EU State Aid Control

Fiona Wishlade, European Policies Research Centre, University of Strathclyde

Introduction

The use of subsidies by national governments often makes headline news in the European financial press and European Commission attempts to curb intervention are frequently controversial. The control of State aids[1] is a key component of the EU competition rules and has become an increasingly important strand of the internal market provisions. The European Commission's role in disciplining subsidies is unique in international law. This is not only because its supranational authority is unparalleled, but also because the context for its decisions extends beyond considering the economic impacts that are familiar to trade economists; the Commission must assess the potential trade and competition effects of State aid against the contribution that intervention could make to wider EU Treaty objectives such as economic and social cohesion, sustainable development and research and technological development.

Provisions on the control of State aids were included in the Treaty of Rome from the outset. The authors of the Treaty clearly recognised that some means of limiting subsidies and other forms of government intervention were vital in the establishment of a 'common market'; as barriers to trade – tariffs, quotas, discriminatory standards, and so on – were being outlawed, the temptation for Member States to resort to other types of protectionism was considered likely to increase. In the 1980s this view was reinforced. The further dismantling of trade barriers to take place as part of the Single Market programme would leave subsidies as one of the few remaining instruments of protectionism available to governments and make their effects more keenly felt by

[1] The definition of a State aid is discussed later; it is somewhat wider in scope than a subsidy.

competitors of beneficiary firms. As a result, the control of State aid began to move higher up the Commission’s policy agenda in the early 1990s (Brittan, 1989).

In contrast with the competition rules addressing the behaviour of firms (restrictive practices and abuse of dominant position) the use of the State aid provisions was very tentative in the early years of the Community. EU State aid control was long regarded as the Cinderella of the EU competition rules, and consequently omitted from many volumes on the subject; it is, however, increasingly being seen as a policy that has come of age. Over the last few years State aid control procedures have been progressively formalised and a higher priority has been given to the enforcement of Commission decisions (Hansen, van Ysendyck and Zulhkle, 2004).

In terms of substance, the scope of Commission scrutiny has broadened beyond the ‘classic’ instruments of government intervention such as grants, soft loans and capital injections to include aspects of fiscal and social security systems and the financing of public service obligations. Moreover, the liberalisation of large segments of hitherto state-owned monopoly sectors has increased the range of activities potentially open to competition and therefore subject to the State aid rules. In parallel, however, the environment in which policy operates has become increasingly complex. Successive Treaty amendments have emphasised the linkages between policy areas, such as the requirement for national and EU policies to contribute to economic and social cohesion. Of key importance, enlargement to embrace ten new Member States presents significant challenges both to the substance of policy and to its practical application.

At macroeconomic and political levels, attitudes towards State aids have been influenced by the so-called Lisbon agenda,[2] with the Council of Ministers taking a growing interest in the scale and efficiency of government intervention, reflected in the declared objective of 'less aid, but better'. However, while the Council has ostensibly become increasingly supportive of Commission attempts to rein-in State aids, this commitment is often noticeably absent when national interests are at stake in individual cases, typifying the ambivalence encapsulated in former Commissioner Peter Sutherland's observation that: 'in my time in the Commission I have detected a marked tendency in all Member States to regard other people's State aids as bad and their own as fully justified.'(Sutherland, 1987).

Against the backdrop of this changing economic and geopolitical environment, this chapter provides an overview of the key elements and recent evolution of State aid control policy. The chapter is structured in four parts as follows. The first part sets out the broad context and aims of State aid control. The second part identifies the types of instrument that are subject to scrutiny – in other words, what constitutes a State aid? This is a crucial issue since measures that distort competition, but do not involve State aid, must be dealt with under other Treaty provisions, with notably less powerful means of redress. The third part of the chapter reviews the Commission's approach to State aid in different policy areas, exploring how the Commission has interpreted its role in balancing trade and competition considerations against the wider objectives of the European Union. The final part of the chapter discusses a number of

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[2] The commitment made by the European Council in March 2000 for the EU to become 'the most dynamic and competitive knowledge-based economy by 2010.' This was to be achieved by a series of goals in areas such as employment, innovation, enterprise, liberalisation and the environment.

current themes in the evolution of policy, considers key recent developments against this background and highlights some future issues and challenges in State aid control.

The context and rationale for State aid control

In spite of the evolving context for policy, the basis for the control of State aids has remained substantially unchanged since the Treaty of Rome. The key provisions are set out in Articles 87 to 89 of the EC Treaty. In essence, Article 87 prohibits State aids, subject to certain exceptions; Article 88 sets out the role of the European Commission and of the Member States; and Article 89 enables the Council to adopt Regulations for the implementation of Article 87 and 88. The key player, however, is the European Commission which arguably has more autonomy and authority over the Member States in this sphere than in any other arena of EU policy; it has progressively extended the scope of its discipline over government intervention and increasingly sought to monitor and to reduce overall levels of spend. This section begins by outlining the legal basis for restricting the use of State aid, before discussing the role of the European Commission and providing an indication of the overall scale of State aid spending.

The legal basis for State aid control

The first paragraph of Article 87 provides for a general prohibition of State aids insofar as they affect trade between the Member States.

The second paragraph (Article 87(2)), indicates those aids that are *de jure* exempted from this general ban. Three categories of aid are identified. In broad terms, these are: aids of a 'social' nature;[3] aids related to the damage caused by natural disasters;[4] and aids to parts of the Federal Republic of Germany affected by the

[3] Aid must be granted to individual consumers and not undertakings.

[4] Such as floods, droughts, earthquakes and volcanic eruptions.

division of Germany.[5] The third paragraph (Article 87(3)) outlines those types of aid that *may* be considered to be compatible with the common market.

Perhaps the most striking feature of Article 87 is that it does not define what an aid actually *is*. Schina (1987, p. 13) takes the view that this apparent omission was intentional on the part of the authors of the Treaty; a clear definition would simply have encouraged governments to find ingenious ways of circumventing the rules. Moreover, a consideration of the wide-ranging powers accorded to the European Commission in the implementation of Article 87 supports this view. Importantly, the definition of State aid is not static and the scope of Article 87(1) is frequently the subject of Commission decisions or European Court of Justice rulings that fine-tune, or sometimes radically extend, the range and type of measures that are subject to control. These definitional issues are not mere legal niceties, but questions of fundamental importance to policymakers in the Member States and to actual or potential beneficiaries and competitors alike. The second section of this chapter addresses the question of what is meant by 'State aid' under the Treaty.

Although, as described, *in principle* State aids are banned under the Treaty, Articles 87(2) and (3) provide for a number of exceptions. Article 87(2), which provides for some mandatory derogations from the ban is relatively restrictive in scope and has *generally* been uncontroversial. By contrast, the interpretation of Article 87(3) has resulted in a significant body of soft law and, increasingly, secondary legislation. This has led to the authorisation of State aid for a range of policy purposes such as regional development, research and development, supporting

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5 For most of the post-war period the German Federal government operated special measures for the so-called Zonal Border Area (the *Zonenrandgebiet*) and West Berlin under these provisions. Since reunification this provision has scarcely been invoked but the German authorities have sought its retention in successive Treaty amendments. In the draft Constitution, there is scope for this provision to be repealed after five years.

small and medium-sized enterprises (SMEs) and environmental protection. The interpretation of Article 87(3) is discussed in the third section of this chapter.

Before moving on to the substantive issues covered in the rest of this chapter, it is worth outlining the role of the European Commission in State aid control and providing some indication of the scale of policy both in terms of Member States' spending on State aids and Commission activity to control it.

Role of the European Commission

Article 88 of the Treaty gives the European Commission wide-ranging powers in the sphere of State aid control. Indeed, it has arguably more autonomy in this field of EU policy than any other. There are three principal aspects to these powers. First, the Commission has a general duty to review aid and propose 'any appropriate measures required by the progressive development or by the functioning of the Common Market' (Article 88(1)). Second, Member States must notify the Commission of any plans to offer aid *in advance* of implementation, in order for the Commission to assess their compatibility with the common market. This means, in effect, that there is a 'stand still' requirement – aid cannot be paid until the Commission has given its approval. Unnotified aid or aid paid prior to approval is illegal and the Commission can require its repayment. Third, after formal investigation, to which other Member States and third parties may contribute, the Commission can require Member States to abolish or amend aid measures if it considers them incompatible with the Common Market.

