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REFINED ECONOMIC APPROACH IN EUROPEAN STATE AID CONTROL – WILL IT GAIN MOMENTUM?

The European Commission (Commission) is currently reforming its State aid rules and procedures. This reform is part of the overall process to modernise the competition rules. Since the adoption of the State Aid Action Plan, a number of new regulatory texts have been adopted (such as the new regional aid guidelines) and others are currently under revision. The review process should largely be completed by 2009.¹ With respect to this reform the European Commissioner for Competition Policy, Mrs. Neelie Kroes, announced: "It's my flagship project as Competition Commissioner. And it's the first ever comprehensive reform of State Aid policy in fifty years of Community law."²

ECONOMICS IN THE EUROPEAN STATE AID RULES

There are currently three areas in State aid law where the refined economic approach is already implemented.³ In the following these areas are addressed.

Balancing Test

The first area is the application of the so-called balancing test in Article 87(3) ECT. The balancing test weighs the positive effects of e.g. risk capital measures or aid to research and innovation against potential crowding-out or other negative effects on competition and trade. The economic argument is that State aid may correct market failures and thereby restore competition again. In this analysis, several types of market failures are relevant which are discussed in a more detailed way below.

The balancing test operates in three steps to decide upon the approval of a State aid measure. The first two steps are addressing the positive effects of State aid whereas the third is addressing the negative effects thereby resulting in a balancing of the positive and negative effects. The following issues need to be addressed from an economic perspective:

¹ Vademecum Community Rules on State Aid, April 2007

² N. Kroes, "Two years into the SAAP - State of Play and prospects" Speech /07/316, [2007], European State Aid Law Institute Conference.

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<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/518&format=HTML&aged=0&language=EN&guiLanguage=en>

- (1) The aid needs to address a well defined market failure or a well-defined objective of common interest (e.g. growth, employment, cohesion, and environment).
- (2) The aid must be well targeted. The question is whether the aid is well designed to deliver the objective of common interest i.e. does the proposed aid address the market failure or other objective. In this context it is assessed whether State aid is the appropriate policy instrument, whether there is an incentive effect, i.e. does the aid change the behaviour of firms and whether the aid measure is proportional, i.e. could the same change in behaviour be obtained with less aid.
- (3) Another aspect is that the distortions to competition and trade resulting from the State aid measure must be limited enough so that, on balance, it can be declared compatible.

However, it is not sufficient for a State aid to target a market failure. Before resorting to State aid, which is in general only the "second best" option to achieve an optimal allocation of resources, it should be verified whether other less distortive measures could remedy the market failure. It will be assessed whether there are other, better placed instruments, which are either more effective or less costly in reaching the objective chosen.

A State measure needs to involve a change in behaviour of the firms in order to be justified. This change in behaviour is assessed by means of the incentive effect. In order to identify the incentive effect of the State measure, reference values are used.

The Commission applies the following assessment e.g. with respect to risk capital. The first question to be asked is which changes should exactly be produced by the State funding. By means of a counterfactual analysis important findings are gained: The incentive impact is expressed as the difference between two scenarios comparing a situation with and without the State measure. Furthermore a continuous evaluation guarantees the observation of the incentive effect. The implementation of pilot projects and the definition of benchmarks ensure documentation. These references serve as indicators of the incentive effect. From the economic perspective it is important that the incentive effect generates benefits for the consumers as a result of the State measure. Without an incentive effect, firms behaviour is not affected and consumers are not affected either, since the aid is simply transferred from the tax payer to the firms.

The balancing of the positive and negative effects of the State aid is the next step. It is analysed whether generated positive effects outweigh the negative effects caused by the distortion of competition. To conclude, the balancing test is the measurement of positive effects in relationship to possible negative effects. If the positive effects dominate the negative effects, an exemption under Article 87(3) ECT is likely.

Market failures

The assessment of market failures is another area where economic analysis is important. There are a number of market failures that prevent the market from functioning.

