EUROPEAN UNION LAW OF STATE AID

SECOND EDITION

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INTRODUCTION TO STATE AID LAW AND POLICY

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Main policy documents

State Aid Action Plan: Less and better targeted State aid: a roadmap for State aid reform 2005–2009 ('State Aid Action Plan'), COM(2005) 107 final

EU State Aid Modernization (SAM) ('State Aid Modernization Communication'), COM(2012) 209 final

Staff working paper: Common principles for an economic assessment of the compatibility of State aid under Article 87.3 (15 May 2009)

A. General Themes of State Aid Control

Overview. The purpose of this book is to set out the detailed rules for the application of European Union (EU) State aid control (both in its substantive and procedural aspects) by the Commission, European Court and national courts. These detailed rules are addressed in Chapters 2 to 20. Practitioners seeking an immediate answer to a practical problem should turn to those chapters. The aim of this chapter in contrast is to provide an introduction to the political and economic themes that have shaped the development of State aid law and practice within the EU over the last decades. After a brief overview of the history of State aid control policy, this chapter reviews the main reasons why States intervene in the economy and the rationale behind EU State aid control. It concludes with some general remarks on current practice in the application of the State aid provisions as well as a discussion of the avenues for reform. **1.01**

The Treaty provisions. The basic legal framework governing State aid control is set out in Articles 107 and 108 of the Treaty on the Functioning of the European Union (TFEU), **1.02**

of which the substantive rules are contained in Article 107. That provision is split into three parts:

(a) Article 107(1) sets out a general definition of aid that is *prima facie* incompatible with the internal market, ie aid provided through State resources that 'distorts, or threatens to distort, competition by favouring certain undertakings or the production of certain goods'.
(b) Article 107(2) lists the type of aid deemed to be compatible with the internal market, ie aids that have a social character granted to individual consumers, aids to make good the damage caused by national disasters or exceptional occurrences, and aid granted to certain areas of Germany affected by the division of that country.
(c) Article 107(3) allows the Commission the discretion to permit a number of other categories of aid for which any adverse effects are outweighed by other benefits.

1.03 **State aid as a European peculiarity.** The inclusion of State aid control in competition law provisions is a European peculiarity; no other jurisdiction or trade area has similar provisions. To some extent that is understandable; governments in individual countries are unlikely to want to constrain their own ability to grant aid in circumstances that they consider to be desirable or expedient, nor are they likely to want to cede sovereignty over such a sensitive issue to supranational institutions governing loose trade areas. But even in federations such as the United States, where a central authority imposes significant limits on States' powers, there is generally no federal control analogous to EU State aid control that limits States' abilities to compete with each other to grant subsidies.[1] The closest provisions to Articles 107 and 108 TFEU are the anti-subsidy provisions in the World Trade Organization (WTO), but those are more limited in scope and in enforcement regimes.[2] The reason why the EU equipped itself with such a unique State aid control regime has to do with the unique politics of the European integration project, and in particular with the political imperative of ensuring that national economic rivalry did not stifle the creation of the internal market that was and remains a central element of that project.[3]

1.04 **Genesis and evolution of State aid control.** The main rationale for including State aid control as part of the Treaty of Rome was to avoid State support for a national champion triggering retaliatory support from another Member State, which could ultimately result in a 'subsidy race', which might undermine the creation and functioning of the internal market.[4] The main concern at the time was thus the political damage to economic integration that subsidy races would create, rather than their economic efficiency. However, notwithstanding their genesis within the realm of internal market objectives, a concern to avoid distortions of competition was also built into the relevant Treaty provisions from the outset, and oversight over those provisions has (for the most part) been exercised by the Commission's Directorate General for Competition ('DG Competition'). The resulting mix of competition and internal

[1] See C K Head, J Ries and D Swenson, 'Attracting Foreign Manufacturing: Investment Promotion and Agglomeration' (1999) *29 Regional Science and Urban Economics,* 197–218 for a study of competition between US States to attract foreign investment.

[2] See Chapter 4.

[3] See eg speech of Vice President Almunia of 11 January 2013, 'Doing more with less—State aid reform in times of austerity: Supporting growth amid fiscal constraints', SPEECH/13/14; and C-D Ehlermann, 'State Aid Control in the European Union: Success or Failure?', (1994) *18 Fordham International Law Journal,* 1212.

[4] See W Mederer, N Pesaresi and M Van Hoof (eds) *EU Competition Law, Vol. 4 State Aid* (Claeys & Casteels, 2008) pp 26–8. To some extent this still remains a concern—see eg para 6.81 below on the 2014–2020 Regional Aid Guidelines.

market objectives has at times led to a confused policy. More recently, as economic integration has become more established, the emphasis of State aid control has shifted from internal market concerns towards policies centred around the efficiency of government intervention in the economy.[5] This evolution is, however, far from complete, and at the moment State aid policy is an eclectic mix of internal market (trade) policies, competition provisions and considerations of economic efficiency and fiscal discipline.

