government. The issue of regional selectivity was considered by the European Court of Justice for the first time in the *Azores* case.

The *Azores* case concerned the notification to the Commission by the Portuguese government of a scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores. The scheme introduced reductions in the rates of income and corporation tax in comparison to those payable on the Portuguese mainland. The Commission had held that the tax system constituted an unlawful State aid within the meaning of Article 87(1).[481] The Commission took the entire Member State as the geographic frame of reference, and classified as aid those taxes in the *Azores* that departed from the rules applicable on the Portuguese mainland. The decision was appealed before the European Court of Justice.

In his Opinion, Advocate General Geelhoed criticised the Commission's use of the entire territory of a Member State as the frame of reference for examination of the regional specificity of a given subsidy: "*prima facie* all national tax variations limited to a geographic subsection of

480 Commission decision 2005/261/EC of 30 March 2004 on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform, paragraph 127.

481 Commission decision of December 11, 2002, on the part of the schemes adopting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax, O.J. 2003 L 150, p. 52.

a Member State qualify as '*geographically*' selective".[482] AG Geelhoed distinguished "*symmetrical*" and "*asymmetrical"* devolution of tax powers.[483] In the first instance, all national government power for taxation has been devolved to each of the local authorities, such that there is no national taxation rate. In such a case, there is effectively no nationwide tax rule, and therefore no tax rule from which to depart. An "*asymmetrical*" devolution of tax powers exists where autonomy has been granted by a government to a particular region or local authority that is then free to establish its own taxation regime. According to the Advocate General a differential tax rate in this case would constitute an unlawful State aid where the geographic region is not institutionally, procedurally and economically autonomous.

Although the ECJ has since approved the Commission's verdict and ruled that the measures constituted an unlawful State aid, the Court did apply the institutional, procedural and economic autonomy test suggested by AG Geelhoed for determining the frame of reference for assessment of the tax measure. The Court held that for an autonomous local region to constitute the appropriate geographical frame of reference for assessing that region's tax laws, the Member State must show that the region has a political and administrative status separate from the central government. Second, it must be demonstrated that procedurally, the central government did not intervene directly as regards the content of the measure. Third, the reduction in the regional tax rate must not be "*offset by aid or subsidies from other regions or central government*", *i.e.*, the autonomous region must have economic independence. Since the Azores government's reduction of revenue tax and fiscal measures, designed to address financial problems resulting from the region's insularity, was derived from budgetary transfers made by the national government, the region lacked the requisite economic independence.[484]

The response of the ECJ must be considered a first step in the right direction. The three-step test for independence should allow for devolved regions with fiscal authority, *e.g.*, Scotland in the UK, to set their own tax regimes, on the basis that it will be the devolved government that "*assumes the political and financial consequences*"[485] of doing so. The Court however determined that in the circumstances, although the Azores region enjoyed a great degree of autonomy from the Portuguese mainland, it was the central State, through the mechanism of Articles 5(1) and 32 of Law No 13/98 and the national principle of solidarity, which provided the financial wherewithal for the Azores to adopt its differentiated tax system.

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482 Opinion of the Advocate General in Case C-88/03 *Portuguese Republic v Commission* [2005] E.C.R., paragraph 45. Equally, the Advocate General recognised that it would be unsatisfactory to take the whole of the geographic subsection as the frame of reference, since in that case, no variation could be considered selective. To do so would reduce markedly the arsenal of tools at the Community's disposal for limiting distortions of competition, to Articles 94, 96 and 97.

483 *Id*., at paragraph 60.

484 Case C-88/03 *Portuguese Republic v Commission* [2006] E.C.R. [not yet published], at paragraph 75: "the reduction in tax revenue is in any event offset by a financing mechanism which is centrally managed. In this case, that financing is expressly provided for in Article 5(2) of Law No.13/98 [of 24 February 1998 on the finances of the autonomous regions, passed by the Portuguese Republic's National Assembly] in the form of budgetary transfers".

485 *Id*, at paragraph 68. The Court followed the argumentation of the United Kingdom Government, which supported the Portuguese government's appeal against the Commission's ruling.

Nevertheless, in comparison to the rules of the WTO on tax systems, the approach of the European institutions remains much stricter. The WTO adopts a non interventionist attitude to the regulation of Member States' internal tax systems, whereas the EU has established strict criteria for determining the admissibility of differential taxation schemes. That makes the adoption of regional tax exemptions/regional tax regimes more difficult if not marginal. The differing approach of the two institutions is perhaps to be expected. The EU aims to create a common market based on increased tax policy coordination among Member States as a means of supporting wider EU policy goals.[486] The economic and constitutional logic of this preference for Member State uniform taxation is often very unclear. By comparison, the WTO's brief is limited to the regulation of Member States' international trading practices, stopping short of intervention in the internal taxation policy of the Member State.

II. The influence of the contrasting institutional frameworks of the EU and WTO

Externally imposed disciplinary systems. There are initial similarities between the EU and WTO systems. Both are externally-imposed subsidies disciplines; EU rules are designed to constrain the power of Member States to subsidise their industries, and the rules of the WTO apply to the GATT signatories.[487] Beyond this, however, the Commission has developed a more complex mechanism of surveillance than has the WTO. There is a broad prohibition of State aid measures that risk distorting competition, and a detailed procedure for their notification to the Commission.

