How the EU manages subsidy competition

Adinda Sinnaeve

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I. Introduction

If one asks economists whether subsidies are good or bad, one will probably get so many different answers that the conclusion can only be: it depends. It depends on the objective, the type of subsidy, the beneficiary, the economic context, etc. Precisely because it depends on many factors, the EU has set up a control mechanism for subsidies, or State aid, as we call it, with a view to distinguish the good from the bad subsidies and make sure that only “good” subsies are granted. This raises two questions: how to determine what a “good” subsidy is; and how to organise a functioning control mechanism.

In the following half an hour I propose to explain in a nutshell how the EU system works, what its main features are and what alternative approaches could be imagined.

II. EU State Aid Control in a Nutshell

State Aid Control in the EU exists since the start of the EEC in 1958, i.e. for more than 45 years now. Its inclusion in the EC Treaty was quite remarkable and novel as there were no other examples of comparable State aid disciplines at the time.

* Dr. Adinda Sinnaeve, European Commission. The views expressed in this speech are the author’s own and should not be attributed to the European Commission.
Among the reasons for introducing State aid control one could first of all refer to general economic arguments against subsidies: the risk of a subsidy race, where EC Member States might outbid each other and transfer problems from one country to another; the waste of public money; the risk of weakening the competitive position of European industry if companies rely too much on State intervention, instead of taking care themselves of the necessary innovation, restructuring, R&D, etc.

The inclusion of State aid rules in the EC Treaty is also closely linked to the establishment of a common market, where goods and services can circulate freely and where tariff and non-tariff barriers to trade are abolished. Barriers to trade that have been dismantled in the integration process, should not be replaced by other barriers in the form of State aid. Therefore, strict control is necessary also from a common market perspective.

Finally it is important to underline that the State aid provisions were inserted in the competition chapter of the EC Treaty. The logic of the Treaty is to ensure undistorted competition regardless of whether distortions are caused by the behaviour of businesses, for which the anti-trust rules were adopted, or by the action of the State. State aid control should thus be seen in the light of its role to avoid unjustified distortions of competition.

The Treaty uses a rather wide definition of State aid. It includes all advantages granted by the State or through State resources, in a selective way, which distort competition or threaten to distort it and affect trade between Member States, e.g. grants, loans at non-market conditions, State guarantees, all types of tax advantages, the sale of land at non-market conditions etc. This notion is broadly comparable, although not identical, with that of a subsidy under the WTO rules.

The selectivity criterion (i.e. whether an aid measure is specific or selective) is determined at the level of each Member State. This implies that if Member States
apply different levels of taxes, this is not State aid. If, however, they lower the tax rate or grant other types of tax advantages only to certain sectors or to certain types of enterprises (such as SME or coordination centers for multinational companies) or to enterprises located in a certain area within the Member State, this would constitute State aid and have to respect the relevant conditions.

What does the EU control mechanism now look like? The Treaty starts from the principle that State aid is incompatible with the common market, unless it falls under one of the exceptions of the Treaty (Article 87). The Commission has the power to decide whether or not this is the case. The exceptions are formulated in a very general way (they refer e.g. to broad concepts such as “the development of regions with an abnormally low living standard or serious underemployment”, and “the development of certain economic activities”). As a result, the Treaty gives the Commission a wide discretion to develop criteria for the approval of certain types of aid and design a State aid policy. This policy will necessarily evolve in the same way as the common market and the EU objectives.

The basic principles, however, remain the same: the aid should contribute to the achievement of Community objectives in such a way that the distortion of competition is justifiable. Aid by definition distorts competition. The reason why it can, nevertheless, be authorised lies in the fact that it promotes other EU objectives, such as regional development, R&D, employment etc., which outweigh the distortion in a proportional way. In other words: where the benefits to the EU as a whole exceed those which would result from undistorted competition, authorisation is justified.

It is clear that these general principles need to be embodied in more operational criteria. The Commission has therefore translated the principles into concrete assessment criteria, which are laid down in frameworks and guidelines. These quasi-legislative texts define the conditions under which aid projects can be authorised for
different types of aid, in particular aid for regional development, promotion of SME, employment, R&D, environmental protection, training of workers, restructuration of enterprises in difficulties, provision of risk capital - to mention the most important objectives. They aim at ensuring greater legal certainty for Member States and companies, predictability and equal treatment.