Political dimension. Unlike most of the other competition provisions, the EU State aid rules are addressed to and regulate the conduct of governments rather than companies. Because of this, they are more likely to interfere with national sovereignty and issues of national interest than other competition provisions. This gives State aid a very significant political dimension that is not lost on the Commission, which is also a political body. Thus the discourse between the two main actors (governments and Commission) is often more political than technical. This is compounded by the fact that third parties (beneficiaries or complainants) have limited procedural rights in State aid proceedings and thus are often unable to participate effectively in the debate between the government and the Commission. This political dimension has often been the basis for complaints that the State aid procedures are not transparent and predictable. It also infuses the Commission's State aid policy with more general political objectives, such as support to the green economy, the digital agenda, small and medium-sized enterprises (SMEs) and regional aid. **1.05**

A large number of complex rules. As discussed in more detail in the rest of this chapter and Chapter 2, the concept of aid under Article 107(1) has been interpreted broadly, with low thresholds for the requisite effect on competition and inter-State trade. This is tempered by wide-ranging exemptions under Article 107(2) and (3), which give the Commission ample discretion in approving aids. But it would not be acceptable for the Commission to maintain a general discretion as to the type of aid that is deemed compatible, because this would open the door to political pressure. In consequence, the Commission has adopted a large number of guidelines which specify in detail how an aid needs to be designed in order to be approved. This set of rules has the dual benefit of providing detailed guidance to public sector entities, and enabling the Commission to resist political pressure as much as possible. On the other hand, the level of detail in the guidelines and the need to maintain consistency with past decision practice has resulted in a rather complex system of rules that are not always coherent, particularly due to the changing policy considerations over time referred to at paragraph 1.04 above. **1.06**

State Aid Action Plan. The complexity and limited transparency of State aid rules was recognized by the Commission in its 2005 State Aid Action Plan, which sought to implement the Lisbon Strategy.[6] The State Aid Action Plan anticipated the need for the modernization of State aid control on the basis of four main objectives: less and better targeted State aid; a refined economic approach; more effective procedures and enforcement, greater predictability and transparency; and sharing of responsibility between the Commission and the Member States. In short, it set out a vision of simpler, more effective and transparent procedures for State aids which are efficient from an economic perspective. The Commission has sought to pursue this vision through the introduction of several instruments: a new *de* **1.07**

[5] See speech of Vice President Almunia of 11 January 2013, 'Doing more with less—State aid reform in times of austerity: Supporting growth amid fiscal constraints', SPEECH/13/14.

[6] State Aid Action Plan: Less and better targeted State aid: a roadmap for State aid reform 2005–2009, COM(2005) 107 final.

minimis Regulation, the General Block Exemption Regulation (GBER), the introduction of a simplified procedure for the approval of certain types of aid and a Code of Practice for the conduct of State aid control proceedings, a Notice on the enforcement of State aid law by national courts, and a number of revised Guidelines and Communications spelling out the State aid rules for specific sectors or objectives of common interest.

1.08 **State Aid Modernization.** The vision of the State Aid Action Plan was further advanced in 2012, when the Commission published its State Aid Modernization Communication,[7] launching a programme of further reform of the State aid rules. This initiative has three objectives: (1) facilitating aid that fosters growth and efficiency through the adoption of common unifying economic principles for State aid control, and the revision of the existing guidelines along these common economic principles; (2) focusing enforcement on larger, more distortive aid, in particular through an expansion of the Enabling Regulation allowing the Commission to declare further categories of aid exempt from *ex ante* notification (eg aid for culture and to cover losses from natural disasters), and a revision and planned extension of the GBER to cover the revised categories of aid included in the Enabling Regulation; and (3) streamlining the State aid rules and procedures.[8]

1.09 **A more economic approach to State aid.** A more refined economic approach to State aid has been considered an important tool to maximize the benefits of State aid, while minimizing its negative effects on competition and the internal market.[9] In particular, the State Aid Action Plan and the State Aid Modernization Communication focus on the concept of market failure and on its importance in justifying public intervention, as well as on the incentive effects of the aid, ie whether the aid is likely to bring about the changes in economic behaviour needed to tackle the market failure it is designed to address. The more economic approach to State aid has been implemented through the so-called 'balancing test', which weighs the positive effects of the aid (ie its contribution towards a goal of common interest) against its negative effects (ie distortions of competition and trade).[10] This balancing test was first introduced in the State Aid Action Plan and was subsequently enshrined in the horizontal aid guidelines adopted since then, such as the research, development and innovation (R&D&I) Framework (2006), the Risk Capital Guidelines (2006), the Environmental Aid Guidelines (2008), the Training Communication (2009) and the Employment Communication (2009).[11] The same approach is confirmed in the State Aid Modernization Communication as the tool to determine whether aid is 'good aid': 'Modernized State aid control should facilitate the treatment of aid which is well designed, targeted at identified market failures and objectives of common interest, and least distortive'.[12]

B. Why Governments Grant State Aid

1.10 **Governments, economic activity and State aid.** The economic activity of governments is significant. Over much of the twentieth century, the role of governments in the economy has gone

[7] EU State Aid Modernization (SAM), COM(2012) 209 final.
[8] See further paras 1.32–1.33, 3.38, 5.03, 18.03 and the Preface to this book.
[9] State Aid Action Plan, para 22.
[10] See Staff working paper: Common principles for an economic assessment of the compatibility of State aid under Article 87.3 (15 May 2009) for more details; and see further paras 3.29–3.30 below.
[11] See Chapters 8–11.
[12] State Aid Modernization Communication, para 12.

from marginal to central, as government spending in many Western European countries went from around 10% of gross domestic product (GDP) in the 1870s to over 40% in the 1970s.[13] Much of that increase has been due to the emergence of the welfare state, which developed in Europe between the 1950s and the 1970s. The introduction or extension of pension schemes, universal health coverage, and access to education has been the primary driver of the increased economic role of the State. This was in addition to the more traditional role of the State as a provider of security and key infrastructure. Quite obviously, however, not all government expenditure can be considered State aid. Indeed in 2011, excluding crisis aid, State aid accounted for only 0.5% of EU GDP compared to overall public expenditure of 49.1% of EU GDP.[14] This is because, so far, the largest categories of public spending have not been regarded as involving economic activities subject to State aid control. For instance, direct provision of infrastructure (such as roads or bridges) is subject to the public procurement rules but not generally to the State aid rules; pensions and social security, health, defence, public order and education are considered social (as opposed to economic) services and thus again are not generally captured by the State aid rules. However, over time these sectors have started to open to market participants. As market mechanisms become more established in these areas, an increasingly large number of services may become subject to the State aid rules. But until that happens, State aid control will maintain its traditional focus on the small portion of government spending that is accounted for by support for productive activities (mainly industry and services).