Prohibited v. Actionable Subsidies. While EU State aid rules prohibit all specific subsidies unless notified and cleared by the Commission (with limited exceptions), the ASCM prohibits outright only export subsidies and those subsidies made contingent upon the use of domestic

486 The Commission does not, however, currently believe that the interests of the Community would be served by the harmonisation of Member States' tax systems across the board. See, the Commission's statement of tax strategy, at http://ec.europa.eu/taxation_customs/taxation/gen_info/tax_policy/index_en.htm.

487 See also, Horlick: (1999) "*Subsidies discipline under WTO and US rules*", European University Institute Competition Workshop on State aid Control in the European Union. Horlick identifies three categories of subsidy: (i) inherent, e.g., those constrained by a lack of resources, (ii) self-imposed, such as constitutional limits established in US states like Kentucky, and (iii) external subsidies.

goods.[488] While all non-prohibited subsidies are still actionable under the ASCM, certain limited categories of aid, may escape the Article 87 prohibition (*e.g.* social aid or "exempted" aid). However, the fact remains that in order for a WTO member to contest the application of a non-prohibited subsidy, that member must demonstrate injury to its domestic industry, whereas many of the non-prohibited subsidies would have been unlawful outright under EU State aid rules if they affect intra-Community trade (a test that is very easily met).

Ex ante notification. Under the EC system of State aid control, Member States are obliged to notify State aid projects to the Commission and obtain authorisation for the scheme before implementation. The Commission also has the power to order the *ex post* suspension and recovery of aid given without authorisation, regardless of whether that aid would have been authorised had it been properly notified. The *ex ante* approach to authorisation, and the possibility of negotiation and adjustment of an existing program reflects the difference in nature between the supra-national WTO and the integrated quasi-federal nature of the EU.

Discretionary powers of the Commission. Within this framework, the Commission has considerable discretion to prohibit aid granted to national companies by the Member States. Indeed, under Article 87(3)(e), the Commission may propose new categories of prohibited aid, although this requires the approval of a qualified majority in the Council. Although judicial review at the Court of First Instance is available to a penalised Member State, the Commission is the key enforcer of the legislation governing State aid. This organisation has resulted in criticism:"*[P]lacing review of State aid measures in the hands of the Commission reflects the fact that an approach which emphasises legal rules and orders is unsuited to dealing with the complex subsidy and tax incentive programs of advanced, mixed economies*".[489] In contrast, there is no administrative agency in charge of policy direction at the WTO. Instead, much needed policy impetus is the aim of the (frequently deadlocked) intergovernmental conferences. Although there is a specific subsidies and countervailing measures Committee within the WTO, this Committee meets only twice a year to supervise implementation of the ASCM. As a result, complaints by Member States related to the ASCM will instead pass through

488 Although the EU rules on subsidies and countervailing measures, including the definition of a subsidy, mirror to a large extent those laid down in the ASCM, the Community rules are undoubtedly broader. The EC rules are not limited to the impact of State aid on trade in goods, as are the ASCM rules, but can equally be applied in respect of distortions of competition in the financial and banking sector. During negotiations on the ASCM, the EU advocated that any definition of subsidies must incorporate the notion of a "cost to the government", but the United States took the opposing "benefit to the recipient" approach. The resultant text appeared to fudge the issue somewhat. The state of the law is clearer following the analysis of differing regions' interpretations of the ASCM in: Canada: DS70/R, Panel Report of April 14, 1999 *Measures Affecting the Export of Civilian Aircraft*, paragraphs 5.28 to 5.34 and 5.42 to 5.50. In this case, Brazil argued that, although Canada advocated the need to demonstrate a "cost to the government", its own internal Handbook on Import Measures acknowledged that a benefit could accrue to the importer or exporter without a cost in turn being incurred by the government. The Appellate Body subsequently swept away the "cost to the government standard" that both Canada and the European Union had supported, and this test now applies only in Article 14 cases.

489 Trebilcock and Howse, "*The Regulation of International trade – The GATT and regional trading blocks*" (2001), at page 47.

the judicial review channel that is the reserve of an *ad hoc* DSB, convened upon receipt of a complaint and comprised of all General Council members, acting as arbitrators.[490]

In the case of the WTO, compromises reached by the Member States when drawing up the substantive rules are more likely to cause uncertainty than to allow for flexibility. By way of example, despite a large number of potentially distorting subsidies being envisaged by the WTO rules, defensive action by a contracting state is only authorised where these subsidies would cause or have caused "*adverse effects*". The expression is defined at Article 5 of the ASCM but in a manner that is sufficiently expansive for it to be unlikely to stop the Member States from applying unilateral countervailing measures permitted under WTO law. In contrast with the role of the Commission, an administrative body with considerable discretionary power, the WTO dispute settlement system serves a limited *ex post* judicial review purpose. By the time that the dispute settlement system takes effect, considerable economic resources may have been wasted in retaliatory measures.