For each of these horizontal objectives, a number of precise conditions define under which circumstances aid can be granted. Normally a maximum aid intensity will be determined. This is the maximum amount of aid, expressed as a percentage of the eligible costs. These percentages are further modulated according to the size of the aid beneficiaries (small enterprises can get higher amounts of aid) and the region where they are located (higher aid is allowed in poorer regions). E.g. a company setting up a new plant in a poor Portuguese region can get a higher aid than if it had established its new plant in the Netherlands. If the company is a small enterprise, it can in addition get an SME bonus. If, however, a Member State wants to grant the company a straight tax break without any condition, this will normally not be authorised by the Commission because there is no counterpart for the aid (such as new investment, job creation).

In procedural terms Article 88 of the EC Treaty establishes a mechanism of prior control, based on the notification obligation and the standstill clause. Member States have to notify in advance all their aid projects to the Commission and may only implement them after the Commission has given its green light.

Simple cases are decided after a preliminary examination within two months starting from the receipt of a complete notification. For more complex cases, which raise doubts about their compatibility with the common market, the Commission will after the preliminary examination open a formal investigation. In this second phase, all interested parties, in particular the aid beneficiary and its competitors have the opportunity to present their comments on the aid project.
If Member States do not respect these procedural obligations, the aid is granted unlawfully and the Commission can at any time start an investigation, e.g. following a complaint by a competitor or ex officio. If the Commission finds that the unlawful aid is incompatible with the common market, it will order its reimbursement – so aid grantors (and aid beneficiaries) run a serious risk if they don’t follow the rules.

III. Some Reflections based on the EU Experience

One of the main strengths of the EU regime is obviously the fact that it has the legal and institutional framework for conducting State aid control; it has the necessary means at its disposal to make this work, in particular:

- an independent authority (the Commission) to set and enforce the rules, under the control of the Court of Justice;
- the legal and administrative mechanisms to organise the system of prior notification and authorisation;
- flexibility, i.e. the possibility to adapt the rules if changes in the economic environment or in the priorities of the EU require so. E.g. where it is found that Europe underinvests in R&D, this will be taken into account when the rules on aid for R&D are revised; if on the other hand certain sectors suffer from over-capacity, a more restrictive aid policy will be followed (see also the recently created rules on venture-capital).
- another important feature of the EU system is that it has the necessary acceptance by all the actors involved (governments, industry, public at large). Of course State aid control is also subject to criticism, but not more than any other policy. What contributes to this acceptance is the fact that the State aid regime still leaves sufficient room to Member States for developing their economic policies including subsidies. There is no general interdiction; Member States can still grant all types of aid (except export aid and local content aid, forbidden under WTO rules), they only have to respect certain conditions. The more distortive the aid is, the stricter
the conditions will be, but the approach is balanced and makes sense from a common market perspective.

Not all of these features of the EU regime are necessarily indispensable, but they certainly facilitate the functioning of the system.

Can we then call the EU system a success? Yes, we probably can, since it has fulfilled the objectives rather well. The most distortive types of aid are under control: very strict conditions are applied to

- operating aid, i.e. aid granted without any condition or counterpart, which relieves an enterprise of the expenses it would itself normally have to bear in its day-to-day management or its usual activities.
- aid to large enterprises in rich areas of the EU
- sectoral aid: the Commission’s policy favours aid with horizontal objectives (SME development, R&D, training of workers) and takes a strict approach on sectoral aid
- aid to enterprises in difficulty: while in the past, it was considered rather “normal” that the State intervened to save jobs if enterprises risked to go bankrupt, it is now acquired that such intervention is only allowed under very strict conditions. The company must in particular provide a viable restructuring plan, it has to make a significant contribution and reduce its capacity on the market in order to compensate the distortion, the one-time last-time principle applies, etc. The fact that the Commission’s decision can be challenged before the Court offers an additional guarantee in this respect.

So, the most distortive aid is under control and in addition, the rules normally also ensure that aid is not the main reason for a company to take certain decisions. E.g. the aid allowed can rarely be so substantial that a company would delocate merely because of that aid. Other factors like infrastructure, presence of trained workforce, general tax levels, administrative procedures etc. are more decisive. But if the company considers several alternative locations for a new plant, all meeting its requirements, it may choose the site in a disadvantaged area, because it can get a
comparatively higher aid amount there. This is in line with the EU’s “cohesion policy”.

Like any system, EU State aid control also has its weaknesses. Let me mention some of them and explain how they have been tackled already, or how this could be done.