Why governments grant State aid. Notwithstanding the comments above, State aid does **1.11**
remain a politically important instrument for governments to intervene in their economies. Governments often grant State aid in order to benefit their own enterprises at the expense, among others, of rivals located in other Member States. Governments can favour their own enterprises in many ways, for example by subsidizing their exports, paying for their R&D, imposing import tariffs, and offering attractive terms to foreign investors. Although typically an expensive exercise, this type of subsidy can create benefits for the national economy. A larger share of industry profits will be earned domestically, and other sectors of the economy may also benefit by supplying inputs, sharing the benefits of a more skilled workforce, and so on. In the long term, however, subsidization of this nature may be economically wasteful if it results in inefficient subsidy races. On the other hand, State aid may increase economic welfare in two main ways: by improving *efficiency* when the market fails to deliver an optimal economic outcome, and—depending on social and political preferences—by improving *equity*, when the market outcome is characterized by significant socio-economic inequality. In non-technical terms, the efficiency objective is commonly referred to as 'making the pie larger', while the equity objective is commonly referred to as 'sharing the pie fairly'.

Efficiency rationale. Where the market alone fails to provide the optimal level of a good or **1.12**
service, a more efficient outcome can be achieved by removing the market failure,[15] possibly through the use of State aid. In other words, the quantity produced and consumed of a particular good will be inefficiently low or high in the presence of market failures, and State aid measures that address those market failures can bring about an expansion in economic activity (or a reduction in a negative element of economic activity), which can deliver an improvement in economic welfare.

[13] See J Hindriks and G Myles, *Intermediate Public Economics* (MIT Press, 2006), Chapter 3.
[14] Eurostat and State aid Scoreboard—Autumn 2012 update, COM(2012) 778.
[15] For a definition of market failure, see J Ledyard 'Market Failure' in S Durlauf and L Blume, *The New Palgrave Dictionary of Economics* (2nd edn, Palgrave Macmillan, 2008).

1.13 **Sources of market failures.** The Commission's recent policy documents discuss four main sources of market failures in particular: externalities, imperfect information, coordination problems, and public goods:

(a) *Externalities* are aspects of transactions that affect economic agents other than those who take the investment, production or consumption decision. As such these wider 'external' effects to society at large will not generally be taken into consideration by a private investor when deciding how much to invest, produce or consume. This implies that private actors—disregarding external effects on other actors—will generally invest, produce or consume too little or too much from a public interest perspective.[16] Thus correction of externalities can offer an improvement in efficiency that increases overall social welfare, and thus can justify State aid.[17]

(b) *Asymmetric or imperfect information* can also be a source of under-provision of a certain good or service and thus require State intervention to be rectified. In general, when there is incomplete information (eg when a bank is unwilling to make a loan to a low-risk customer because it cannot be sure from the available information that the customer is indeed low-risk), the market will not achieve an efficient outcome.

(c) *Coordination failures* arise when economic agents fail to coordinate to achieve a mutually beneficial outcome. For instance, two products that are used together may each need to be widely available in order for them to be valuable to consumers. In this situation, if the producers of the different products cannot coordinate on releasing their respective products, the outcome might be that neither product is marketed. A coordination failure may thus prevent products for which a demand would exist from reaching the market.

(d) *Public goods* are goods which can be enjoyed without reducing the amount available to others (non-rivalry in consumption) and which cannot be provided selectively to certain members of the public only (non-excludability).[18] Because of the (economic) impossibility of excluding non-paying agents, the market will always tend to provide an inefficiently low quantity of public goods, and State intervention may help achieve a more efficient provision of those goods.

1.14 **Equity rationale.** In addition to its efficiency rationale, State aid is often justified on the basis of equity considerations. The equity motive for State intervention concerns the redistribution of resources in order to reflect the preferences of society in terms of wealth distribution. Thus, provided that its positive effects are felt in less developed regions or by socially disadvantaged groups, aid can be justified on the basis of considerations about equity and social cohesion. Equity considerations often provide the main rationale behind regional aid, employment aid, rescue and restructuring aid and certain types of aid for services of general economic interest. However, the discussion of equity issues in the Commission's policy papers is relatively short and high-level.[19]

[16] A common example of a positive externality is investment in basic (non-patentable) R&D. This benefits everybody but the inventor is unable to appropriate the return from these benefits, so the market will deliver too little basic (non-patentable) R&D from the point of view of society as a whole.

[17] Note that externalities result in market failures only if there are *incomplete markets*. An efficient economic outcome would be attained even in the presence of externalities, if everything could be traded that is valued by an actor in the economy and involves interaction with one or more other actors.

[18] Although pure public goods are relatively rare (eg policing, free-to-air TV, a beautiful landscape, or clean air), various goods present characteristics of non-excludability (eg open water and fisheries), and are called *common goods*.