The basic provisions of Article 88 have been subject to much case law.[6] This was largely codified in a procedural regulation adopted in 1998,[7] which also reinforced the

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6 See, for example, R. D'Sa 1998, but note that several important procedural developments postdate this book.

Commission's powers to order the repayment of illegal aid. It is also important to note that aggrieved competitors can complain to the Commission about aid believed to have been paid out illegally, or can bring a case before the national courts, which can declare aid unlawful and order its repayment. For its part, the European Court of Justice has played an important role in buttressing the Commission's authority, particularly in the early case law on procedural matters, and has employed a relatively light touch in its scrutiny of the Commission's interpretation of substantive matters, thereby reinforcing the discretionary powers of the Commission.

The combination of discretion and exclusive competence might lead to the perception that the Commission is legislator, policeman, prosecutor and judge in matters of State aid. For all this, the Commission's task in disciplining State aids is not unfettered. Commission's decisions are subject to appeal before the European Courts by Member States or by interested parties, such as competitors of aid beneficiaries. Moreover, the very fact that it is the policies of Member State governments that are subject to control means that decisions are often highly sensitive, especially where national interests are stake. Cases of major national importance – such as aid for the restructuring of a firm where many jobs are at risk – are often the subject of face-to-face negotiations between ministers and the Commissioner for Competition Policy. In consequence, outcomes have frequently been regarded as politically motivated. The perception that the Commission simply bows to pressure from Member States is, however, increasingly outmoded; in recent years the Commission has been more and more willing to reach negative decisions on State aid in sensitive cases and to enforce decisions with recovery orders where aid

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7 See Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJEC No L 140 of 30 April 2004, pp 1-134.

has already been paid. For example, in July 2004 the Commission ordered the repayment of aid estimated at up to €1.1 billion by France Télécom.[8] Where Member States fail to recover illegal aid, the Commission can, and does, refer the matter to the European Court of Justice. Competition Commission Neelie Kroes has confirmed her intention to 'take a very strict line with Member States that fail to comply with Commission decisions on state aid. Taking a firm stand is the only way of ensuring the credibility of our state aid policy.'[9]

The Commission typically registers up to 1000 State aid cases annually, around half of which concern manufacturing and services.[10] Recent trends in the origin of these latter cases are set out in Table 1.

Table 1: State aid cases registered (excluding agriculture, fisheries, transport and coal)

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Notified aid	510	680	550	515	342	469	473	322	349	306
Unnotified aid	68	113	91	140	97	98	86	46	67	53
Existing aid	16	10	3	1	5	2	10	49	5	18
Complaints							94	152	192	175
TOTAL	**594**	**803**	**644**	**656**	**444**	**569**	**663**	**569**	**613**	**552**

Source: Compiled from European Commission annual competition reports, various editions.

In practice, the scale of Commission activity in monitoring State aid is difficult to assess meaningfully. In particular, a notified aid may involve an aid scheme or programme for which there may ultimately be hundreds or even thousands of beneficiaries or it may involve assistance to a single firm; each counts as one

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8 RAPID Press Release, *Commission rules that France Télécom received illicit aid and orders that it be paid back to the state*, IP/04/981 (Brussels, 20 July 2004).

9 RAPID Press Release, *Commission refers Germany to Court of Justice for failure to recover illegal aid to Kahla,* IP/05/189 (Brussels, 16 February 2005).

10 Distinct rules apply to agriculture, fisheries, transport and coal and the lead in implementing State aid policy in these sectors is taken by the relevant 'sectoral' directorates-general, as opposed to DG Competition.

notification. In similar vein, the table suggests an overall decline in the number of aids notified. However, this partly reflects the adoption of a number of block exemption Regulations that enable national authorities to implement particular types of aid scheme, without prior authorisation from the Commission, on condition that certain precise criteria are met. The aim of these Regulations, which concern support for SMEs, for training and for employment, is to reduce the administrative burden on the Commission. Perhaps most interesting is the significant rise in the number of cases arising from complaints (although it would appear that data was simply not disaggregated in this way prior to 2000, rather than there being no complaints before this date). In the 1990s the Commission actively promoted the role of third parties in enforcement. To some extent, though, the implications were double-edged; the Commission was sometimes forced into reactive mode by challenges from third parties, with implications for the coherence of policy and its ability to set the policy agenda (Mitchell, 2001).

As Table 2 shows, the Commission raises no objections to the majority of State aids considered by it. This might lead to the conclusion that the Commission is relatively ineffective in disciplining State aids. However, the opposite conclusion can also be reached: the Commission has become increasingly explicit about the types and forms of aid[11] that can be exempted from the general ban on State aid so that policymakers can, with some confidence, design measures that are likely to be 'rubber-stamped' for approval. For its part, the Commission *must* open the formal investigation procedure if it has any doubts about the compatibility of the measure concerned with the common market.

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[11] Reflected in the growing body of aid codes, communications and frameworks covering a range of policy areas – see <http://europa.eu.int/comm/competition/state_aid/legislation/>

Table 2: Trends in Commission Decisions

	1994	1995	1996	1997	1998	1999	2000	2001	2002
No objection	440	504	373	385	308	258	330	315	271
Initiation of formal scrutiny	40	57	43	68	66	62	65	67	62
Positive	15	22	14	18	16	28	11	15	29
Negative	3	9	23	9	31	30	5	26	37
Conditional	2	5	3	5	8	3	0	3	5
Appropriate measures/other	27	22	18	17	31	63	34	25	33
TOTAL	527	619	474	502	460	444	445	451	437

Source: European Commission annual competition reports, various editions.

It is now well-established that the Commission has the authority to require the repayment, with interest, of aid paid out illegally. Moreover, provisions of national law, involving, for example, the principle of legitimate expectation[12] can provide no shelter. In practice, though, enforcement of repayment orders remains problematic, depending as it does, mainly on national authorities. No systematic information appears to be available either on the number and scale of recovery orders or on the amounts actually repaid. However, the Commission's 1998 annual competition report indicates that 24 repayment orders were made in that year, most involving individual awards to firms (principally firms in difficulty), but some involving aid schemes with potentially many hundreds of beneficiaries (European Commission 1999, p 305). The same report listed 19 recovery orders dating back to 1987 that had not yet been repaid. More recently, in 2003 the Commission took 11 (partly) negative decisions involving the recovery of over € 1.3 billion. At February 2004, some 88 recovery orders were pending, of which 40 concerned Germany and 20 concerned Spain (European Commission, 2004).

Scale of State aid spending

In the mid-1980s the Commission began to focus on the scale of State aid as part of its attempts to target particular categories of support in the run-up to the completion of

[12] The notion that firms should be entitled to assume that the award of State aid was lawful.

the internal market. The aim was to produce an inventory of aid schemes and accompanying expenditure data. In practice, owing to pressure from the Member States at the time, only the latter has ever been published. Initially this took the form of so-called State aid Surveys which were published every two years. Latterly, these have been superseded by the more regular ‘Scoreboards’,[13] instigated to monitor the Stockholm European Council commitment in 2001 to ‘demonstrate a downward trend in State aid in relation to GDP by 2003’ and also to ‘redirect aid toward horizontal objectives’.[14]

Table 3: Trends in State Aid Expenditure (EU15)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total aid exc railways € billion	70.4	75.2	72.4	71.0	71.5	67.1	60.5	52.5	50.9	49.5	48.8
Total aid exc agriculture fisheries and transport € billion	54.4	60.2	55.4	52.6	54.2	50.2	46.4	37.6	36.6	35.4	34
Total aid exc railways % of GDP	1.09	1.18	1.11	1.00	0.98	0.88	0.77	0.64	0.59	0.57	0.56
Total aid exc agriculture fisheries and transport % of GDP	0.85	0.95	0.85	0.74	0.75	0.66	0.59	0.46	0.43	0.41	0.39

Source: Extracted from European Commission, 2004.