A first problem is the **high administrative burden** which results from the notification obligation. If the Commission had to assess every single measure, however small and unimportant, this would not be feasible and would not be a very efficient use of resources. Therefore, the obligation of prior notification has been softened. Member States can notify so-called aid schemes which define the general conditions under which a certain type of aid will be granted. If the scheme complies with the rules, it will be approved for a certain number of years and the individual applications of the scheme do not need to be notified anymore. Furthermore, in recent years a number of block exemption regulations have been adopted for certain less distortive types of aid. They exempt e.g. aid for SME under well-defined conditions from the notification obligation. Block exemptions liberate the Commission from a number of routine cases, so that the Commission can concentrate on the more problematic cases. However, they also shift part of the responsibility to the aid grantors, which now have to control themselves whether their aid projects fulfil the conditions of the block exemption. Therefore, in order to avoid a weakening of the control system, increased ex-post monitoring, as well as the vigilance of competitors, who can complain to the Commission or go to national courts if the conditions of a block exemption are infringed, is of utmost importance.

Block exemptions are also a good illustration of a second difficulty, that is finding the right **balance between** on the one hand, the need to have **legal certainty**, with simple and predictable rules, and on the other hand the risk that such pre-defined rules do not leave room to take account of the merits of each individual case. In theory the Commission has a wide **discretion** to decide in every case whether a subsidy is good
or bad. However, Member States and enterprises call for clear and transparent assessment criteria, which also ensure equal treatment. The Commission has over the years replied to this justified request by establishing rather precise rules for most types of aid. Once established, these rules bind the Commission and thus considerably reduces its discretionary power. This leads to a situation where Member States feel obliged to consider only aid measures fitting within the established criteria, even if other creative new projects might be equally defendable. Vice versa, the Commission cannot prohibit measures which fulfil the criteria of its block exemptions or guidelines, even if a particular case does not seem very convincing. This permanent tension between individual discretion and legal certainty is, however, inherent to all legislation and unavoidable. It is ultimately a question of permanently seeking the right balance.

A third difficulty worth mentioning is the fact that the EU control mechanism is not designed to ensure that aid measures are economically **efficient**. I would not call this a weakness, it is simply the consequence of how the system was conceived: State aid policy is part of competition policy and its first aim is to limit distortions of competition. The paradox is that the most distortive aid may also be the most efficient, in terms of achieving the goal of the aid provider. E.g: tax holidays are likely to attract investments, but they distort competition and the level-playing field between enterprises too much to be acceptable in a common market. Conversely aid schemes which do not create significant distortions, might get a Commission approval, even if they are not so efficient, e.g. because the aid is too small to have an effect (a small tax advantage for the recruitment of new workers may not create any jobs which would not have been created anyhow). The Commission is reluctant to take a position on the efficiency of a proposed aid measure, also in view of the division of powers between Member States and the Commission. Ultimately it is up to Member States to decide how they pursue an economic policy adapted to their own situation and spend - or waste - money.
This does not mean, however, that efficiency does not play a role. If aid were completely inefficient it would not normally be authorisable, as it could hardly be considered to be in the interest of the Community. To some extent efficiency requirements are thus incorporated in the conditions for authorisation. They ensure e.g. that for any aid there must be a significant counterpart from the company like job creation; the enterprise must make a substantial own contribution (aid can never finance the whole project); if aid is granted for investment or job creation, the investment or the jobs must effectively be maintained for a certain number of years, and so on. But these criteria are defined at a general level and they are not conceived to select the most efficient measure in any particular case. The Commission will thus not analyse whether other measures might be more appropriate and more efficient than State aid. That is up to Member States.

In this respect the question may be raised whether more prior and ex post assessment should be done before and after aid is granted. E.g. Member States should more often make a study on what type of economic measures would be most appropriate, before having recourse to State aid. Currently this indispensable preliminary question is often ignored. Similarly, during the operation of an aid scheme a study of its impact could be useful, so that adjustments could be made in case the objectives are not reached. But here we have a time problem. Schemes have a limited duration of normally 5 years. Before the effects can be seen and a study can be completed, the scheme already comes to an end. In any case, as a minimum some kind of ex post assessment on the effects of aid measures should be required. In that way, aid grantors could benefit from the experience; at the same time the Commission would be better equipped to evaluate and adapt its own policy. The Commission has recently made attempts to encourage Member States to carry out such assessments, in the context of the Scoreboard project, which is published on the Website.

A last problem to be mentioned is the volume of illegal aid. It has to be recognised that a significant number of aid measures is still granted without authorisation. Partly
this is because especially local and regional aid providers lack awareness of the rules or believed that their measure did not constitute State aid - given the unclarities of the State aid definition it is often far from obvious what is aid and what is not. Many of these cases are discovered by the Commission, either because competitors complain or because politicians tell the newspapers how good they have been for the local industry... But not all cases are discovered. Is this a real problem? One should not overestimate it. First of all, if there is a big distortion and a real competition problem, it cannot be hidden. Competitors will know and will complain to the Commission. Secondly there is a powerful remedy: if the illegal aid does not fulfil the conditions for ex post authorisation, the Commission will order its recovery, with interests. And reimbursement can go back for 10 years. Certainly, the recovery procedure may be long and cumbersome because it is the Member State who has to recover from the beneficiary and the latter may exhaust all remedies under national law against the reimbursement. But the jurisprudence of the Court is such that ultimately reimbursement will have to take place. Therefore, the recovery rules are an important deterrent to prevent the granting of clearly incompatible aid. And, compared to e.g. the WTO rules, the recovery tool definitely increases the efficiency of the EU system.