Furthermore, the EU system provides a private right of action for competitors to challenge the State aid awarded before their respective national courts based on directly applicable provisions. In contrast, the European Court has held that it is impossible for a private individual to invoke WTO rules before the Court, and that the rules of the WTO are not binding on individuals. [491] Where no national competitor challenges a possible State aid, the Commission may challenge the measure on its own initiative. The WTO subsidy system is much less aggressive, with a significantly lower rate of subsidies being challenged, and without an objective third party watchdog to challenge measures that the members themselves do not oppose, whether by leniency or complicity. Only members of the WTO can participate as parties or third parties in dispute settlement procedures. At best, private parties may submit their views directly to the panels or the Appellate Body (in the form of so-called *amicus curiae* briefs[492]); exceptionally, they may be called to appear as experts in oral hearings before the panel or Appellate Body.

Certain authors have recommended the use in WTO procedure of a mechanism based on EU rules, whereby "*actionabl*e" subsidies are prohibited or suspended, subject to notification, thereby forcing the subsidising country to justify, *ex ante*, its potentially injurious measures. Such a mechanism was employed in respect of non-actionable subsidies. However, the procedure proved so onerous that it was not used prior to its expiration five years after agreement

490 For further information on the procedural organisation of the WTO, see http://www.wto.org/english/thewto_e/whatis_e/tif_e/org2_e.htm.

491 However, private parties, such as companies injured by the State aid awarded to a competitor from a third country, cannot invoke dispositions of the GATT before the European courts. The agreement does not have direct effect, as the Court established in *International Fruit Company NV and others v Produktschap voor Groenten en Fruit* [1972] E.C.R. 1219. The exclusion of direct effect of provisions of the GATT has since been approved in a number of cases, see e.g., Case C-280/93, *Federal Republic of Germany v Council ("Bananas")* [1994] E.C.R. I-4973, paragraphs 110-112.

492 Neither the Appellate Body nor the Panel have any legal duty to take into consideration amicus curiae briefs submitted to them. See, Panel Report of 15 May 1998, WT/DS58/R, paragraph 7, *United States – Import Prohibition of Certain Shrimp and Shrimp Products (United States – Shrimp)*. See also, the decision of the Appellate Body in the same matter: Appellate Body Report of 12 October 1998, WT/DS58/AB/R, paragraph 98 *United States – Import Prohibition of Certain Shrimp and Shrimp Products (United States – Shrimp)*.

on the ASCM was reached; any extended *ex ante* notification system was excluded from the Uruguay Round after concerted American pressure.[493] This is, to an extent, compensated for by both a moral imperative which has pushed major trading members to notify certain aid, and a "dynamic of reciprocal cross-notification" leading contracting members to challenge trading partners for implanting subsidies that they feel are harming their domestic economy.[494] More importantly, as a direct result of the expiration of the Article 8 category of non-actionable subsidies, certain environmental, R&D and regional aid that are allowed under EU State aid rules, and were previously licit under WTO provisions, are now liable to challenge where the WTO member is able to demonstrate adverse effects. Nevertheless, there is a risk that WTO subsidy rules are, as a result, enforced asymmetrically. The stricter and more complex EU State aid rules have often been criticised for putting European companies in an unfavourable position compared to their third country counterparts.[495]

III. An Examination of the "Matching Clause"

In our opening remarks, we referred to the existence of asymmetries and loopholes in the rules of the WTO. Of particular note for the EC is the failure to extend the provisions of the ASCM, which governs goods, to services.[496] In the US, certain companies may have profited greatly from this oversight. One of the examples often cited by EU sources is the US aeronautics industry, which is the beneficiary of considerable sums of financial support from the US government via the intermediary of NASA (chosen because NASA technically purchases "*services*" from Boeing, rather than selling "*goods*" to the company). It may not be coincidental that the EC has introduced into its Framework on R&D&I, a "*matching clause*", providing for a similar grant of financial subsidy to firms that find themselves unable to compete with third country enterprises subsidised in excess of the EU ceiling.

The "*matching clause*" for State aid for R&D&I. The so-called "*matching clause*" appears in the 1996 Framework for State aid for Research and Development and applies where an EU applicant for State aid is able to demonstrate that a competitor has received, in respect of a project in a third country that is comparable to that in which the applicant is engaged, a higher

493 Horlick: (1999)"*Subsidies discipline under WTO and US rules*", European University Institute Competition Workshop on State aid Control in the European Union

494 *Id*. See, e.g., Commission Press Release IP/05/638, on the EU/US dispute concerning Boeing and Airbus.

495 Indeed, in the shipbuilding sector, the EU has since 1988 negotiated on a bilateral or trilateral basis with the Japanese and Korean governments in an attempt to better protect EU companies. These negotiations eventually led to an OECD settlement, but the sector remains vulnerable. For further details, see http://www.europarl.europa.eu/factsheets/4_7_3_en.htm.