European Commission sources suggest that EU15 expenditure in 2002 totalled almost €49 billion for all sectors, except railways; and €34 billion when agriculture, fisheries and transport were excluded (see Table 3). In terms of its weight in the economy, there is a fairly clear downward trend over the past decade. Nevertheless, these aggregate figures conceal some significant differences between countries. Aid as a percentage of GDP in 2002 ranges from 0.16 (Sweden) to 0.72 (Denmark); measured

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13 The Scoreboards and the later Surveys are available on the DG Competition website at: <http://europa.eu.int/comm/competition/index_en.html>

14 The overall aim here is to reduce aid considered most harmful, specifically, rescue and restructuring aid, sectoral aid and *ad hoc* aid, this latter being offered to an individual firm on a one-off basis rather than as part of an aid scheme that is ostensibly generally-available. Horizontal objectives are not listed exhaustively but include research and development, support for SMEs, environmental protection and, explicitly, cohesion. Cohesion is not, however, defined.

in Purchasing Power Standards (PPS) per head, spending in 2000-2 averaged just 36 in the UK, as against 228 in Denmark.

Table 4: State Aid for Horizontal Objectives and Particular Sectors 2002 (% of total, excluding agriculture, fisheries and railways)

	EU	Bel	Den	Ger	Gre	Spa	Fra	Ire	Ita	Lux	Net	Aus	Por	Fin	Swe	UK
Horizontal Objectives	**73**	**97**	**100**	**66**	**100**	**67**	**60**	**49**	**96**	**92**	**98**	**96**	**39**	**98**	**84**	**70**
Research and Development	15	15	5	14	10	12	18	8	13	9	26	33	5	45	18	27
Environment	16	0	53	30	-	4	3	0	0	0	39	19	5	21	39	5
SME	14	20	1	6	16	20	17	2	33	21	4	17	15	7	5	15
Commerce	1	0	-	0	-	0	2	-	2	1	5	-	0	4	-	0
Employment aid	2	7	34	0	-	3	0	8	1	-	0	4	6	6	-	0
Training aid	2	2	3	0	-	8	0	4	1	-	-	10	5	0	1	2
Regional development	23	52	3	16	74	19	18	26	46	61	24	14	3	16	21	21
Particular sectors	**27**	**3**	**0**	**34**	**0**	**33**	**40**	**51**	**4**	**8**	**2**	**4**	**61**	**2**	**16**	**30**
Manufacturing	3	-	0	4	0	5	2	35	3	-	2	4	4	0	-	1
Coal	16	-	-	30	-	28	16	-	-	-	-	-	-	-	-	1
Other Non-manufacturing Sectors	2	-	-	-	-	0	0	-	0	-	-	0	-	-	-	28
Financial Services	5	-	-	-	-	-	22	14	-	-	-	-	57	-	-	-
Other services	0	3	-	0	-	0	-	3	-	8	-	-	0	2	16	-
Total aid less agriculture, fisheries and railways (€ m)	**34005**	**933**	**1274**	**11431**	**410**	**3503**	**6197**	**525**	**4528**	**56**	**780**	**453**	**649**	**231**	**406**	**2629**

Source: European Commission 2004, but the figures for Finland have been recalculated by the author to take account of an error later identified in the R&D expenditure data by the Commission.

There are also significant disparities between countries in the shares of expenditure aimed at various policy objectives, as illustrated in Table 4. For example, 53 per cent of Danish expenditure (excluding that on agriculture, fisheries and railways) is targeted at environmental protection, but in most other countries (Austria, Finland, Germany, the Netherlands and Sweden being the exceptions), this amounts to less than five per cent of the total. Research and development aid accounts for around a third of the total in Austria, but just five per cent of spending in Portugal.

There are, however, considerable methodological difficulties involved in gathering and analysing the data, some of which undermine its usefulness. In particular, depending on data availability, the figures mix expenditure committed and that actually paid out. In addition, many aid schemes have multiple policy objectives, so that the apparent absence of spending on a given policy does not reflect reality but rather the way in which measures are classified for statistical purposes. In spite of these misgivings, the Commission reports remain the only comparable source of information on aid spending.

What is a State aid?

The absence of a concrete definition of State aid was alluded to earlier. Article 87(1) states that:

> '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.'

These provisions have been elaborated in a substantial body of case law and Commission decisions spanning a period of over 30 years. Space prohibits an extensive discussion of definitional issues here, and the topic is well covered in the literature (for example, Bacon, 2003). Nevertheless, it is worth outlining the scope of what is currently understood by State aid.

There are five main aspects of the definition of a State aid: the notion of 'aid'; that it must be granted 'by a Member State or through State resources'; that it may be 'in any form whatsoever'; that it must 'distort or threaten to distort competition'; and that it must do so by 'favouring certain undertakings or the production of certain goods'.

Concept of aid

The notion of aid was considered early on by the European Court of Justice in the context of the European Coal and Steel Community Treaty. The Court concluded that an aid was a wider concept than a subsidy and extended to intervention which mitigated charges normally incurred by an undertaking. [15] The Court later also argued that if the *effect* of a measure was to provide a benefit, then it should be regarded as aid, even if this was not the primary intention of the measure. [16] In other words, aid involves an advantage that would not be conferred in the normal operations of an undertaking.

State and State resources

Commission decisions supported by Court of Justice rulings have resulted in a wide definition of the terms 'State' and 'State resources'. It is now clear that the Treaty provisions cover measures by all public bodies, or agencies acting on their behalf, at national, regional and local levels.

The extent of this definition has important consequences not just for the range of measures potentially concerned, and their complexity, but also for domestic

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[15] *De Gezamenlijke Steenkolenmijnen in Limburg* v *High Authority of the European Coal and Steel Community* [1961] ECR 1.

[16] *Italian Government* v *Commission* [1974] ECR 709.

arrangements for ensuring compliance: it is the national government that is held to account for unnotified or illegal aid, irrespective of whether it is responsible for the administering body offering the aid.

Form of aid

Article 87 concerns aid 'in any form whatsoever'. Reflecting this, there is no definitive listing of the types of assistance that fall within the ambit of the Treaty provisions. Clearly, grants, tax exemptions, preferential interest rates, the acquisition of land and buildings on favourable terms are all covered. For some instruments – for example, guarantees,[17] the sale of land and buildings,[18] fiscal aids,[19] and, most recently, venture capital[20] – the Commission has issued specific guidelines, largely as a consequence of the difficulties involved in determining when certain forms of intervention constitute State aid.

Complicated issues arise in the case of State shareholdings or capital injections. Consideration of these issues by the Commission and the Court has resulted in the so-called 'market investor' principle.[21] In short, if a transaction is undertaken in circumstances which a private investor would not be prepared to accept, then this would constitute a State aid. Over time, this notion has become more sophisticated. For example, it has been accepted that a private investor might be prepared to endure a loss in the short-term in making an investment if this were likely to secure the long-term survival of the enterprise. Also, the Court developed the concept of 'public

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[17] Commission notice on the application of Article 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJEC No C 71 of 11 March 2000.

[18] Commission notice concerning aid elements in land sales by public authorities, OJEC No C 209 of 10 July 1997.

[19] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJEC No C 384 of 10 December 1998.

[20] Commission communication on State aid and risk capital, OJEC No 235 of 21 August 2001.

[21] European Commission, 'Public authorities' holdings in company capital', *Bulletin of the European Communities*, 9/1984 (OOPEC, Luxembourg).

creditor' in *Tubacex* in considering whether a debt repayment and rescheduling agreement constituted State aid. In that instance, it concluded that the public authority was acting in the same way as a private investor would have done and the Commission consequently revised its recovery decision (European Commission 2001, point 312).

The distortion or threat of distorting competition

The provision of State aid does not, of itself, contravene the Treaty; in order to fall foul of Article 87, it must distort or threaten to distort competition (and, as discussed below, it must do this by favouring certain firms or products). In practice, this is not a serious limitation on the scope of Article 87, given the increasing interdependence of markets within the EU economy. Nevertheless, in *Philip Morris*[22] the European Court rejected the Commission's contention that aids always distort competition and that it was therefore not necessary to assess their actual effects.