[19] See eg Staff discussion paper: Common principles for an economic assessment of the compatibility of State aid under Article 87.3 (15 May 2009).

1.15 **Political economy considerations.** The economic literature on political economy suggests that the magnitude and focus of public spending is determined by the interaction between actors with different preferences over the level of government economic activity (with less affluent stakeholders typically preferring more government intervention and more affluent ones less).[20] Governments will therefore tend to choose the level of economic intervention (including State aid) that ensures re-election. While the outcome of this process can often be characterized as 'democratic', in that it emerges from democratic decisions, it is not necessarily economically efficient from the point of view of society as a whole. There is also the risk that powerful and determined stakeholders may influence the political process to achieve an outcome which is even less efficient for society as a whole. Political economy considerations have been advanced by commentators, including a previous Commission Chief Economist, as an explanation for why State aid control may be a useful tool in resisting pressure from special interest groups of powerful and determined stakeholders, and in this way in avoiding 'wasteful' public spending and in delivering a more efficient economic outcome.[21]

C. The Aims of EU State Aid Control

1.16 **Avoiding wasteful subsidy races.** The original rationale for imposing EU oversight on State aid was to prevent countries from deliberately using State aid to benefit their own enterprises at the expense of rivals located in other Member States. If a country subsidizes national producers of goods for which there is international trade, similar subsidies may be granted in retaliation by other countries, which in turn creates an escalation in the level of subsidies and ignites a potentially wasteful subsidy race. But while it is clear that the avoidance of subsidy races was a political imperative at the time when the internal market had to be built and national protectionism had to be abandoned, it is less clear whether such an objective is still imperative now that the internal market is established. Recent economic thinking is less critical towards subsidy races, for two main reasons. First, not all State aid results in subsidy races, since State aid to undertakings active in markets that are essentially national or regional does not substantially affect trade. Secondly, not all subsidy races are wasteful, as sometimes a subsidy race may be seen as a market-oriented mechanism (ie an auction between governments) to determine the most efficient location of a production facility.[22] The modern economic literature on international trade shows that subsidy races are likely to be wasteful only when product markets are not competitive; there is significant trade between Member States but fairly limited trade with countries outside the EU; and beneficiaries' locations are fixed or their location decisions create limited positive spillovers for the economy.[23] However, the Commission's current approach rarely takes account of the extent to which the aid is likely to result in wasteful subsidy races or indeed in any effect on trade

[20] See T Persson and G Tabellini, *Political Economics. Explaining Economic Policy* (MIT Press, 2000), pp 115–58.

[21] Friederiszick, Röller and Verouden, 'European State Aid Control: An Economic Framework' in P Buccirossi (ed), *Handbook of Antitrust Economics* (MIT Press, 2008) p 652.

[22] T Besley and P Seabright, 'The Effects and Policy Implications of State Aids to Industry: An Economic Analysis' (1999) 14 *Economic Policy* 13–53.

[23] T Besley and P Seabright, 'The Effects and Policy Implications of State Aids to Industry: An Economic Analysis'; see also P Krugman, *Geography and Trade* (MIT Press, 1991).

at all. Instead, EU State aid control has largely refocused on promoting economic efficiency and budgetary discipline.

1.17 **Avoiding distortions of competition.** A traditional view of State aid is that it distorts competition by interfering with the level playing field on which companies compete, with the potential consequence that less efficient companies can account for an inefficiently large share of output. More importantly, State aid may distort the competitive process by crystallizing inefficient industry structures; it may crowd out private investment; it may reduce effective competition by increasing market power or by reducing the incentives to compete; it may distort production and location decisions across Member States; and it may foster overly risky or otherwise inefficient behaviour. These distortions of competition may result in various types of market inefficiencies. It is useful to distinguish between static (allocative or productive) inefficiencies and dynamic inefficiencies:

(a) The traditional distortion of competition considered in State aid analysis is the *static* productive inefficiency arising from allowing inefficient players to survive and to maintain their market share. The focus on this type of distortion is often tinged by non-economic 'fairness' considerations, such as maintaining a level playing field.[24] However, recent economic commentary (also to some extent reflected in the Commission's policy papers) has highlighted that from a static perspective the distortions caused by State aid are often relatively modest. Thus, by subsidizing production, State aid tends to expand output and to allow more companies to survive. So from a purely static perspective, State aid can bring about an increase in economic efficiency by offsetting the effects of market power; the more concentrated the market, the more State aid may be efficient, especially if directed to smaller undertakings or new entrants.[25]
(b) On the other hand, State aid may distort the dynamics of the competitive process: aid may help perpetuate failed business models; it may reduce the incentive to compete; and may create moral hazard by encouraging excessive risk taking. These effects are likely to be more serious and long-lasting than mere distortions of the level playing field. In particular, moral hazard is a key concern. An implicit promise of future aid may affect firms' incentives by protecting them from the adverse consequences of their risk-taking, thereby fostering overly risky behaviour. Repeated State aid may eventually create the expectation that certain undertakings are 'too big to fail' (or too politically important to fail), and thus perpetuate overly risky or inefficient business practices.