496 [EC Anti-dumping rules re: services, CHO to provide citation.]

intensity of aid than that permissible under the applicant's EU State aid rules on R&D.[497] If we assume that the matching clause is only intended to be invoked where an EU member is concerned that third country subsidies are likely to cause material damage to its interests, then the matching clause does resemble to some degree a countervailing duty.[498] The ASCM permits a country alleging the existence of an unlawful subsidy to launch its own investigation into the offending third party measure, and if able to prove that the subsidised imports are hurting domestic producers, the member may impose a countervailing duty designed to compensate that injury.[499]

However, the matching clause goes further than the provisions in the ASCM covering the use of countervailing duties. The mechanism of the matching clause can operate without the need for prior authorisation by a specially convened Dispute Settlement Body ("DSB"), and without the need for any proof more conclusive than "circumstantial evidence".[500] The matching clause therefore risks having a similar effect, within the area of R&D, to that of the Protocol of Provisional Acceptance negotiated by the US on its entry into the GATT, which left the US government "*free to countervail without demonstrable economic justification*".[501] The clause allows the Commission, under certain conditions, to allow an EU State to match the intensity of aid given in the third country, thereby exceeding the normal permitted ceilings for EU State aid. The matching clause in the 1996 framework has never been used,[502] but it has been preserved in the Commission's staff paper preliminary draft of the Community framework for State aid for R&D&I (the existing Framework expires at the end of December 2006).[503] The matching clause will address "*actual or potential direct or indirect distortions of international trade*",

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497 Community Framework for State aid for Research and Development O.J. C 45 of February 17, 1996, at page 5 *seq*. Another example of a matching clause can be found in the OECD Export and Credit Arrangement, which allows an OECD member to match an illegal export subsidy implemented by a third country that falls below the minimum OECD export credit standards. The OECD matching clause has proven a source of some contention and was discussed in *e.g.*, Canada: DS70/R, Panel Report of April 14, 1999 *Measures Affecting the Export of Civilian Aircraft*.

498 Paragraph 3 of Article VI of GATT 1994 defines a countervailing duty as "a special duty levied for the purpose of offsetting any subsidy bestowed directly or indirectly upon the manufacture, production or export of any merchandise".

499 Article 10, ASCM and Article VI of GATT 1994.

500 By contrast, article 10 of the ASCM states explicitly: "countervailing duties may only be imposed pursuant to investigations initiated and conducted in accordance with the provisions of this Agreement…"

501 Winham (1986), *International Trade and the Tokyo Round Negotiations*, at page 116. The United States was able to obtain an exemption from the need to demonstrate injury before applying countervailing measures, in respect of those countries that had not signed the Tokyo Round Subsidies Code. The exemption continued to apply until WTO members signed the ASCM at the close of the Uruguay Round.

502 Use of the clause has, however, been considered as a potential course of action by the Community institutions. See, Commission Decision of December 20, 1995 amending Spanish aid schemes for the motor vehicle industry, O.J. L 119: "if it were demonstrated that the international competitors of Community motor manufacturers were benefiting from more generous treatment, the Commission would consider applying the "matching clause" written into the new Agreement [on Subsidies and Countervailing Measures]". C.f., at a Member State level, such retaliatory measures are prohibited. See, Commission Decision of 30 June 2004 on the State aid which the Netherlands is planning to implement in favor of four shipyards to support six shipbuilding contracts (2005/122/EC).

503 Community Framework for State aid for Research and Development and Innovation, Staff Paper Preliminary Draft of April 20, 2006, section 5.2.1.

a wording that follows the Treaty provisions on State aid. Higher intensities of aid may thus be permitted within the EU where a non-EU competitor has received in the last three years, or will receive, aid of an equivalent intensity.[504] Exceptionally, the matching clause may be applied in respect of a distortion of international trade having its effect outside the three-year period. It should be noted that the clause does not apply in simple situations where an applicant claims that he could receive higher aid intensity in a third country. Equally, application of the matching clause could in theory be challenged before the WTO by a third country whose interests are adversely affected by the EU's retaliatory R&D subsidies.

Attraction of marketplace innovators. Despite the matching clause appearing liable to being used in protectionist fashion, the clause nevertheless serves a useful purpose, just as countervailing duties can be usefully applied and need not be an instrument of regional prejudice. The results of the consultation on State aid for innovation, published by the European Commission in May 2006[505], revealed that many respondents from the Member States, including regional development bodies, Member States, and business federations, feel that the EU may be at a disadvantage in innovation compared with other world regions. The respondents felt that the EU was perceived by businesses as reluctant to attract investors heavily involved in R&D&I. A matching clause mechanism enables Member States to compensate for this comparative weakness, making the region a more attractive location for companies involved in R&D, thereby increasing competitiveness. Since the application of the matching clause is discretionary it can be used by the Commission and Member States to support only target industries, *i.e.*, those requiring a particularly significant level of investment, or specific target projects with proven European interest, such as Airbus. One might argue that the matching clause does not go far enough, since it only covers R&D&I; however economists often cite R&D as an area where "market failure" is particularly likely, (*i.e.*, it may not be in a company's individual interest to make socially useful investments, or a monopoly situation may arise in particular where R&D investment is sub-optimal). In general, only large established market players have the necessary funds to invest in R&D, and the amount of venture capital invested in R&D is insufficient.[506]

IV. Conclusion

As might be expected from an international organisation, the WTO rules on subsidies are less stringent and less precisely defined than those of the EU in relation to State aid. While

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504 *Id*. The intensity of the aid can be calculated either on the basis of individual R&D&I projects, or at the level of an undertaking. In both cases, the intensity is measured by calculating the ratio between the overall tax relief and the sum of all eligible R&D&I costs incurred over a period of three years or less.