Evans and Martin (1991) have argued that the Commission's approach almost amounts to a *per se* rule: 'if aid is granted, the conclusion that the aid distorts competition is almost automatic'. Notwithstanding this rather sweeping approach, the Commission has also asserted that: 'while all financial assistance to enterprises alters competitive conditions to some extent, not all aid has a perceptible impact on trade and competition between Member States'.[23] This was the justification for the introduction of the so-called *de minimis* facility, on which basis the Commission considered that for aid below a given threshold Article 87(1) could be said not to

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[22] Case 730/79 *Philip Morris Holland BV* v *Commission of the European Communities* [1980] ECR 2671.

[23] Community guidelines on State aids for small and medium-sized enterprises (SMEs), OJEC No C 213 of 19 August 1992.

apply. In 2001 *de minimis* aid was the subject of a block exemption Regulation,[24] meaning, in essence, that aid of less than €100,000 in a three-year period to the same firm need not be notified for approval. More recently, there is evidence of Commission attempts to limit the scope of Article 87(1) by finding that there are no impacts on trade between the Member States. A recent example concerned support for the renovation of Brighton Pier UK, which a neighbouring competitor had challenged, but which the Commission considered had no effects on competition beyond the domestic market.

Favouring of certain undertakings

Article 87 does not apply if all undertakings in the Member State benefit from the measure without distinction between them. Aid is selective if it applies to a particular type of activity, a sector of the economy, a particular geographical area or to firms with the same characteristics. In this way, a line is drawn between measures of *general* economic policy, on the one hand, and measures which *directly* or *indirectly* assist certain firms or activities, on the other.[25] This line is not always a clear one and measures that are ostensibly general may, in practice, be found to fulfil the selectivity criterion. For example, an Italian social security concession which provided higher rates of concession in respect of female employees was found to constitute sectoral aid since it favoured the production of goods in which female labour predominated, notably textiles, clothing, leather goods, and so on.[26] The emphasis here is not on the *intent* of the measure but on its *impact*.

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[24] Council Regulation (EC) No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to *de minimis* aid, OJEC No L 10 of 13 January 2001.

[25] See Bacon, 1997, for an in-depth treatment of this issue.

[26] Commission Decision 80/932/EEC of 15 September 1980 concerning the partial taking-over by the State of employers' contributions to sickness insurance schemes in Italy, OJEC No L 264 of 8 September 1980.

The interpretation of what is sometimes known as the 'specificity criterion' is crucial in distinguishing between what constitutes a State aid within the meaning of Article 87 and what have come to be known as 'general measures'. Moreover, the need to make the distinction is itself of paramount importance because Article 88 only empowers the Commission to take action against measures that distort competition *to the extent that they constitute State aid*; general measures that distort competition must be addressed through other mechanisms, with notably fewer and less powerful means of redress.

The setting of interest rates is typically used as an example of a general measure; the base rate set applies throughout the economy and no particular groups are favoured. In practice, however, changes in rates of interest impact very differently on different firms – cash-rich firms will clearly benefit from higher interest rates whilst those with loans to service will be disadvantaged. Similarly, government decisions about the burden of revenue-raising – i.e. whether it should be on labour or capital-related contributions – impact very differently on different activities. Nevertheless, such broad policy decisions are viewed as part of general economic policy-making and few would argue that it should be otherwise.

State aid as an evolving concept

A notable feature of State aid policy is the extent to which the notion of State aid is continually being refined, or even, on occasion, redefined. In the sphere of taxation, for example, the activities of the Council in the context of harmful tax competition[27] led the Commission to embark on a review of the tax arrangements in force in the Member States. An early casualty of this interest was the Irish 10 per cent tax rate for

[27] Conclusion of the ECOFIN Council Meeting of 1 December 1997 concerning taxation policy, OJEC No C 2 of 6 January 1998.

manufacturing. In the 1980s, the Commission had not objected to this, reaching the rather surprising conclusion that it did not constitute State aid.[28] By the late 1990s, the Commission had changed its mind and, following protracted negotiations with the Irish authorities, issued proposals for the phasing-in of a standard rate of corporation tax.[29] This is now being implemented by the Irish government.

An important recent issue in the definition of State aids has been the treatment of arrangements for funding so-called services of general economic interest (SGEI).[30] This has come to the fore for a variety of reasons. In particular, liberalisation and deregulation have altered the context for providing public services and raised new issues about public service obligations. This in turn has thrown into sharp relief the question of whether monies paid to organisations entrusted with the discharge of SGEIs should be regarded as compensation or State aid (a distinction with important procedural consequences for all tiers of government and a wide range of public services). A series of cases culminated in the Altmark judgment[31] that identified a number of criteria which such payments must fulfil in order to escape notification and scrutiny under the State aid rules. For its part, the Commission has adopted a number of draft instruments designed to increase the legal certainty concerning the financing of SGEIs.[32] Notwithstanding this, considerable uncertainty remains and it has been argued that yet more extensive legislative proposals are required to improve the

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28 The measure was clearly selective in that higher rates of taxation applied to services and agriculture.

29 Proposals for appropriate measures under Article 93(1) of the EC Treaty concerning Irish corporation tax (ICT), OJEC No C 395 of 18 December 1998.

30 This refers to ‘market services which the Member States subject to specific public service obligations by virtue of a general interest criterion. This would tend to cover such things as transport networks, energy and communications’ (European Commission 2000).

31 This case is attracting an expanding literature. See, for example, *European State Aid Law Quarterly* (3) 2003.

32 Including a proposal for a Community framework for State aid in the form of Public Service Compensation, see <http://europa.eu.int/comm/competition/state_aid/others/>

transparency and predictability of the financing of public services in relation to the State aid rules (Rapp-Jung, 2004).

The good, the not-so-good and the ugly: Commission treatment of different aid types

As outlined above, the first stage of analysis for the Commission in considering a given measure is to establish whether or not it involves State aid within the meaning of Article 87(1); the second stage is to determine whether it can anyway be deemed compatible with the Treaty. The prohibition on State aid in Article 87(1) is far from absolute, but tempered by a number of mandatory, and, more importantly, discretionary exceptions to the general ban. The discretionary exceptions are set out in Article 87(3) as follows:

a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;
b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;
c) aid to facilitate the development of certain economic activities or of certain economic areas where such aid does not adversely affect trading to an extent contrary to the common interest;
d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest; and
e) such other categories of aid as may be specified by decision of the Council acting by qualified majority on a proposal from the Commission.

It is for the Commission to decide whether one of these exceptions applies. By far the most important of these exceptions is Article 87(3)(c), although, as will be seen, Article 87(3)(a) has been used since the late 1980s to justify the authorisation of State aid to the worst-off areas of the EU on regional policy grounds. In broad terms, four main categories of State aid can be identified: horizontal aids, where measures are not sectorally or geographically restricted and aim to contribute to objectives that are viewed positively, such as support for SMEs, research and development and training; regional aids, where support is tightly controlled, or prohibited, in the more prosperous areas, but allowed to reach generous levels in the poorest countries and regions; restructuring aid, where the Commission's *a priori* attitude is essentially negative; and sectoral aid, where frameworks have been developed to reflect the particular needs and characteristics of certain activities.[33] An exhaustive review of the rules developed by the Commission policy in the various policy areas is beyond the scope of this chapter, not least because of the large number of regulations, codes and frameworks, but the discussion that follows highlights some of the key features of the Commission's approach.

Before turning to this, a general point is that the Commission takes a negative attitude to two types of aid: support for exports to other Member States; and operating aid. The former is never authorised by the Commission, for obvious reasons, and its opposition extends to aid schemes which explicitly favour export-oriented activities. So-called operating aid (support which is not tied to an investment or job creation project, but is of an ongoing nature or, for example, simply feeds into working capital) is rarely authorised. Last, it is worth noting that the aid types discussed in the

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33 For example, postal services, broadcasting, audiovisual production, electricity, shipbuilding, transport, steel, agriculture and fisheries.

rest of this section (horizontal aid, regional aid and restructuring aid) have no formal status.[34] Although the Commission refers to these categories of aid, their precise content varies between documents. For instance, on occasion, the Commission has distinguished regional, horizontal (including rescue and restructuring) and sectoral aid,[35] but in the more recent Scoreboards on expenditure it distinguishes horizontal aid (including 'cohesion' ie. regional aid), and sectoral aid. Clearly, this later classification reflects the political imperative to reduce expenditure overall and to refocus spending on horizontal objectives, including cohesion, endorsed in various European Councils.