Externalities are the most frequently discussed type of market imperfection in the context of State aid policy. An externality exists whenever one individual's actions affect the well-being of another individual, whether for the better or for the worse, in ways that need not be paid for according to the existing definition of property rights in the society. Externalities of either the "positive" or the "negative" sort create a problem for the effective functioning of the market to maximize the total utility of the society. The "external" portions of the costs and benefits of producing a good will not be factored into its supply and demand functions because rational profit-maximizing buyers and sellers do not take into account costs and benefits they do not have to bear. Hence a portion of the costs or benefits will not be reflected in determining the market equilibrium prices and quantities of the good involved. Accordingly, aggregate supply and demand for goods that entail positive externalities is too small. On the contrary, goods that entail negative externalities may encounter demand above the socially optimal level.

The term public good is used to describe goods that are characterised by non-rivalness and non-excludability. Public goods cannot practically be withheld from one individual consumer without withholding them from all ("nonexcludability") and for which the marginal cost of an additional person consuming them, once they have been produced, is zero ("nonrivalrous consumption"). Consequently private production of the good is unprofitable, and the good may not be provided at all by the free market. National defence is an example for a public good.

A market failure can also arise through differently distributed information. Information asymmetry models assume that at least one party to a transaction has relevant information whereas the other(s) do not. Information asymmetry occurs when one party to a transaction has more or better information than the other party. If the buyers are less informed than the suppliers of a good, this might be exploited by suppliers providing products with reduced quality and thus at lower costs which is not realized by buyers due to their information deficit. The consequence is a so called adverse selection: worse products drive out qualitatively better products.

Markets may also not function efficiently when there is a coordination problem between market actors. This aspect plays a key role in standards setting. Another aspect is market power. Notably, market power leads to prices that are too high from society's point of view, thereby not achieving efficiency.

The aims of State intervention and implementation of State aid are to correct market failures because it would be more efficient and welfare-enhancing than market solutions. In the case of an identified market failure the government can calculate the net benefit caused by the intervention. Its objective is to grant aid where that net benefit is positive: the benefits outweigh the costs. Because of these economic considerations a thorough economic analysis is necessary to disclose the real intention and the justification for a State measure.

The third area for the use of the refined economic approach is the justification for the conditions for compatibility. In so doing, a distinction is made between a lighter and a more detailed assessment, depending on the risks of distortion of competition and trade. There are a limited number of cases a detailed assessment is required.

REFINED ECONOMIC APPROACH IN ARTICLE 87 (1) EC TREATY

As illustrated above, the application of the more economics based approach in State aid is currently focused on Article 87 (3) ECT. However, a comparison with the other competition law provisions reveals similarities between the early approach under Article 81 ECT and the current policy under the State aid provision.

Modernisation of Article 81 (1) EC Treaty

The reform of Article 81 (1) ECT by means of Regulation No 1/2003⁴ initiated an exception system in Europe. The new regime changed the interpretation of the two elements (1) "may affect trade between Member States" and (2) "which have as their object or effect the prevention, restriction or distortion of competition" in Article 81 (1) ECT as well. By applying the so-called "more economics based approach", the economic assessment in Article 81 ECT became much more detailed. For the purpose of assessing whether an agreement or its individual parts may restrict competition it needs to be considered how and to what extent the agreement affects or is likely to affect competition on the market. The following two questions provide a useful framework for making this assessment. (1) Does the agreement restrict actual or potential competition that would have existed without the agreement? (2) Does the agreement restrict actual or potential competition that would have existed in the absence of the contractual restraint(s)?⁵

Today, the analysis under Article 81 (1) ECT is a full economic assessment on a case-by-case basis. In order to facilitate application, the Commission introduced market share caps - agreements below a certain market share threshold are not assumed to restrict competition - as well as a hardcore list. To conclude, Regulation No. 1/2003 with the shift to the authorisation system as well as the introduction of the more economics based approach changed the application of Article 81(1) ECT. The question is whether the Commission will apply this policy change to the State aid rules, in particular to Article 87 (1) ECT, as well?

The two Articles, Article 81 (1) and Article 87 (1) ECT, share the same substantive structure: both provide a general prohibition. Both prohibitions are subject to a number of exemptions which are based on efficiency or public policy considerations. Articles 81 and 87 ECT use similar jurisdictional conditions (an effect on trade between Member States) and substantive tests (i.e. a distortion

⁴ 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.