505 Results of the Consultation on State aid for Innovation, May 5, 2006.

506 Between 1992 and 1996, only 2-5% of European venture capital funds were invested in the seed or startup phase of a business, which covers the research and development phase. For further details, see http://www.nsf.gov/statistics/issuebrf/sib99303.htm.

the latter have been strongly influenced by the former, it is equally clear that the Commission has interpreted the black letter law in a way that leads to a greater number of differential treatment schemes being considered as unlawful State aid. Interestingly, this is not an accident of restrictive initial law making but a conscious decision taken by the Commission. We have highlighted the considerable flexibility in the procedural mechanism of the Community, and also the similarity of the basic legal provisions of the WTO and the EU, notably in the context of material and regional selectivity. Therefore, the Commission has consciously used the discretionary powers afforded it by the Treaty to impose a constrictive approach on State aid. This may lead to a globally asymmetrical set of laws where EU industrial enterprises are placed at a disadvantage in comparison to companies located in non-EU, WTO signatory countries. In light of this, the mechanism of the matching clause is of considerable interest, since it allows the Commission to adapt the enforcement of its State aid rules to the current international context. The Commission has afforded itself some room to apply countervailing measures against third country R&D subsidies, while adopting a stance within the EU designed to eliminate Inter Member-State protectionism as far as possible. The aim of increasing competition, a key element of the Common Market, therefore remains but in the case of subsidies (and more specifically, R&D subsidies), the focus is also on external competition with other regional blocs and trading partners, rather than internal competition within the EU. The key question is likely to be whether in view of the rapid rise of globalisation, the EU will able to face the pressure resulting from the very rapid industrial changes and to respond to the necessity of creating incentives for innovation within its own territory.

Keynote speech: will the economic analysis always lead to a stricter approach?

Loretta Dormal-Marino*

Will the economic analysis always lead to a stricter approach? The Commission has frequently been asked this question ever since the publication of the State aid Action Plan[507] which announced a reform of the State aid discipline based, among other things, on an "improved economic approach". The advocates of a stringent State aid policy, on the contrary, formulate the question the other way around, namely "will economic analysis always lead to a more lenient approach?" This already suggests that the outcome of the discussion is not likely to be set in stone.

This paper tries to get a better grasp of the issues at stake by examining two decisions where the Commission applied the announced approach for the first time. The first case concerns the financing of digital TV in Berlin- Brandenburg, which the Commission did not consider to be compatible with the EC Treaty. The second concerns the rollout of broadband networks in Ireland, to which the Commission did not object. The examination will show that a more refined economic approach, while presenting no inherent bias, brings more rigour in the reasoning, more substance in the assessment, more clarity in the decisions. Although in itself it is not a revolution, it offers predictability in terms of methodology, and should help Member States to shape their interventions better towards a situation of less but more effective public interventions.

In both decisions, the Commission applied a structured approach based on three steps:

– Does the measure address a well-defined **market failure** or pursue a well defined **objective of common interest?**
– If so, is the proposed aid well designed to address the market failure or other objective? (Is it the **appropriate** instrument? Does the measure provide the right **incentive** and is the aid kept to the minimum necessary?)

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* European Commission. The views expressed are personal.

507 State aid Action Plan – Less and better targeted aid: a roadmap for State aid reform 2005 – 2009, COM(2005) 107, http://ec.europa.eu/comm/competition/state_aid/reform/saap_en.pdf.

– Are the distortion of competition and effect on trade limited so that the **overall balance** is positive?

This “balancing test” is at the heart of the economic approach. We now look at how it has been applied to the two illustrative cases.

I. Digital TV in Berlin-Brandenburg[508]

TV signals can be delivered via several transmission networks (cable, satellite, terrestrial) and in analogue or digital mode. The traditional analogue mode is in the process of being replaced by the digital mode, which will allow a higher capacity, namely the possibility to broadcast more channels while using the same amount of frequency spectrum. The process by which digital transmission technology replaces analogue transmission is called the digital switchover.

In the German State of Berlin-Brandenburg, the digital switchover in the terrestrial platform took place between November 2002 and August 2003. The whole switchover process was organised and managed by the regional media authority Mabb. On top of other measures, Mabb provided for subsidies to be paid to several commercial broadcasters (e.g., RTL) for five years after the switchover, to give them an incentive to provide digital terrestrial services.

Following a complaint by cable operators on the grounds that subsidies were only granted for the terrestrial platform, the Commission opened an investigation. In November 2005, it decided that the measures constituted incompatible aid which had to be paid back by the commercial broadcasters. The decision is based on detailed reasoning which focuses on market failures during the switchover and provides guidance for market players.

The subsidies were part of contracts between Mabb and the broadcasters. The same contracts also provided for the attribution of licences for free which were not awarded under a proper tender procedure. Thanks to the new licences, the main broadcasters were able to use more capacity and, consequently, developed more channels. T-Systems, the operator of the digital TV transmission infrastructure, also benefited indirectly from the aid, in the form of guaranteed income from the commercial broadcasters for several years.