The 'good': horizontal aid

In a number of policy areas, the Commission's attitude towards State aid is broadly positive, often reflecting the existence of the EU's own proactive policies. In several policy areas the Commission has adopted a block exemption Regulation, obviating the need for prior notification and scrutiny of aid measures that meet certain criteria. Instead, national authorities notify a summary of the aid scheme within 20 days of its implementation. The Regulations in operation concern aid for SMEs, aid for employment and aid for training.[36] In several other policy areas, the Commission's approach is essentially positive, but prior notification and approval is required and proposed measures are assessed by the Commission against published guidelines. Examples include support for research and development and environmental protection.

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34 The various sectoral frameworks are not discussed further; owing to their industry-specific nature in many cases they merit a chapter in their own right.

35 See, for example, the *Vademecum* on Community State Aid Rules available at: <http://europa.eu.int/comm/competition/state_aid/others/>

36 See <http://europa.eu.int/comm/competition/state_aid/legislation/>

The block exemption Regulation for SMEs concerns support for firms meeting the size criteria.[37] In addition, it must respect the rules on the types of expenditure eligible for aid (essentially general investment, consultancy and R&D) and the aid ceilings. These are expressed as a percentage of eligible expenditure. For general investment, rates of aid range from 7.5 per cent (for medium-sized firms in non regional aid areas) to 75 per cent of eligible costs (for small firms in the highest priority regional aid areas).

The block exemption for training concerns aid for firms of any size. Training may be specific (ie. directly related to the current employment) or general (which is perceived to have wider benefits). The standard maximum rate (ie. for large firms in non-regional aid areas) for specific training is 25 per cent of eligible costs; for general training the standard maximum is 50 per cent; in both cases ‘top-ups’ are available in designated regional aid areas and for SMEs.

The block exemption for employment aid only allows aid to large firms where they are located in a designated regional aid area or where the recruits are disadvantaged. SMEs are eligible everywhere and higher rates apply in the regional aid areas.

The principles governing research and development aid date essentially date back to 1986.[38] They concern aid for firms undertaking R&D, other than that commissioned according to market conditions (for example by an open tender procedure); public financing of R&D activities by public not-for-profit research establishments or higher education falls outside the scope of the State aid rules. The

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37 Broadly, medium-sized firms are those with fewer than 250 employees and small firms those with fewer than 50. In addition, certain financial and independence criteria apply.

38 The current guidelines are Community framework for State aid for Research and Development, OJEC No C 45 of 17 February 1996, p.5-16.

guidelines distinguish different phases of the R&D process as developments approach commercial viability. Accordingly, they allow up to 100 per cent of eligible fundamental research costs to be assisted, but only 50 per cent of industrial research and 25 per cent of pre-competitive research expenditure to be subsidised. Higher rates of award apply to SMEs and to firms located in designated problem regions. The R&D guidelines are scheduled for review before the end of 2005. A key consideration here is likely to be the essentially linear innovation model, an approach that has been criticised as being outmoded (UNICE, 2004) and the need to reconcile Barcelona Council objective of raising R&D expenditure in the EU to approach 3 per cent of GDP by 2010 with that of continued State aid discipline.

The guidelines on State aid for environmental protection[39] aim to balance the Treaty requirements of sustainable development against the imperative of undistorted competition. The underlying principle is that the 'polluter pays' so that only SMEs may qualify for assistance to meet existing environmental standards; however, larger firms may receive assistance to improve on compulsory standards, for relocation on environmental grounds, investment in combined heat and power, renewable energy and the rehabilitation of polluted sites. As under the R&D framework, higher rates of award apply in the designated problem regions and for SMEs. The current framework is due to expire at the end of 2007 but has been criticised on a number of grounds, including: the restrictive interpretation of the guidelines to cover pollution caused by the beneficiary; the impediment to innovative environmental policy that improves on lowest common denominator standards; the interference with national environmental policy options; and the failure to prevent distortions of competition, notably by

[39] Community guidelines on State aid for environmental protection, OJEC No C 37 of 3 February 2001, p 3-15.

allowing higher than necessary levels of aid (Holmes, 2004; and Ewringmann, Thöne and Fischer, 2002).

The 'not-so-good': regional aid

Regional policy was the first area in which the Commission developed guidelines for the discipline of State aids. These date back to the early 1970s when the Commission sought to 'coordinate' the use of investment aids for large firms in the more prosperous regions of the Community, mainly in response to concerns at competitive-outbidding for mobile investment. Over time the system of regulating regional aids has become progressively more elaborate, with the Commission becoming increasingly involved in determining the extent of the regional aid maps, the types of assistance that may be offered and the value of that assistance, such that large firms may now only receive general investment aid if they are located in the designated problem regions. At the same time, the emergence of EU Cohesion policy (ie. the Community's own regional policy) has raised important issues of policy coordination.[40] Indeed, since the late 1980s, the Commission has promoted the control of regional aid as a aspect of cohesion policy, viewing it as having the capacity both to contribute to cohesion and to undermine it: it has sought to rein-in the use of incentives to large firms in the richer regions, partly with the intention of maintaining a 'differential' between regions of varying prosperity; at the same time, it has recognised that incentives may play a role in attracting and maintaining investment in the problem regions and allowed aid on relatively generous terms.

The current approach to regional aid is set out in the 1998 Guidelines.[41] These have a number of key features. First, regional aid control is perceived in terms of the

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40 See Wishlade (2003) for an historical overview.

41 Guidelines on National Regional Aid, OJEC No C 74 of 10 March 1998.

need to restrict assisted area coverage expressed as a percentage of the population. Within the stipulated ceiling - 42.7 per cent of the EU15 population - regions where GDP(PPS) per head was at or below 75 per cent of the EU average were deemed eligible for the Article 87(3)(a) derogation[42] (around 21 per cent of the EU population).[43] Second, the remaining population (around 22 per cent) was allocated among the Member States as quotas for the designation of areas on the basis of Article 87(3)(c). For most countries, this resulted in significant cutbacks in assisted area coverage, although all of some Member States (Greece, Ireland and Portugal) remain eligible for national regional aid until December 2006.[44]

Table 5: Final coverage figures for 2000-2006 under Article 87(3)(a) and (c)

	Article 87(3)(a)	**Article 87(3)(c)**	**Total assisted area %**
Austria	3.5	24.1	27.6
Belgium	0.0	30.9	30.9
Denmark	0.0	17.1	17.1
Finland	13.4	28.9	42.3
France	2.8	33.9	36.7
Germany	17.2	17.7	34.9
Greece	100.0	0.0	100.0
Ireland	26.6	73.4	100.0
Italy	33.6	10.0	43.6
Luxembourg	0.0	32.0	32.0
Netherlands	0.0	15.0	15.0
Portugal	66.6	33.4	100.0
Spain	58.4	20.8	79.2
Sweden	0.0	15.9	15.9
UK	8.6	22.1	30.7
EU15	21.9	21.1	43.0

Note: The 42.7 per cent ceiling was exceeded owing to the special treatment given to Northern Ireland.
Source: Wishlade (2003) Figure 34 at p 205.

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42 This is essentially the same as the definition of Objective 1 areas for the purposes of EU cohesion policy.

43 This ceiling was set on the basis that coverage should not exceed 50 per cent of the population, taking account of the then anticipated enlargement to 21 Member States.

44 National ceilings for regional aid coverage under the derogations provided for in Article 92(3)(a) and (c) [*Article 87(3)(a) and (c)*] of the Treaty for the period 2000 to 2006, OJEC No C 16 of 21 January 1999.