⁵ Communication from the Commission, Notice Guidelines on the application of Article 81(3) of the Treaty, (2004/C 101/08)

or restriction of competition). Although the wording is different, the overall similarities are quite high. In the following a likely modernisation of Article 87 (1) ECT is discussed.

Modernisation of Article 87 (1) EC Treaty

In principle, Article 87 (1) ECT acts as a screening device by identifying whether a measure is considered as State aid or not and whether or not it qualifies for exemption under Article 87 (2) or (3) ECT. Member States can not grant any State aid unless it has been notified and authorised by the Commission. Thus, the Commission has the monopoly to authorise State aid measures under the provision of Article 87 (3) ECT. As with Article 81 (1) ECT, the Commission and the EC Courts have interpreted the concept of State aid in a wide way in the past. Under this approach, the assessment of the criteria "distortion of competition" and "effect on trade" under Article 87 (1) ECT was rather rudimentary. The Commission confirmed this approach in April 2007 in its Vademecum on Community Rules on State Aid. The Commission still advocates for a wide approach. According to the Commission, in the assessment of State aid it is sufficient that 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. This brief description of the criteria defining State aid confirms that the scope of Community State aid rules is still wide (but not open-ended).⁶ However, recent case law⁷ of the CFI suggests that a change is about to happen.

APPLICATION OF THE REFINED ECONOMIC ANALYSIS TO ARTICLE 87 (1) EC TREATY

In accordance with the effects based approach in Article 81 (1) ECT, the effects on competition and trade need to be examined in Article 87 (1) ECT as well.

Assessment of distortions of competition

Any analysis should start with a basic evaluation of the market facts. First, the relevant product and geographic markets should be defined and the market position of the undertakings should be assigned. The idea is that an aid for an undertaking with a high market share may lead to a substantial effect on competition. On the other hand, aid provided to undertakings with low market shares is not capable at all to distort competition. This principle would allow in accordance with Article 81 (1) ECT the creation of "safe harbours". If the market share of the aid recipient is e.g. below 30%, it is not necessary to notify the State aid to the Commission. By means of self assessment, the State can measure itself whether the State aid granted is in coherence with the Treaty provisions. Another key element in the analysis is the assessment of the market

⁶ Vademecum Community Rules on State Aid, April 2007.
http://ec.europa.eu/comm/competition/state_aid/studies_reports/vademecum_on_rules_2007_en.pdf.

⁷ Court of First Instance, Case T-34/02, *Le Levant vs. Commission*, [2006], paras. 123 f. and Court of First Instance, Joined cases T-304/04 and T-316/04, *Republic Italy vs. Commission*, [2006], para. 69.

failure. There are always reasons when markets do not work properly. The issue is to find out whether the State aid addresses the market failure identified accordingly and whether the State measure is appropriate to heal the market failure without distorting competition. The issue to address is the counterfactual. The following two questions may provide a useful framework for making this assessment. (1) Does the State aid restrict actual or potential competition that would have existed without the State aid? (2) Does the State aid restrict actual or potential competition that would have existed in the absence of the market failure? The result of such an analysis is a statement based on economic evidence whether a State measure causes distortions of competition in terms of Article 87 (1) ECT. Any assessment of a distortion of competition would apply the criteria outlined below:

- Definition of the relevant product and geographic market;
- Identification of the market position and market circumstances;
- Identification of the market failure and the corresponding state aid;
- Measurement of the impact of the state aid on the market failure;
- Identification of distortions of competition.

Assessment of effects on trade

Pursuant to Article 87 (1) ECT, State aid is not compatible with the common market as long as it affects trade between Member States. The criterion “effect on trade” provides a basis to define the relationship between European State Aid Control and the national law of the Member States. According to case law, the Commission has to set out the circumstances, in which the aid is threatening to affect trade. However, in accordance with an effect based approach it would be necessary to prove substantially that trade is actually or potentially affected by a State measure.