IV. The EU system as a model?

Since the EU experience is overall quite positive, the question arises whether and how it could be a model for other jurisdictions. Again, the answer should probably be: it depends. One has to recognise that EU State aid control is linked to the common market and to competition policy. The system as such can therefore probably only be successfully transposed to groups of countries or regions with a comparable level of economic integration and also the political will to entrust an independent authority with the power to determine the common interest of all members.

Such groups of countries exist. E.g. the EFTA Surveillance Authority fulfils the same role as the European Commission for Norway, Iceland and Liechtenstein (in the past
also for Austria, Finland and Sweden). This example proves that EU State aid control is not unique.

Another interesting, somewhat different example of subsidy control is that of the 13 accession candidates, 10 of which will soon become member of the EU. The EU concluded with these countries, well before accession, bilateral agreements on the basis of which they were required to respect the State aid regime of the EU, as a kind of preparation for accession. This was not easy, since none of the accession candidates had any experience with State aid control. They all set up separate State aid authorities from scratch and created the necessary legislative framework to comply with this new task. Obviously this process was not a full success story for all countries but it proved its value, and not only as a transitional solution in the run up to EU accession. It has shown that State aid control, not by a supranational authority but at national level can work, provided the State aid authority has the necessary legal framework, administrative capacity and functional independence from the grantors of State aid - they should function in a comparable way as competition authorities. In federal states such system might be an option in order to avoid interstate or even inter-city bidding wars.

Organising State aid control by an independent State aid authority does not necessarily mean that the system must be a copy of the EU, which is admittedly rather heavy. Both in terms of procedural enforcement and of substance, a “light version” can be imagined. For example, procedurally one could exempt all the less-important cases and set such a threshold that only the big cases are subject to control, in order not to overload the system. One could also replace the general prohibition with exceptions after prior authorisation by its opposite: all aid is allowed unless it is forbidden. Or one could replace it by a system where enterprises or other regions have a right to complain if they suffer from subsidies granted elsewhere (a sort of actionable subsidies within a certain jurisdiction). As regards the substantive rules, one could envisage only some basic, minimum criteria (e.g. define specific objectives
for which aid can be granted and the conditions which the recipient must achieve, put a cap on the aid amount etc.).

The alternative to organise State aid control without a separate State aid authority, e.g. through legislation by which all aid grantors are bound, is probably more difficult. In such regime, the rules would have to be agreed by national, regional or local governments, which would weaken the whole mechanism and in practice be very difficult if the rules should go beyond some minimum conditions. Furthermore, in a system without independent authority to apply, with a certain margin of discretion, the rules to a concrete case, there would be no flexibility. The rules would have to be exhaustive. And their regular update in function of economic developments would be cumbersome. And who would in such regime control and enforce the rules? Presumably, in the absence of a central State aid authority, the rules should be enforceable through the Courts, but that would again create some problems. So this alternative is less promising.

Ultimately, to what extent the EU system can be a model depends thus on the situation and the objectives one pursues. Creating an independent authority to set and enforce the rules is certainly a big step but an easier starting point for a well-functioning system. However, other less ambitious options should not be disregarded, even if they would just consist of some general minimum requirements, as that would still be better than having no rules at all.

V. Conclusion

To make a proper evaluation of the EU system, I would in fact have to compare the current regime with a situation without any State aid control. Only such hypothetical comparison would demonstrate the full impact of the system.
I have not gone through this exercise, but I would expect that, in broad terms, it would reveal that:

- The EU system strikes a reasonable balance between limiting distortions of competition, and allowing measures that promote EU objectives; since all aid, and especially the most distortive types of aid, are subject to conditions, the distortions are kept to an acceptable level;
- Since the rules are rather precise and transparent, many cases will never be proposed in the first place. Member States are generally well aware of the basic principles; therefore they will plan their interventions accordingly and not propose any “unworthy” projects. An important part of the impact of our system lies therefore in all the potentially distortive measures that were never even considered, or were withdrawn when it became apparent that no approval could be expected.

To conclude, the EU regime is maybe not perfect, but it works well and there seems to be no reason why many elements of it would not be useful also in another context.