Third, although Member States were responsible for selecting the assisted areas within their respective quotas, the methodology was constrained by the guidelines and the outcome had to be approved by the Commission. Fourth, the validity of the maps approved by the Commission for national regional policy was timed to coincide with the Structural Fund planning period (2000-6) and a special derogation was introduced to encourage Member States to designate areas both for national regional aid and the Structural Funds Objective 2 within their respective ceilings. Last, the Commission imposed lower award maxima across the board, although aid values are set to reflect the severity of the regional problem; typically, these range from 50 per cent to 20 per cent net grant-equivalent.[45]

A key feature of the evolution of competition policy control over regional aid has been the emphasis on devising frameworks within which aid schemes could be authorised, thereby obviating the need for case-by-case analysis of individual awards. The downside of this approach is that it shelters many thousands of awards from scrutiny, enabling them lawfully to be offered without any assessment of their competition effects. In the course of the 1990s the Commission, and to some extent the Council, became concerned at this lacuna in regional aid control and began to develop approaches for individual scrutiny and control of aids to exceptionally large projects. This culminated in the 1998 Multisectoral Framework[46] which required that projects/awards meeting specified size and sectoral criteria be notified and evaluated prior to implementation, partly with a view to reducing the rate of award offered. For a variety of reasons, the 1998 Framework failed to have any real impact (Wishlade

45 Net grant-equivalent (NGE) refers to the after tax value of assistance and is used by the Commission for comparing the value of all forms of regional aid.

46 Multisectoral framework on regional aid for large investment projects, OJEC No C 107 of 7 April 1998.

2003, p 127) and was superseded by the 2002 Multisectoral Framework.[47] The 2002 Framework takes a more straightforward approach and applies an arithmetical formula to reduce aid rates to projects involving eligible expenditure exceeding €50 million. This operates in a progressive way so that the larger the project, the lower the rate of award. For example, in a region where the standard award rate is 20 per cent NGE, the maximum for a € 100 million investment would be 15 per cent and for a € 500 million investment 8.4 per cent. Moreover, the Commission must individually approve aid for investments of more than € 100 million where the aid proposed exceeds a specified amount; the onus in such cases is on the Member State to demonstrate that the aid will not reinforce a high market or increase capacity in a stagnant sector. Significantly, the framework provides for the Commission to adopt a list of sectors in which regional State aid would be banned altogether. In practice, the adoption of such a list was postponed due to 'methodological and technical difficulties' and to take account of Member State requests (European Commission 2004a, point 389). The "technical feasibility and the political and economic opportunity" to adopt a list of sector with structural difficulties will be examined again by the Commission before end 2005 (Cavallo and Junginger-Dittel, 2004).

The impact of EU competition policy on regional aid has been significant (Wishlade, 2003, chapter 7). Successive policy revisions have constrained the types of regional aid on offer and subjected the extent of the assisted area maps to intense scrutiny. Most recently, award values have been progressively reduced. However, arguably the most striking feature of the Commission's approach to date is that it focuses on whether regional aid is justified, rather than on whether competition is

[47] Multisectoral framework on regional aid for large investment projects – Rescue and restructuring aid and closure aid for the steel sector, OJEC No C 70 of 19 March 2002.

distorted. Moreover, the emphasis has been on competition between Member States rather than between firms. In short, while the Commission has clearly achieved considerable discipline in the availability of investment aid to large firms, it is by no means clear that its approach to regional aid control actually ensures that distortions of competition are prevented.

The 'ugly': rescue and restructuring aid

Support for rescue and restructuring is perceived as one of the most distortive types of aid by the Commission which, in principle, views the exit from the market of failing firms as a normal feature of a functioning market economy. Nevertheless, intervention may be justified by social or regional policy considerations by examining the distortion of competition set against the employment effects of redundancies owing to closure and/or the regional effects resulting from the impact of closure on suppliers. Exceptionally, rescue and restructuring aid may be justified by competition considerations, for example where the disappearance of a given undertaking would result in a monopoly or tight oligopolistic situation.

The current (2004) guidelines on aid for rescue and restructuring[48] require all proposals to support large firms in difficulty to be notified individually.[49] The number of cases is relatively small – 120 over the period 1990-2002[50] – but the amounts involved may be significant – ranging from under € 1 million to over € 20 billion. Of these, 35 cases involved Germany, 20 were in France and there were 15 each in Italy and Spain. (European Commission, 2003). In broad terms a firm in difficulty is one that is deemed to be unable to stem its losses and that, without public intervention,

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48 Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty OJEC No C 244 of 1 October 2004.

49 Restructuring aid schemes for SMEs can be approved by the Commission.

50 Excluding *Treuhandanstalt* operations in the former east Germany.

will go out of business in the short to medium term. Rescue aid is temporary assistance to keep the company afloat while a viable restructuring plan is worked out; restructuring aid is based on an approved plan to restore a firm's long-term viability.

According to the 2004 guidelines, rescue aid may take the form of loan guarantees or loans bearing normal commercial interest rates; however, it must be restricted to the amount needed to keep the firm in business and to the time needed (a maximum of 6 months) to devise the recovery plan. In addition, it must be warranted on the grounds of social (ie. labour-related) difficulties and have no adverse effects on the industrial situation in other Member States. Last, it must be a one-off operation.

Restructuring aid can be granted only if certain criteria are met. These include: the submission of a restructuring plan to return to viability within a 'reasonable' time; the adoption of compensatory measures to avoid undue distortions of competition (such as reductions of capacity or divestment of assets); the limitation of aid to the minimum needed for the implementation of the restructuring measures, to which beneficiaries must also make a significant contribution (normally at least 50 percent for large firms); and monitoring and annual reporting. None of the aid must be used to finance new investment that is not essential to restoring the firm's viability.

In markets where there is long-term structural overcapacity, the reduction in capacity required of the firm may be 100 percent, in which case the Commission will only allow aid to alleviate the social costs (eg. redundancy payments and early retirement packages) of restructuring and environmental aid to clean up polluted sites that might otherwise be abandoned.

Restructuring aid can be granted once only (the 'one-time-last-time' principle). On the other hand, the Commission takes favourable view of aid to cover the social costs of restructuring and allows for the capacity reduction and reporting requirements to be applied with greater flexibility in the assisted regions and in the case of SMEs.

Rescue and restructuring operations have given rise to the most controversial State aid cases. Guidelines to set out how the Commission intended to handle such cases were first introduced in 1994 and tightened in 1999. In 2003 the Commission began a review of the 1999 guidelines, which expired in October 2004. In the first instance a number of issues were identified (European Commission 2003, p. 18), notably: the lack of a definition of firms ‘in difficulty’; the problem of applying the special criteria applicable to firms that are part of a group; the fact that rescue aid often has to be granted prior to Commission approval in order to prevent collapse of the firm; the ‘one-time-last-time’ principle and the instances of firms ineligible for restructuring aid receiving further rescue aid; the need to clarify the various time limits; and the scope of compensatory measures – when can these be said to be sufficient ‘to mitigate the potentially distortive effects of the aid on competition?’

Commentators endorsed and added to this list of shortcomings (Nicolaides and Kekelekis, 2004; Anestis *et al*, 2004). In particular, Nicolaides and Kekelekis pointed to the lack of a definition of a ‘significant’ contribution by the beneficiary as being one of the most serious defects of the 1999 guidelines, not least because this contribution determines the amount of aid that can be offered. Moreover, unlike the other aid frameworks discussed here, the rescue and restructuring guidelines do not stipulate aid ceilings expressed as a percentage of eligible costs. As a result, the amounts of aid and the compensatory measures required were partly determined by the negotiating skills of the parties involved, rather than objective criteria.