1.18 **The recent focus on dynamic distortions.** Historically, considerations of fairness and maintaining a level playing field have often been the main element of the Commission's analysis of distortions of competition in the context of State aid policy. In the last few years, however, the Commission's policy statements have started focusing instead on the potential negative

[24] Consistent with this focus on maintaining a level playing field, the Commission traditionally considers that horizontal aid (aid concerning schemes potentially benefiting all companies) is less likely to distort markets than sectoral aid (aid targeted at specific industries or sectors). In line with this clear preference on the part of the Commission, over time there has been a significant shift away from sectoral aid: in 1992 sectoral aid accounted for 48% of EU State aid, whereas in 2011 that figure was only slightly above 10%: see Staff working document, 'Facts and figures on State aid in the EU Member States' SEC(2012) 443. Figures exclude aid for agriculture, fisheries and transport.

[25] This is because, by subsidizing production, State aid may actually reduce one pervasive market failure: market power. Although the Commission has stated that the reduction of market power is not an acceptable goal for State aid, from an economic perspective it is a market failure like any other.

effects of aid on producers' incentives, ie dynamic distortions. This development is consistent with the refined economic approach where aid is judged on the basis of efficiency considerations, rather than fairness. More importantly, as noted by economic commentators since the publication of the State Aid Action Plan, it is essential that a distortion of competition analysis should focus on the aid's dynamic effects on incentives and market structure, as opposed to the standard static effects of distortion of the level playing field, which often do not appear to be significantly or even unequivocally harmful.[26]

1.19 **Avoiding wasteful government spending.** Over time, the analysis of effects on trade has also become less important, as the focus of EU State aid policy has moved away from internal market considerations and towards concerns of budget discipline.[27] This focus is evident in the State Aid Modernization Communication, where budgetary considerations are prominent.[28] The balancing test at the heart of the Commission's more economic approach to State aid crystallizes the shift from trade control to budget control, by focusing on the efficiency of State intervention (ie whether it offers economic value for money) while omitting a requirement that State aid should only be deemed incompatible if it negatively affects trade. From this perspective, the Commission's role in the implementation of State aid control is no longer a form of 'internal WTO', but has become, in large part, that of a financial controller with special responsibility for subsidies. While this is consistent with current case law and the stated political objectives of the State Aid Action Plan and the State Aid Modernization Communication, several commentators have perceived this as a potential encroachment on Member States' fiscal and spending policies.[29] The question therefore arises whether the Commission should be a financial controller, or whether Member States should be responsible to their electorates for curbing wasteful spending that does not have clear deleterious effects on inter-State trade. A possible argument in favour of the Commission's role is that it is often politically very difficult for Member States to refuse aid. Thus Member States might welcome the intervention of the Commission, preventing them from squandering fiscal resources on doubtful State aid schemes.[30] This may explain why Member States accept the Commission's supervision on government spending which poses limited or no threat to the internal market.

1.20 **Conclusion: State aid policy in development**. State aid control currently covers only the very small part of overall public spending that involves (direct or indirect) subsidies to specific economic activities. However, as more and more traditional non-economic activities of the State are opened to market mechanisms and market participants, and as State aid control branches out from its initial internal market niche to encompass broader efficiency and fiscal discipline considerations, State aid control has the potential to become a significantly more far-reaching instrument. In recent years the Commission has been reconsidering its State aid

26 See eg P Heidhues and R Nitsche, 'Study on Methods to Analyse the Impact of State Aid on Competition', *European Economy*, European Commission Economic Papers, No 244, February 2006.

27 See Buelens et al, 'The Economic Analysis of State Aid: Some Open Questions', *European Economy*, European Commission Economic Papers, No 286, September 2007, pp 5–6 and 8.

28 State Aid Modernization Communication, paras 5, 12 and 14.

29 See eg C Kaupa, 'The More Economic Approach—A Reform based on Ideology?' [2009] EStAL 311–22.

30 See M Dewatripont and P Seabright, 'Wasteful Public Spending and State Aid Control', (2006) *4 Journal of the European Economic Association*, 513–22; M Monti, 'Quelques aspects politiques et pédagogiques du contrôle des aides', (2008) 3 *Concurrences* pp 4–5; D Spector, 'Le Rôle de l'Analyse Économique dans la Politique des Aides d'Etat', (2008) 3 *Concurrences*, pp 8–10; and para 1.15 above.

rules to prepare for this potential expanded role of State aid control. The two main pillars of the Commission's retooling are a more streamlined and efficient process for distinguishing 'good aid' from 'bad aid', and a more coherent economic approach to State aid which balances the benefits of government intervention in the economy with the potential distortions of market incentives. While this efficiency-based approach is sensible from an economic perspective, it is a long way from the original purpose of Articles 107–8, and there is continuing debate about the extent to which the Commission should be using the State aid rules to intervene in Member States' fiscal and budgetary decisions.

D. Implementing State Aid Policy

1. The Article 107(1) prohibition

1.21 **The general prohibition.** Pursuant to Article 107(1) TFEU, the Treaty prohibits State aids that distort or threaten to distort competition by favouring certain undertakings or the production of certain goods insofar as they affect trade between Member States. However, in certain circumstances, aids will be permissible if they promote a legitimate objective in a proportionate manner. This section considers in more detail some aspects of the definition of aid. Section 2 below addresses the approval of aid under Article 107(2) and (3).