To assess the compatibility of the measures, the balancing test described above was applied. The Commission first considered whether the subsidies pursued a **well-defined objective of common interest**. In the Action Plan eEurope 2005 and in three Communications, the Commission has underlined the advantages of the digital switchover in terms of more efficient spectrum use and increased transmission possibilities. The Commission’s Switchover Communication[509] recognises in particular that the digital switchover is in line with the common

508 Commission decision of 9 November 2005 in case C 25/2004 Digital terrestrial TV (DVB-T) in Berlin-Brandenburg, OJ L200/2006 of 22 July 2006.C

509 Commission Communication on the transition from analogue to digital broadcasting (from digital ‘switchover’ to analogue ‘switch-off’), COM (2003) 541 of 17 September 2003, followed by the Commission Communication on accelerating the transition from analogue to digital broadcasting, COM (2005) 204 of 24 May 2005.

interest because it aims to use the frequency spectrum used for TV signals more efficiently. It also recognises that State intervention may be necessary and beneficial. There was thus no doubt about the existence of a very well-defined objective of common interest: this was clearly a very strong element in this case. Nonetheless, as the State aid Action Plan highlights, and the more refined economic approach spells out in more detail, the existence of a common objective, however important, is not an automatic, universal justification for granting State aid.

As to the existence of potential **market failures** in the switchover process, the Commission recognised that in this case there were genuine coordination problems (all market players had to agree on a switchover date) and positive externalities (the interest for society in better use of the freed-up spectrum), but considered that the subsidy was not an appropriate instrument.

The Commission rejected the existence of other market failures. In particular it did not accept the German government's submission that the measure was necessary to strengthen competition between platforms by inducing the operators of other platforms, in particular cable, to upgrade their services. A careful examination of the market showed that the measure had no positive effects on competition between platforms. The existence of an excessive risk for the network operator or a high degree of uncertainty preventing innovation was not established. Neither did the Commission endorse the existence of risks for network operators to launch a new platform. As suggested by the existence of other transmission platforms (ADSL, satellite), there was no reason to believe that the market could not cope with this risk.

As to the **design** of the measure, bearing in mind that the final goal of the State aid Action Plan and the more refined economic approach is to achieve "less and better targeted State aid", the Commission considered that State aid to private broadcasters, in this particular case, was neither necessary, nor the most appropriate policy instrument. The coordination problem could have been solved without aid, notably by regulation. There was also no need to compensate the broadcasters for giving up the analogue licences as they were already given valuable digital frequencies for free, allowing greater transmission capacity at lower costs per channel (thus internalising positive externalities). Moreover, the aid was granted without objective justification, was not based on specific switchover costs and was decided after the switchover had been agreed. In other words, the aid had no incentive effect.

On the **distortion of competition**, the Commission noted that the measure was causing a strong distortion vis-à-vis other platforms (cable, satellite, and broadband). The measure was also in contradiction with the provision of the "Switchover communication" which insists on technological neutrality to avoid favouring a specific platform: in other words, there should be no advantage for one of the several means of bringing digital signals to consumers' screens, be it digital terrestrial TV, satellite, cable, …

The Commission assessed the contribution of the measure to the common objective of facilitating the switchover against the distortion of competition vis-à-vis other platforms and arrived at a negative decision.

Apart from taking a position on the specific case, the Commission also included indications in the decision on the type of measures that it would consider appropriate to support the common objective of the digital switchover. The decision mentions as examples subsidies to consumers, provided that they do not entail an unnecessary distortion between technologies, public funding of roll-out of a transmission network in areas where there would be insufficient coverage, or financial support to compensate broadcasters which are required to give up the use of analogue spectrum before the expiration of licences.

In February 2006, the Berlin-Brandenburg decision was appealed in the Court of First Instance by a local broadcaster, the German Federal Government and the Berlin-Brandenburg media authority[510]. One line of argument by the parties is that the State aid rules entitle the Commission neither to interfere with a political decision by a Member State to maintain the terrestrial platform and to carry out its digitalisation, nor to consider whether other measures would have been more appropriate than granting State aid. It will be interesting to see how the Court assesses these aspects.

II. Metropolitan Area Networks in Ireland[511]

The second case concerns a notification by the Irish authorities in June 2005 of a project to construct open, carrier-neutral fibre rings in 120 towns: the so-called Metropolitan Area Networks (MANs). The justification provided for this State intervention was the need to close the «broadband gap», as Ireland was lagging behind in terms of broadband uptake with only 5.3% of citizens using it. The Irish government was therefore planning to invest € 170 million in passive infrastructure (i.e., ducts and fibre) to enhance the offer of services in towns outside Dublin.

In parallel, the Commission received an informal complaint pointing out that the Irish authorities were (also) targeting urban areas where broadband services were already provided or planned. Hence, the complainant alleged that the measure had the potential to crowd out present or future private investments, thus distorting competition in various markets for electronic communications.

The Irish MAN project presented the following characteristics:

– A passive infrastructure which would remain the property of the public sector had been contracted out;
– A wholesale operator (PPP) would activate the network and offer wholesale services to retail operators;
– The concession for the wholesale operator would be tendered out;
– The network would provide the "middle mile" between local loop and regional networks.