In practice, the 2004 guidelines retain the key principles of the existing rules, but introduce a number of important changes in response to some of the perceived weaknesses of the 1999 rules. Specifically, the 2004 guidelines apply simplified and accelerated procedures for the approval of rescue aid and a formula for determining the maximum amount of rescue aid. In addition, as noted, the compensatory measures required for restructuring aid may be up to 100 per cent of the beneficiary's capacity if the market concerned has long-term structural problems. Also, minimum contributions towards restructuring costs, varying by firm size, were introduced so that the obligations on shareholders are more explicit than before. Nicolaides and Kekelekis (2004) argue that while these provisions represent an improvement on the 1999 guidelines, they are too generous in their treatment of rescue and restructuring aid for SMEs and fail to address a number of the points which the Commission had itself identified, including the definition of firms in difficulty and the timescale over which a return to viability is required. Nevertheless, it can be argued that, while not involving a radical departure from the 1999 guidelines, the new framework tightens up the rules, especially for large firms, so that increasingly only firms that have clear prospects of returning to viability and whose efforts to restructure will not damage competition should benefit from State aid (Valle and Van de Casteele, 2004).

Although frequently controversial, the real impact of Commission decisions in rescue and restructuring aid cases is difficult to assess. A recent study (London Economics, 2004) points to 'basic data difficulties' that hamper the evaluation of the sectoral impacts of rescue and restructuring aid. Nevertheless, the study reaches the tentative conclusion that 'perhaps, in a number of cases the recovery of a State aid receiving company appears to occur at the expense of EU competitors'.

Current themes, recent developments and future challenges

The control of State aids has enjoyed a higher political profile since the start of the decade. This partly reflects the substance of the Lisbon agenda and its emphasis on economic reform, innovation and social cohesion, which followed on from the Stockholm Council commitment to less State aid spending overall and a reorientation of that expenditure towards ‘horizontal objectives of common interest, including cohesion objectives’.[51]

Successive European Councils have added little in the way of substance to the means of achieving the ‘less, but better’ objective, at least in terms of *concrete* commitments to reduce spending by the Member States. Nevertheless, political discussions have given an impetus to Commission action in the form of so-called ‘Scoreboards’[52] on State aid expenditure cited earlier and a progress report on the reduction and reorientation of State aid (European Commission, 2002).

Several important themes have emerged from recent Council conclusions and Commission reports: first, a consideration of the role of market failure in the justification for State aid; second, an emphasis on the efficiency and effectiveness of State aid and, related, a growing interest in evaluation and exchange of experience; third, a Commission commitment to consider the feasibility of developing economic criteria for assessing State aid impacts; and last, efforts to simplify, modernise and clarify the State aid rules. These themes are reflected in some recent developments in State aid control, notably the proposals for a significant impact test to underpin the assessment of some forms of aid and Commission working paper on the future of the regional aid guidelines. Nevertheless, against the backdrop of enlargement, attempts to integrate often diverse policy objectives and the growing complexity of public-private economic relations, State aid control seems set to face a number of challenges for some time to come.

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51 Presidency Conclusions, *Stockholm European Council*, 23 and 24 March 2001.

52 See: <http://europa.eu.int/comm/competition/state_aid/scoreboard/>

Current themes

Recent developments in State aid control have given greater prominence to *market failure* arguments in the justification for State aid. On the one hand, it has been stressed that State aids should be targeted at clearly identified market failures;[53] on the other, the Commission has emphasised the need to question whether State is always the most appropriate response to market failures – for example, it has argued that Member States: 'should assess, on a case-by-case basis, whether existing market imperfections affecting SMEs would be better addressed through the provision of state aid, advisory and information services, the intensification of structural reforms, or a combination of these measures.' (European Commission, 2002a).

A related question is that of the *efficiency and effectiveness* of State aid. The Commission has procured external research which aims, *inter alia*, to draw up a list of criteria that make it possible to assess the circumstances in which aid is likely to be more or less effective (European Commission, 2002). For their part, at the November 2002 Competitiveness Council, the Member States undertook to improve the exchange of experience on a range of issues, including *ex ante* and *ex post* evaluations of State aid.

The role of *economic analysis* in State aid control is also rising up the Commission's agenda. Two main factors appear to underpin this. First, the Commission has been sensitive to criticism of its hitherto rather formalistic approach. The Director General of DG Competition has observed that 'there is the impression that we are simply applying rules which aim to curtail state aid as such rather than concentrating on controlling aid which really distorts the European single market'

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53 2467th Council meeting – Competitiveness (Internal Market, Industry, Research) – Brussels, 26 November 2002, 14365/02 (Presse 360).

(Lowe, 2003). Second, the impact of enlargement on resources means that greater priority needs to be given to those measures that have the most impact on EU competition and trade.

There are two levels of analysis at which the role of economic criteria are relevant. First, there is the decision about whether a measure is caught by Article 87(1) at all. Does it, *inter alia*, distort or threaten to distort competition or affect trade between Member States? As mentioned earlier, it has been observed that the Commission interpretation of Article 87(1) almost amounts to a *per se* rule, but some recent cases have suggested a rather more reasoned approach. For example, in the Dorsten Swimming Pool case, which has been highlighted by the then Commissioner as an instance in which the definition of aid has been more tightly circumscribed (Monti, 2001), the Commission found that there was no aid because there was no effect on intra-Community trade.[54] As already mentioned, a similar conclusion was reached in the UK Brighton Pier case.[55]

The second level of analysis concerns the severity of the distortion involved. This led the Commission to attempt to develop an economic basis for distinguishing between aid that is particularly harmful and aid that, although it falls within the scope of Article 87(1), does not *significantly* distort competition and trade (Lowe, 2003); this is sometimes referred to as a 'significant impact test'. The aim was that this distinction could be reflected in procedural reforms that might ease the burden of examining less significant cases and identify those where closer scrutiny were merited (European Commission, 2002). This approach underpinned the so-called draft frameworks on lesser amounts of State aid (LASA) and aid with a limited effect on

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[54] Staatliche Beihilfe Nr. N 258/00 – Deutschland – Freizeitbad Dorsten, SG(2001) D/ 285046 of 12 January 2001.

[55] Aids N 560/01 and NN 17/02 – United Kingdom - Brighton West Pier, C(2002) 942 fin of 9 April 2002.

trade (LET). The objective of these frameworks was to enable the Commission have a 'light touch' approach to the scrutiny of measures that complied with the LASA and LET criteria; in other words, there would almost be a presumption that aid meeting the conditions would be compatible with the Treaty.[56]

The LASA draft proposed a new category of State aid: aid which exceeds the *de minimis* thresholds, but which is still regarded as too modest to pose a serious threat to competition, provided that it contributes to the achievement of certain Community objectives and that specified criteria are met. The LET draft was cast in a similar mould to LASA. While the principle underlying LASA was that 'size matters', the objective of LET was to provide a simplified framework for measures that could be expected only to have a limited effect on trade and need not be a cause for concern at Community level.[57]

In practice, both proposals were dropped by DG Competition early in 2005. They failed to gain widespread support among the Member States, although the UK was an ardent supporter of a significant impact test approach. In addition, it seems probable, although unconfirmed, that the legal services of the Commission may have had concerns about LASA and LET being open to challenge in the Courts. It remains to be seen whether the Commission will make further attempts at devising a significant impact test as part of the wider review currently underway.

A number of steps have been taken, or are envisaged, with respect to the *simplification, modernisation and clarification* of the State aid rules. In 2003 Commissioner Monti announced that the Commission was reviewing existing State aid control instruments with a view to simplification and elimination of potential

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56 For an overview of LASA and LET see Wishlade (2004).

57 As discussed earlier, measures that have no effect on trade do not involve State aid.

conflicts between the texts.[58] Regarding enforcement and sanctions, the Commission has formalised its approach to complaints[59] and indicated its intention that, in the future, reimbursement of unlawful state aid will be subject to interest at compound rates.[60] Together with the procedural Regulations adopted over the 1999-2001 period, these changes amount to a substantial reform package (Lowe, 2003a).

Recent developments

Against the backdrop of these themes and trends, a number of State aid frameworks are due for renewal before 2007, providing the Commission with: 'an unprecedented window of opportunity for a comprehensive review of the horizontal, and particularly Lisbon, objectives, and the new cohesion policy set out in the forthcoming Structural Fund regulations as well as to consolidate, and wherever possible simplify the rules.'(European Commission 2004b). In addition to the new guidelines on rescue and restructuring aid and proposals on aid for SGEIs discussed earlier, DG Competition has also begun to formalise it approach to aid to innovation, to review the R&D aid guidelines and, of key importance given the recent enlargement and the debate on EU Cohesion policy post-2006 (European Commission, 2004c), to consider the future of the regional aid control post-2006.