1.22 **Definition of State aid.** The classical form of State aid is a direct subsidy to an undertaking. However, there is a wide range of other government actions that can constitute State aid. To constitute aid, a State measure under scrutiny must exhibit certain characteristics. These are examined in detail in Chapter 2, to which reference should be made. In overview, however, the defining features of a measure that falls within Article 107(1) are as follows:

(a) The measure must confer an *economic advantage* on the recipient that it would not have received under normal market conditions. If, by contrast, a Member State provides funding to an undertaking at the same conditions as the market, then the funding does not constitute State aid. This is a key distinguishing factor between State aid and State investment or compensation in a wide variety of measures, including not only capital injections and loans but also asset sales, payments for public services, State guarantees and even fiscal measures.
(b) The measure must entail an actual or potential use of *public resources*. This does not, however, require an actual transfer of resources as such, or an overall loss to the State budget.
(c) The measure must be *selective* by relating to particular undertakings or to a particular type of product. General fiscal and economic measures will not constitute State aid, while measures that benefit certain undertakings over comparable undertakings may satisfy this condition. In certain circumstances, even a measure applicable to a whole sector may be selective.
(d) Finally, the measure must be liable to distort competition and affect trade between Member States.

1.23 **Distortion of competition and effect on trade.** The requirement to show that the measure is at least liable to distort competition and affect inter-State trade is the condition that articulates the reason for prohibiting aid in principle, and thus the most important condition from an economic standpoint. However, the Court's case law establishes a very low threshold for the fulfilment of this condition. There is no requirement to show that State aid will lead to consumer harm (which is what is normally intended by 'distortions of competition' in other areas of competition law), and there is not even, in practice, any need for extensive analysis showing a material distortion to the level playing field. The basic test for a distortion of competition is limited to establishing whether the recipient of the aid is strengthened (for example because its costs were reduced) compared to others competing in intra-EU trade. However, it is not necessary to define the relevant market, or confirm that there are direct competitors at all (a measure benefiting a whole sector can be aid); there is no need to show that the impact is substantial or that it negatively affects consumers; and indeed the goods and services for which competition is distorted need not be the ones affected by the aid.[31] Instead, the selectivity of the aid has traditionally been considered to imply a distortion of the level playing field, and thus of competition; and that distortion of competition in a market in which there is inter-State trade has traditionally been sufficient to find a potential effect on trade. From an economic standpoint, however, the selectivity test is an inadequate screen for distortions of competition and effects on trade, and in particular for dynamic distortions of market incentives, as in many circumstances such distortions are not related to whether the measure is selective. This lack of rigorous analysis of distortions of competition and effects on trade has led many commentators to call for reforms that would require a more robust analysis of the potential for a State measure to distort competition in order to limit the scope of the prohibition.[32] This request is consistent with the Commission's recent focus on evaluating the actual effects of particular aids, an element which was conspicuously absent from previous State aid analysis.[33]

Commission and Court response. The Commission's State aid reforms in both the State 1.24
Aid Action Plan and the State Aid Modernization Communication have ignored the calls to refocus the application of Article 107(1) by strengthening the analysis of distortion of competition. One possible reason is that the wide scope of the provision has arisen as the European Court has sought to empower the Commission against the resistance of Member States.[34] The Commission is also reluctant to limit the application of Article 107(1) because the status quo, combined with the discretion the Commission enjoys in applying Article 107(3), gives it a unique role in harmonizing the goals that Member States pursue in their aid policies.[35] The result is a wide prohibition of aid with a very low jurisdictional threshold. Insofar as the concept of aid has been subject to judicial limitations, these have been confined to the other State aid conditions and have occurred on a fairly piecemeal basis,[36] without any coherent economic rationale.

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[31] See generally paras 2.140–2.152 below.

[32] Papandropoulus et al, 'Selectivity, Economic Advantage, Distortion of Competition and Effect on Trade' in J Derenne and M Merola (eds), *Economic Analysis of State Aid Rules—Contributions and Limits* (Berlin, 2006), p 123; C Ahlborn and C Berg, 'Can State Aid Learn from Antitrust? The Need for a Greater Role for Competition Analysis under the State Aid Rules' in Biondi, Eeckhout and Flynn (eds), *The Law of State Aid in the European Union* (OUP, 2004) pp 51–4; and Friederiszick, Röller and Verouden, 'European State Aid Control: An Economic Framework', pp 656–60.

[33] Evaulation in the field of State aid, Issues paper of 12 April 2013.

[34] Blauberger, 'From Negative to Positive Integration?', *Max Planck Institute for the Study of Societies*, Discussion Paper 04/04 (2008), p 8 and references therein.

[35] See Blauberger, 'From Negative to Positive Integration?'.

[36] See eg the insistence in Case C-124/10 *Commission v EDF* (judgment of 5 June 2012) on a rigorous private investor analysis, even (in appropriate cases) for fiscal measures; the demarcation of non-aid elements of public service compensation in Case C-280/00 *Altmark* [2003] ECR I-7747; the adherence to a formal State resources criterion in Case C-379/98 *PreussenElektra* [2001] ECR I-2099; and the exclusion of certain regional tax measures from Article 107(1) under the principles developed in Case C-88/03 *Portugal v Commission* [2006] ECR I-7115 and Cases C-428–434/06 *UGT-Rioja* [2008] ECR I-6747.

2. The derogations in Article 107(2) and (3)

1.25 **Distinction between Article 107(2) and (3).** If a government measure is found to be State aid under Article 107(1), it can still be approved if it satisfies the conditions of Article 107(2) or (3). The exemptions in Article 107(2) are mandatory; if the aid falls within one of the categories specified therein, the Commission is required to approve it and has no discretion. The purpose of these exemptions is to declare lawful three specific categories of aid; social aids to individual consumers, disaster aid and aid compensating for the cold war division of Germany. The vast majority of cases, however, are assessed under Article 107(3), for which the Commission has a wide discretion. While Article 107(3) specifies a number of categories of aid that may be approved, covering regional, horizontal and sectoral aids, the underlying principle is that measures falling under that provision should help achieve an objective of common interest.