After investigating the case, the Commission issued a no objections decision in March 2006.

First of all, as to the presence of a **well-defined objective of common interest**, the Commission has recognised on several occasions (i2010, digital divide report, broadband strategy)

510 Cases T-8/2006, T-21/2006 and T-24/2006 respectively.

511 Commission decision in case N284/2005 of 8 March 2006, http://ec.europa.eu/community_law/state_aid/comp-2005/n284-05.pdf.

that the roll-out of broadband in underserved areas is in line with the common interest. Experience also shows that the roll-out of broadband is not profitable in certain areas, so that aid may be necessary to bridge the digital divide. The Irish government put forward precisely the cohesion argument, insisting that roll-out of broadband in rural areas would contribute to the economic development of the country. At first sight the Commission considered that argument unfounded since the project concerned mainly towns.

Secondly, regarding **market failures,** the analysis of the market situation revealed that structural problems actually existed. As for other network industries, the telecoms sector shows some characteristics which may lead to an inefficient level of supply, under certain circumstances. The high cost associated with the deployment of fixed network infrastructures makes the deployment of this infrastructure economically unviable in less populated areas. Ireland has a very distinct population distribution with a large proportion located in the greater Dublin area. As a result, infrastructure investment is mainly limited to the capital and to regional connectivity linking the major cities. There is also a lack of competing infrastructure (few cable TV networks, ducts, fibres) and, subsequently, a low degree of competition in both urban and rural areas.

After having established the presence of market failures, the Commission examined whether in such circumstances the measure was **appropriate** or whether other, less distortive measures could have been effective to support the roll out of broadband in the entire territory.

The Commission noticed that, as in other European markets, the historic operator in traditional services (voice telephony) had a first mover advantage offering broadband to their existing customers. These characteristics of the sector had helped to give the incumbent operator market power in a number of markets. Moreover, the Irish market presented special features, such as the fact that the incumbent is not obliged to make its basic fibre infrastructure available to other operators. Under those circumstances, alternative operators who wanted to serve the retail market would have to either build a network themselves or lease capacity from the incumbent (leased lines). The prices of these products are subject to regulation; however, it was apparent that prices remained high, despite regulation. Moreover, even if operators could use wholesale products from Eircom, the incumbent operator, they would be required to add their own investments in last-mile access to customer premises.

To summarise the detailed analysis, the Commission found that regulation had not been capable of ensuring effective competition in various markets for electronic communications nor led to sufficient investment.

As for possible alternative demand-side measures, the Commission arrived at the conclusion that they would not be able to solve the market failure on the supply side and might favour the incumbent.

To evaluate the distortion of competition implied by the measure, the Commission took into consideration the fact that the project was attributed through an open tender, that it was purely a wholesale project which would not interfere directly with the retail market, but would provide service providers with open, wholesale access to a wide range of products on a transparent and non-discriminatory basis. The Commission also noted that the infrastructure remains in public ownership.

Regarding potential crowding out effects, the analysis showed that there would be only very limited duplication of infrastructure. By providing the so called "middle mile" between local loop and regional network, the MANs, on the contrary, provided a neutral, open, wholesale infrastructure and attracted investments by operators providing connectivity to businesses and retail broadband to residential customers. Moreover, the notified project provided that the authorities would not approve proposals to build MANs in locations where a local fibre in ring configuration existed similar to that deployed on the MANs, or else high-speed wholesale transmission capacity was already offered under conditions of open access and non discrimination and on commercial terms comparable to those available in the Dublin area. It was noted, on the contrary, that the incumbent had accelerated broadband roll-out at the same time as the first phase of the MANs had been launched. Positive effects on competition were anticipated because of the reduction of fixed costs and hence lower barriers to entry for operators. Moreover, the effect on trade was clearly limited. Balancing the positive and (limited) negative effects, the Commission eventually arrived at a positive overall assessment.

It is fair to say that the result was decisively influenced by the fact that the analysis was not limited to pure static coverage considerations, but duly took into account the specificities of the overall market situation in Ireland. The application of the methodology certainly facilitated the analysis and strengthened the conclusions. Going through all the detailed relevant questions of the refined economic test – step by step – was helpful to clarify the competitive situation in the Irish market, including the effectiveness of regulatory provisions.

III. Conclusions

What lessons can we draw from these two case studies?

A first consideration is that the economic approach as such is not a revolution. In practice, the Commission has always made an economic as well as a legal examination. Nevertheless, by proposing a clear methodology based on well known economic concepts and well defined steps of analysis, the economic approach helps to make the assessment of cases more systematic and hence more explicit, favours the quality of the results and, by presenting a systematic assessment method also allows for a better predictability of the results. This is of course all the more important for cases like the two described above for which there are no established guidelines to follow (contrary to other types of aid like, for instance, regional investment aid or aid for environmental purposes…).

Establishing a consolidated methodology also makes Commission decisions more understandable and can provide useful guidance to public authorities in charge of designing more effective and efficient interventions. Granting of State aid should always proceed from identifying the problem to be addressed and choosing the least distortive means to solve it. The overall process should allow the objective of «lesser and better targeted State aid» decided by the Member States and developed in the State aid Action Plan to be pursued successfully.

