

The European Commission's Policy Towards State Aid

The Need for Rigorous Competitive Analysis

State aid poses a threat to the single European programme. Without adequate controls industrial investment and production will continue to be distorted along national lines. Efforts to promote competition and free trade in the EU could easily be undermined, perhaps seriously, if Member States were to outspend each other in offering subsidies and other more subtle forms of state benefits to attract investment or to favour a company or group of companies.

At the other end of the spectrum state aid is bound to increase as a result of Monetary Union as governments deal with structural adjustments required by the move to convergence and the single currency. As a result the Commission can look forward to a growing and more complex caseload of increasingly contentious State interventions (loans, subsidies, guarantees, favourable regulation, state ownership).

EC rules governing state aid although an important part of European competition policy, differ in two important respects from the other competition law provisions of the Treaty of Rome - a much higher degree of political intervention; and a lack of detailed competition analysis.

A High Degree Of Political Intervention

The Commission's objective in state aid cases is to distinguish between aid which furthers a "legitimate" goal such as facilitating the development of particular economic activities or areas and those which merely distort competition between Member States.

Maintaining this distinction is made particularly difficult since the state aid provisions of the Treaty of Rome pit the Commission directly against national governments. For this reason, it is unsurprising that politics plays a larger role in the decisions than any other area of competition law.

Absence of Competitive Impact Analysis

Unfortunately, the Commission's approach to date does little to limit the degree to which politics affects decisions. The absence of an explicit framework or guidelines for the systematic assessment of competitive issues provides the latitude for politics to play a large and influential role.

The *ad hoc* nature of the Commission's decision making stems partly from its overly wide interpretation of the distortive impact of aid. Article 92(1) deems state aid incompatible with the common market if it distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods. The Commission supported by the Court holds that all aid distorts competition. This has meant that the Commission's current practice addresses two main questions: 1) Does the financial assistance constitute aid? 2) If so, does it qualify for an exemption under Article 92(3)?

Market Investor Principle

The first step to receiving aid is simply to assert the problem away by arguing that the government investment does not constitute aid. In this case, Article 92 does not apply and the Commission, the national government concerned and the recipient are happy. Unfortunately, the competitors to the recipient are not.

Determining whether financial injections constitute aid has led to the invention of the market investor principle (MIP). The idea of MIP is that if the terms on which the financial injection is made are similar to those terms on which a rational market investor would be willing to invest then the financial injection is not aid. This concept has led to a good deal of loose and unconvincing analysis and has begun to make a mockery of the one-time-last-time principle which the Commission has sought to implement.

The recent decision which allowed the Spanish airline, Iberia, to receive a state subsidy is a good example. The Commission argued that the financial injection would have been made by a rational private investor and did not therefore constitute state aid. In this way, the Commission neatly side-stepped a condition it had imposed on Iberia in an earlier decision which allowed Iberia to receive Pta120bn in 1992 provided that it received no further support before the end of 1996.

Article 92(3) Exemption

The second route admits that the government financial investment does constitute state aid but that it qualifies

under one of the "gateways" of Article 92(3). Here the Commission's reasoning often lacks coherence. In many cases, decisions do not prove that an aid can or cannot be exempted. Instead, the finding is asserted on the basis of unspecified criteria.

The Commission claims that competitive considerations play a significant part in the decision process, but the evidence suggests otherwise. For example, its approval of FF20 billion state aid to Air France, the Commission imposed a number of conditions on Air France which it considered necessary to prevent the aid from damaging its competitors. But the decision contain no competitive impact analysis nor does it state in general terms how the conditions it imposed would minimise the harm to competition.

Scope For Competitive Analysis

What is needed is rigorous and transparent assessments of the competitive impact of state aid, and a clear specification of "market failure" reasons which would exempt a state aid from the operation of competition rules. Decisions under Article 92 should identify in what ways competition will be distorted. Clearly, the term "distortion" implies that we are dealing in a counterfactual world: comparing today's outcomes with hypothetical outcomes tomorrow. This suggests a narrower interpretation of Article 92(1).

The competitive analysis should focus on how state aid affects competition in the industry in question. This requires a detailed analysis of the competitive constraints which operate in the industry including *inter alia* a definition of the relevant market and an assessment of barriers to entry and exit. In particular, state aid policy should focus on whether aid allows a firm to maintain its operations at levels above that which would prevail in the absence of aid.

The use of competitive analysis in state aid can be illustrated by two stylised examples based on recent decisions involving Volkswagen and Air France.

The "Volkswagen" Decision

Volkswagen plans to open a new car plant. It is considering two locations: the Czech Republic and Saxony. Wherever the plant is located, the definition of the relevant market shows that cars produced in the new plant compete with cars produced elsewhere in Western

and Eastern Europe. Saxony, at a commercial disadvantage owing to higher wage costs, offers Volkswagen a regional grant to locate in Saxony. Does such state aid distort competition? Not necessarily since in a competitive market additional capacity would be added in any event. The only issue is the location.

Of course, more complex issues would be raised if Volkswagen were also considering locating elsewhere in the European Union. State aid in this case would also have distributional effects. One possible solution would be to limit the amount of aid to the minimum required for Volkswagen to invest in the EU rather than outside.

The "Air France" Decision

The aviation industry is suffering considerable losses. Some airlines are in financial distress due to their inability to respond to the greater competition which liberalisation has introduced. Governments anxious not to see their flag carriers fail repeatedly pump in large amounts of state aid - each injection allegedly being on a one-time-last-time basis. Does this state aid distort competition? Almost certainly, since in a competitive market failing airlines would reduce their operations or even exit the market entirely. This is true regardless of the potential for future growth. State aid used to prop up airlines in financial distress therefore represents a distortion to competition.

The Way Forward

The Commission is in an invidious position. A partial solution is rigorous competitive analysis which limits the range and nature of arguments that can be made to justify aid. This has been recognised by the Commission which is currently drafting guidelines. By introducing competitive analysis, the Commission will be able to reduce the degree to which politics influences its state aid decisions. It will also introduce greater transparency and coherence into state aid cases, and limit the introduction of spurious "market failure" arguments which provide an alternative garb for political assistance to failing industries and firms. In this way, a balance of the costs and benefits to the Community can be adequately and openly examined.

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