1.26 **The objectives of common interest**. The range of potential objectives of common interest is very broad. Sometimes they are inspired by economic efficiency and aim to support consumer welfare and the efficient allocation of resources (as when they are targeted at market failures). But common interest objectives may also promote a wider set of social and political objectives beyond strict economic efficiency, such as sustainable growth, competitiveness, social and regional cohesion and environmental protection.[37] Thus the common interest includes an economic efficiency dimension (efficient functioning of markets), an equity dimension, and any other political objective the Commission is particularly keen on (such as Europe 2020 or the Digital Agenda). The Commission's role in deciding whether an aid is justified by an objective of common interest gives the Commission a tool for what has been called 'positive integration'; rather than merely preventing actions that harm competition, the Commission's discretion under Article 107(3) gives it the ability to influence the aid policy of Member States.[38] In the State Aid Action Plan the Commission announces its intention to use this tool in order to further the goals of the re-launched Lisbon Strategy for growth and jobs, and in the State Aid Modernization Communication the Commission emphasizes the role of State aid in promoting sustainable growth and in contributing to the Europe 2020 objectives.

1.27 **A more effects-based approach**. Identifying an objective of common interest is not, however, sufficient for the approval of State aid under Article 107(3). Rather, the Commission's shifting emphasis to considerations of (in particular) economic efficiency has been reflected in its policy objective of moving from a form-based approach towards a more effects-based approach which emphasizes the economic implications of State aid. As indicated in the State Aid Modernization Communication and in other policy statements,[39] the centrepiece of the modernized approach is the adoption of common principles applicable to the assessment of compatibility of all the aid measures carried out by the Commission. These common principles are based on the balancing test referred to at paragraph 1.09 above.

[37] State Aid Action Plan, para 10.

[38] See Blauberger, 'From Negative to Positive Integration?', p 7.

[39] See State Aid Modernization Communication, para 18(a), and the speech of Vice President Almunia of 11 January 2013, 'Doing more with less—State aid reform in times of austerity: Supporting growth amid fiscal constraints', SPEECH/13/14.

Balancing test. The balancing test has three stages.[40] First, it considers whether the aid is aimed at a 'well-defined object of common interest'. This can include both efficiency objectives (typically, market failures) and equity objectives. The justification for government intervention on both of these bases has been discussed in detail in Section B above. Second, the test considers whether the aid is a 'well-designed instrument' with which to deliver the objective identified above. This encompasses three issues: (1) whether aid is an appropriate policy instrument, as opposed to alternatives such as regulation, direct provision of goods or services, or fiscal instruments; (2) whether the aid is likely to bring about the desired change in the behaviour of the beneficiary; and (3) whether the aid is proportional to the problem tackled. Finally, the potential negative effects of the aid (ie its distortive effects on competition and trade) need to be considered and weighed against the positive effects of achieving the objective of common interest. The balancing test thus uses cost-benefit analysis as a means of identifying which State aids fall under the derogation in Article 107(3). 1.28

Secondary legislation and guidelines. While the Commission has set out its approach to the balancing test as a general tool for the application of Article 107(3), the detailed application of Article 107(3) to the approval of the various specific types of regional, horizontal and sectoral aid is set out in a significant body of secondary legislation and soft law comprising block exemptions guidelines, frameworks, communications and notices, which are not always consistent with the general economic framework of the balancing test. Indeed, as the Commission notes in its recent Evaluation Issues Paper, the current secondary legislation does not focus on the actual economic impact of the aid, but rather on a set of predetermined criteria that are assumed to result in positive effects.[41] This extensive body of soft law is motivated by the goals of encouraging particular policy choices by Member States when directing their State aid spending, providing clear guidance to Member States, and enabling the Commission to resist political pressure from Member States. Absent the various block exemptions and guidelines, the wide discretion of the Commission in applying Article 107(3), and the controversies about what constitutes 'good' aid, could leave it exposed to lobbying by particular Member States based on their specific political situations. Of course, this is still bound to occur on occasion.[42] But by limiting its discretion through the use of legislation and soft law, the Commission has limited the scope for such pressure.[43] 1.29

Guiding the aid policies of Member States. The Commission's success in using secondary legislation and soft law as a means of strengthening its position with respect to the Member States has allowed it to pursue an increasingly positive agenda for determining the aid policies of Member States. As noted above, this is sometimes referred to as 'positive integration'.[44] This has been demonstrated, most clearly, in the new approach to State aid policy set out in and pursued since the State Aid Action Plan, and reaffirmed and extended in the State Aid Modernization Communication. This in turn makes it easier for Member States 1.30

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[40] See Staff discussion paper: Common principles for an economic assessment of the compatibility of State aid under Article 87.3 (15 May 2009) for more details; and see further paras 3.29–3.30 below.

[41] Evaluation in the field of State aid, Issues paper of 12 April 2013, p 2.

[42] Particularly in the highly sensitive context of rescue and restructuring aid: see Chapter 12 generally, and Chapter 17 on the particular issues that have arisen in the financial services sector.

[43] Blauberger, 'From Negative to Positive Integration?' See also N Pesaresi and M Van Hoof, 'State Aid Control: An Introduction' in Mederer, Pesaresi and Van Hoof (eds), *EU Competition Law, Vol IV State Aid* (Claeys & Casteels, 2008), para 1.34.