The second consideration is that the test is obviously not perfect and deserves further methodological developments on which the Commission is working, but, on the basis of the experience gathered up to now, it certainly represents an improvement.

As to the «stricter or softer?» question, the opposite conclusions of these two cases indicate that the more sophisticated economic analysis leads neither to stricter nor to softer results. The question as it is put only reflects unsubstantiated fears for a new course.

Annex 1: list of the speakers at the GCLC Conference (21-22 September 2006)

Marco Bronckers	Partner, WilmerHale LLP
Vittorio Di Bucci	Legal Service, European Commission
Jacques Derenne	Partner, Lovells LLP, Chargé de cours adjoint, University of Liège
Mathias Dewatripont	Professor, Free University of Brussels (ULB)
Loretta Dormal-Marino	Director, European Commission, DG COMP-H (now Deputy Director General of DG AGRI)
Lowri Evans	Deputy Director General, European Commission, DG COMP
Hans Friederiszick	Managing Director of ESMT Competition Analysis (previously member of the chief economist team of DG COMP)
Leigh Hancher	Professor at the University of Tilburg and Of Counsel, Allen & Overy LLP
Thomas Jestaedt	Partner, Jones Day
Frédéric Louis	Partner, WilmerHale LLP
Pierre Kirch	Partner, Paul, Hastings, Janofsky & Walker (Europe) LLP
Thibaut Kleiner	European Commission, DG COMP (currently member of cabinet of Commissioner Kroes)
Neelie Kroes	Member of the European Commission, Commissioner in charge of Competition Policy
Massimo Merola	Partner, Bonelli Erede Pappalardo. Professor at the College of Europe
Eric Morgan de Rivery	Partner, Jones Day
Phedon Nicolaides	Professor at the European Institute of Public Administration (EIPA)
Till Müller-Ibold	Partner, Cleary Gottlieb Steen & Hamilton
Damien Neven	Chief Economist, European Commission, DG COMP
Rainer Nitsche	Managing Director ESMT Competition Analysis GmbH, Berlin (previously Principal, CRA International)
Jorge Padilla	Managing Director, LECG
Penelope Papandropoulos	Member of the Commission Chief Economist's Office (previously Principal, CRA International)
Marc Pittie	Partner, Bredin Prat

Ben Smulders,	European Commission, Head of Cabinet of Commissioner Neelie Kroes
David Spector	Associate Professor, Paris School of Economics, Partner, Mapp (Micro-economic Applications)
Jan Peter van der Veer	Senior Associate, RBB Economics
Bernard van de Walle de Ghelcke	Partner, Linklaters LLP
Antoine Winckler	Partner, Cleary Gottlieb Steen & Hamilton

Annex 2: list of the working groups for the preparation of the GCLC Third Annual conference

Group n° 1 :	General economic analysis of State aid issues – Lisbon strategy – evaluation of volume, intensity of aid – definition of economic standard(s) – David Spector, Damien Géradin
Group n°2 :	For a better targeted State aid policy – what is the most appropriate tool? SAAP? Others? – Effects-based approach – Massimo Merola, Penelope Papandropoulos, Rainer Nitsche, Leigh Hancher
Group n° 3:	Market Private Investor Test – Thomas Jestaedt, Eric Morgan de Rivery
Group n° 4 :	Altmark, SGEI (4th criterion) – Jorge Padilla, Phedon Nicolaides, Edith Templeton, Graham Branton, Marc Pittie
Group n° 5 :	Transfer of State resources – Pierre Kirch, Olivier d'Ormesson, José-Wenceslao Rodríguez Curiel
Group n° 6:	Selectivity, Distorsion of competition, Effect on trade – Bernard van de Walle de Ghelcke, Frédéric Louis, Denis Waelbroeck, Penelope Papandropoulos, Rainer Nitsche, Jacques Derenne, Massimo Merola, Julien De Beys, Pablo Ibáñez Colomo, Julie Bousin
Group n° 7:	Compatibility assessment : balancing test, block exemption regulation, rescue & restructuring, – evaluation intensity – Frédéric Louis, Mathias Dewatripont, Conor Quigley, Mikolaj Stasiak
Group n° 8:	Regional aid – Mikolaj Stasiak, Phedon Nicolaides
Group n° 9 :	Horizontal objectives – environment, R & D, innovation, employment, training – Conor Quigley, Antoine Winckler, Till Müller-Ibold, Jan Peter van der Veer, Massimo Merola, Edith Templeton, Graham Branton
Group n° 10:	International Trade – Marco Bronckers, Antoine Winckler, David Spector
Group n° 11:	Procedure – Eric Morgan de Rivery, Sabine Thibault-Liger, Jacques Derenne

"This book makes an important contribution to the growing corpus of State aid economics. In assessing a wide span of State aid issues, including frameworks and justifications for economic analysis in State aid, and the work and policies of the European Commission, it provides a firm foundation for the growth of the discipline of State aid economics, and offers valuable food for thought on State aid, for students, practitioners and policy makers alike."

Neelie Kroes, European Commissioner for Competition

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