A recent Working Paper[61] on the review of the Regional Aid Guidelines sets out DG Competition's current thinking on the reform of regional aid control post-2006.[62]

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58 RAPID Press Release, Mario Monti, *Contribution of competition policy to competitiveness of European economy,* Institute of European Affairs, Dublin, SPEECH/03/264 of 26 May 2003.

59 *Form for the submission of complaints concerning alleged unlawful State aid*, OJEC No C 116 of 16 May 2003.

60 *Commission communication on the interest rates to be applied when aid granted unlawfully is being recovered,* OJEC No C 110 of 8 May 2003.

61 *Review of the Regional Aid Guidelines – a first consultation paper for the experts in the Member States*, available at: <http://europa.eu.int/comm/competition/state_aid/regional/>

62 For an overview of the working paper and a more detailed assessment of its implications see Wishlade, 2004 forthcoming.

The paper states that it draws on the comments submitted by the Member States in response to its earlier consultation, as well as taking account of the literature on the economics and effectiveness of aid, including two preparatory studies commissioned for the review, the conclusions of recent Council meetings and its own experience with the 1998 Guidelines.

The principal features of the proposals for future regional aid control as set out in the Working Paper are essentially threefold. First, that Article 87(3)(a) areas be defined on the basis of EU25 GDP(PPS) per head data, rather than EU15 averages. Second, that Article 87(3)(c) coverage be limited to so-called ‘earmarked’ regions, rather than based on national population quotas as at present. The “earmarked” regions are those losing Article 87(3)(a) status; very low population density regions; and outermost regions not covered by Article 87(3)(a). Third, that aid ceilings across the board be reduced.

Overall, the Working Paper represents a very significant shift in the rules governing regional aid. There are both sharp cutbacks in coverage, most of which are borne by the EU15 Member States, and significant reductions in award values for those regions that will be eligible. The implication of the proposals for the EU15 is a fall in assisted area coverage of 20 percentage points compared to the current position (43 per cent to just over 23 percent). The cutbacks in total coverage within EU15 are dramatic – every country is affected except Greece – but they are not uniform. There would be no assisted area coverage at all in Denmark, Luxembourg and the Netherlands or in mainland France. In Austria, Germany, Ireland and the UK coverage would fall by more than half. Aside from questions related to spatial coverage, some wider issues emerge. At a country level, within EU15, the proposals virtually eliminate the possibility of conducting ‘traditional’ regional policy in many

Member States: this is the case, for example, for France and the Netherlands, where there would be no Article 87(3)(c) areas. Even in countries with some coverage, such as the UK, Austria and Germany, Article 87(3)(c) areas are, like Article 87(3)(a) areas, designated on a 'top-down basis', rather than by national policymakers, and may only partially correspond to nationally-determined needs and priorities. As a matter of principle, one might question whether it is legitimate for EU competition policy to dictate the substance and targeting of national regional policy in this way.

A more general concern is whether the reductions in assisted area coverage and rates might affect the EU's global competitiveness for mobile investment. Some are sceptical about the capacity of incentives to offset locational advantages elsewhere, but it is worth noting that the EU system of State aid discipline is unique; alternative locations are unlikely to display similar levels of self-restraint and are therefore often in a position to offer long-term tax and other advantages that may prove irresistible to mobile investors.

Future challenges

The developments outlined in this chapter bear witness to a policy entering a new phase. The increased emphasis on the economic impact of State aids is surely to be welcomed as a genuine attempt to address the arbitrariness for which past State aid control policy has been criticised. Nevertheless, recent developments in State aid control illustrate the incremental nature of policy change. The new rescue and restructuring guidelines are modest in the scope of change actually implemented; the proposals for a significant impact test in the form of the LASA and LET guidelines have been dropped; and the failure of the Commission to adopt under the Multisectoral Framework a list of sectors with serious structural problems are all testament to the political sensitivities and the technical difficulties and the legal issues involved in altering the course of policy. In short, there are some very real challenges in trying to refocus State aid control.

At a ***conceptual*** level, some important questions remain. The definition of State aid is still fluid and the increasing complexity of public-private economic relations, especially in areas such as service or infrastructure provision will not simplify the Commission’s task in determining the existence of State aid. Moreover, the Commission’s growing interest in examining measures relating to social security and taxation continues to raise difficult definitional issues; these seem increasingly likely to occur at the subnational level where trends to decentralisation and devolution may be difficult to reconcile with the Commission’s approach to regionally-differentiated taxation.

Further conceptual challenges arise from incorporating aspects of the wider State aid reform agenda into regional aid control. The earlier discussion noted the growing interest in taking account of market failure in assessing State aids. Acceptance of market failure arguments is implicit in the Treaty provisions. However, the derogations from the general prohibition of State aid do not explicitly require the identification of market failure in order for State aid to be justified; moreover, the identification of a market failure does not, of itself, justify an exception to the general ban. Article 87(3)(c), which has formed the basis for most policy allowing the use of aid in derogation from the ban, merely refers to ‘aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.’ The identification of criteria to establish what is in the common interest remains elusive. Would evidence of market failure become a requirement for State aid authorisation? Would it be a necessary, but insufficient condition for a granting of a derogation?

Where would the burden of proof lie in market failure arguments for State aid? Would measures that in the Commission's view were ineffective be outlawed even in the absence of significant competition concerns?

Challenges also arise from the emphasis on policy linkages. In particular, the notion of 'cohesion' and how competition policy control of State aids can best contribute to it remains unclear. Since the early 1990s, the emphasis has been on competition policy enabling, or at least not frustrating, the adoption of coincident maps for national and EU regional policies. However, this is arguably a rather superficial preoccupation that conceals the need for a more fundamental debate about the appropriate articulation of spatial policy objectives at different tiers of government. Besley and Seabright (1999) consider the pursuit of coincident maps as 'a very significant flaw' in the Commission's market failure evaluation.

These conceptual issues spill over into and are difficult to disentangle from a range of ***technical*** issues. These are exacerbated by the combined effects of enlargement and the trend to decentralise responsibility for economic development to regional and local levels. This creates an administrative imperative to focus Commission resources on cases of most importance. However, there are clear tensions between what is theoretically relevant and what is administratively feasible; between arbitrariness and relevance; and between transparency and politicisation. The State aid control regime is easy to critique – there is excessive emphasis on formal aspects of policy and insufficient analysis of the *real* effects of aid on competition and trade. Moreover, State aid control policy as it has evolved is ill-suited to assess the increasingly sophisticated range of policy instruments being operated, or to considering those which it has not previously sought to address. However, critics should be under no illusions about the technical difficulties involved in addressing these issues. There are important gaps in the understanding of just how State aids affect competition and trade that are not answered by the academic literature in ways that are of practical relevance; even where the Commission has developed methodologies that sought to address competition issues more directly (for example, under the motor vehicle aid rules or the 1998 Multisectoral Framework), the absence of relevant, comparative and up-to-date statistical data at an appropriate level of analysis undermined the practical application of the methodologies concerned and damaged the credibility of policy.

State aid control continues to face considerable ***political*** challenges: from the outset, the role of the Council in State aid control has varied, with the Commission sometimes resisting Member State involvement and sometimes building on their apparent commitment to restraint. Recent developments suggest that State aid control is being considered more and more within the context of broader macroeconomic policy, reflected in the growing interest in overall levels of spend and the notion of introducing targets to limit spending. Whilst the Commission may welcome the support of the Member States as regularly expressed in Council conclusions, this support is less in evidence when national interests are directly at stake – for example when a major firms faces closure or the Commission seeks to exclude particular regions from eligibility for aid. Furthermore, in practice, Member State views on the matter are far from homogenous and the Commission may find increased Member State involvement in State aid policy formulation to be double-edged as countries float proposals that increase the Council's input into State control.

Looking forward, the control of State aid looks set to continue face many challenges in accommodating the disparate interests of firms and policymakers across a Community with widely varying economic traditions and levels of economic development.

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