[44] Blauberger, 'From Negative to Positive Integration?'.

to give aid in such a way as to limit (or entirely eliminate, in cases falling within one of the block exemptions) the burden of a State aid investigation. The policy choice to limit discretion and provide extensive guidance about how the Commission will perform compatibility assessments perhaps reflects the view that the benefits to governments of speedy and certain confirmations of their State aid policies outweigh the costs of some inevitable errors and inconsistencies.

3. Continuing reform

1.31 **Continuing form-based rules.** In the past, the proliferation of block exemptions and guidelines, and the rigid way in which the guidelines have often been applied, has led to a 'pigeon-holing' approach, ie fitting the aid into the right guideline 'box' based only on its form and analysing it on that basis, leading to errors and inconsistencies.[45] But the use of secondary legislation and guidelines does not in itself preclude a more modern effects-based analysis of whether an aid is compatible with the Treaty. What matters is whether the rules set out within the legislation and guidelines are based on an economic analysis of the probable effects of particular classes of aid on welfare and efficiency, or whether instead the rules reflect judgments that particular types of aid are undesirable regardless of their effect on the market. Since the State Aid Action Plan many horizontal and sectoral guidelines have been updated, and the more economic effects-based approach features in the general principles of the new guidelines. However, perhaps because of the perceived need to maintain consistency with past practice, when the revised guidelines move from general principles to practical applications, the link with the more economic approach sometimes becomes tenuous and the assessment often falls back to using traditional form-based rules that are not always consistent with the new refined economic approach.

1.32 **The efforts towards procedural simplification.** The Commission accepted in the State Aid Action Plan that the proliferation of different guidelines, and the inevitable inconsistencies, had gone too far.[46] However, it remained committed to providing governments with extensive guidance about how Article 107(3) will be applied. While the revisions of the guidelines after the State Aid Action Plan have attempted to reduce the scope for inconsistencies, the Commission accepts that there is a need for further modernization and simplification of the State aid rules.[47] The approach taken by the State Aid Modernization initiative is one of procedural simplification (particularly for State aid which is unlikely to create significant distortions to competition) by means of revisions to the Procedural Regulation, a review of the *de minimis* Regulation, and (as noted at para 1.08 above) revisions to the GBER and a possible extension of its scope to cover further categories of aid.

1.33 **The search for unifying principles.** Alongside this procedural simplification, the State Aid Modernization initiative commits the Commission to continue in the process of revising the existing guidelines in light of the common principles of the more refined economic approach to State aid, as embodied in the balancing test.[48] Having started with the new Broadband Guidelines (adopted in December 2012[49]) followed by the 2014–2020 Regional

[45] See C Ahlborn and C Berg, 'Can State Aid Learn from Antitrust?', pp 47–8; and Friederiszick, Röller and Verouden, 'European State Aid Control', p 630.
[46] State Aid Action Plan, para 17.
[47] State Aid Modernization Communication, para 22.
[48] State Aid Modernization Communication, paras 18(a) and 27.
[49] See Chapter 15.

Aid Guidelines (adopted in June 2013[50]), this process of further revision is (at the time of writing) intended to encompass revisions to the Rescue and Restructuring, Risk Capital and Environmental Aid Guidelines, revisions to the R&D&I Framework, and new aviation guidelines.[51]

Trade considerations, still missing in action. The area in which the Commission's modernized approach to the economic effects of a State aid remains the most disappointing is the assessment of the impact of an aid on trade, or at the very least an account of why effects on trade should not play a material role in State aid control. The new approach hardly mentions effects on trade, relying on the broad presumption that State aid given to an undertaking operating in a market (either as a buyer or a seller) in which there is intra-EU trade would automatically affect trade. As explained above, this exacerbates the confusion as to what State aid control is intended to achieve. **1.34**

Concluding remarks. By stating that it wants to base the analysis of compatibility of an aid on a review of its costs and benefits, the Commission has taken a clear step in the direction of a more coherent economic effects-based approach to State aid control. However, while the guidelines reviewed after the 2005 State Aid Action Plan take this approach into account in their general principles, they also continue to embody a number of simplifications and presumptions derived from past practice and case-law. This is because the development of these guidelines inevitably reflects some of the same pressures that have shaped the existing approach; a desire to resist political pressure through pre-commitment, a desire to provide certainty to notifying Member States, the goal of maintaining consistency with past decisional practice, and the reality that the Commission still lacks the investigative powers needed to conduct its own analysis, so that precise guidelines become a tool for eliciting relevant information from notifying Member States.[52] The Commission's current modernization initiative and the further revision of the guidelines over the next few years should move State aid assessment closer to the more economic approach envisioned by the Commission, leading to decisions that are significantly more grounded in the economic and financial analysis of effects than before. There is now a clearly articulated conceptual framework that identifies a number of substantive points that need to be established, where economic and financial analysis can provide the most credible evidence. This will doubtless continue to be developed over the next years. **1.35**

[50] See Chapter 6.

[51] See speech of Vice President Almunia of 11 January 2013 'Doing more with less—State aid reform in times of austerity: Supporting growth amid fiscal constraints', SPEECH/13/14. Details of the Commission's current timetable, so far as this is known, are set out in the Preface to this book.

[52] The Commission's ability to conduct sophisticated effects-based analysis continues to be limited by the fact that the Commission lacks the ability to gather the necessary data, a problem that is not addressed in the State Aid Action Plan or the State Aid Modernization Communication, but may be addressed by the forthcoming revisions to the Procedural Regulation: see paras 18.07 and 18.70 below.