Reforming state aid policy to best contribute to the Lisbon Strategy for growth and jobs

Thibaut KLEINER, Directorate-General Competition, State Aid Coordination and Policy Unit

Since she took up the mandate of Commissioner in charge of Competition, Neelie Kroes has made no secret that she plans to reform state aid policy. To some extent, reforming state aid is a logical step following the other comprehensive reforms undertaken under Commissioner Mario Monti’s tenure in the field of antitrust and merger control. In addition, with the re-launch of the Lisbon Strategy after five years of disappointing results, state aid policy has gained a specific relevance. There is today a unique opportunity to improve both the rules and the procedures of state aid policy. With the objective of less and better targeted state aid, state aid policy can be used pro-actively to contribute to revamp European economies, and to promote a more efficient use of public money. On the 7th of June 2005, the Commission launched a consultation document, the State Aid Action Plan, to get views about how to best conduct this reform.

State aid can be justified for a series of legitimate political reasons, and notably for equity reasons (ex: social and regional cohesion, cultural diversity) or to increase economic efficiency. This paper focuses on the latter aspect and elaborates on the key concepts that could shape the reform of state aid policy, so that it best contributes to economic efficiency, thus supporting growth and employment.

1. The Lisbon Strategy: less and better targeted state aid

The revived Lisbon Strategy refers to a broad range of objectives and policy tools initially defined in the European Council conclusions of Lisbon in 2000, ultimately with the ambitious strategic goal ‘to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion’. It covers a package of reforms mutually reinforcing one another: product and capital market reforms; investment in the knowledge-based economy; labour market reforms; social policy reforms; and environmental reforms.

The Lisbon Strategy has recently been re-launched, at mid-term, by the Commission and the March 2005 European Council, with a clearer focus on growth and employment. The new Lisbon Action Programme, designed by the Commission, focuses on ten priority areas: 1) effective internal market; 2) free and fair trade; 3) better regulation; 4) improving European infrastructure; 5) investing in Research and Development; 6) boosting innovation; 7) creating a strong industrial base; 8) more and better jobs; 9) adaptable workforce; 10) better education and skills.

As regards state aid policy, successive European Councils have translated the objectives of the Lisbon Strategy into a generic formula: ‘less and better targeted state aid’. The abstract objective of less and better targeted state aid should not be understood as a mere rhetoric against state intervention in markets. It reflects in fact the basic experience that state aid (i.e. 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 firms or the production of certain goods) can be very detrimental for the economy.

State aid distorts competition and may prevent it from creating the right incentives for business to become more efficient and to innovate. To that extent state aid ought in principle to be kept to a minimum. This should not, however, be misunderstood as a request that state intervention in all its forms has to be reduced. Most state interventions (e.g. education, defence, security, taxation, public services) do not come under the legal definition of state aid, because they are not selective or do not distort competition and trade. State intervention can therefore promote competitiveness and avoid loosing the benefits of competitive markets. To that extent, less state intervention in the form of state aid that distorts competition follows the objectives of the Lisbon Strategy.

Better targeted state aid reflects the idea that the choice of state aid as the right policy instrument should be made with great care. Governments do not always have all necessary information to make the right decisions when using tax-payers’ money for state aid. They may be subject to political pressure, to lobbying, and fail to see the problems with giving state aid. It is in the governments’ own interest, however, and in the interest of European citizens, to target state aid well, and make the best
use of taxpayers’ money. In particular, the Spring 2005 European Council calls for a redeployment of aid in favour of support for certain horizontal objectives such as research and innovation and the optimisation of human capital, as well as the reduction in regional disparities.

The principle of less and better targeted state aid is therefore fully in line with the modern concept of competition policy: not as an end in itself, but as an instrument to improve the benefits from a free market economy. Competition policy rests upon the idea -comforted by experience- that competition creates incentives and sanctions for market participants to improve their efficiency and to innovate, in order to provide consumers with the products they wish to obtain, at low prices. Preserving and promoting competition is therefore the key to obtain economic efficiency, which in turn leads to competitiveness, growth and employment.

State aid policy can contribute to the Lisbon Strategy in a dual way. First, by controlling state aid that distorts competition, it makes sure that the benefits of competitive markets are preserved. Second, by encouraging Member States to target state aid better, it can improve the functioning of markets and therefore improve the competitive dynamics, thereby increasing economic welfare. This is the case when markets do not function optimally, e.g. because market players do not sufficiently take into account some side-effects of their actions. Insufficient investment in environmentally friendly technologies or in R&D is a typical consequence of this. State intervention, either in the form of general measures or in the form of state aid, may be needed to improve a situation where competition is unlikely on its own to produce efficient outcomes. State aid can change the incentives of the market players so that they do take such side-effects into account and an efficient outcome is obtained.

State aid may also be needed when market forces produce undesirable results -for instance social or regional inequality- to correct the action of well-functioning markets, thereby fulfilling the equity objective of state aid.

2. Specificities of state aid policy

In 1998, in a seminal economic analysis of the effects of state aid (1), Besley and Seabright underlined that state aid policy was probably the least well understood domain of competition policy. To a great extent, unfortunately, this statement has remained valid and the tremendous academic and professional interest for antitrust and merger control over the last five years has not been matched so far in the case of state aid policy. State aid policy has a number of specificities that are worth reminding.

First of all, state aid policy is about controlling Member States and not undertakings. Article 87 of the EC Treaty prohibits 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 firms or the production of certain goods in so far as it affects trade between Member States. The Treaty has given the Commission the task to monitor proposed and existing state aid measures by Member States to ensure that they do not distort intra-community competition and trade to an extent contrary to the common interest. It falls under its responsibility to make sure that the level playing field would be maintained between Member States, no matter their different levels of resources and their different traditions of state intervention in the markets. This is all the more important e.g. in the context of the liberalisations foreseen in the Lisbon Strategy: by delaying reforms and protecting incumbents through state aid, some governments can not only damage the competitive dynamics in their own market, but also harm competitors from Member States having undertaken reforms, thus reducing the benefits of the reform agenda everywhere.

The State Aid Scoreboard, for instance, shows that there are important variations in the way Member States intervene in the economy. It is clear that European governments have different traditions of economic governance, different levels of overall taxation and different scopes and sizes for their public services. The Treaty does not ask the Commission to judge upon Member States’ use of their public funds. Instead, the Commission has been given the exclusive responsibility to assess those state measures which distort competition and trade between Member States. In that process, the Commission has to balance the negative effects of state aid in terms of distortion to competition and trade with its positive effects in terms of common interest for the Union.

Almost 50 years of state aid law have resulted in a fairly broad definition of state aid. Jurisprudence has led to qualify a measure using state resources as state aid almost as soon as it favours some undertakings, the additional criteria of distorting or threatening to distort competition and affecting trade being almost always presumed fulfilled. The efforts of the Commission to limit this concept to those measures having a significant impact on competition and trade have not so far been translated into legal terms.

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However, the Treaty explicitly allows exceptions to the ban on state aid where the aid has a beneficial impact in overall terms. State aid may be declared compatible with the Treaty provided it fulfils clearly defined objectives of common interest and does not distort intra-community competition and trade to an extent contrary to the common interest. The Commission has a wide discretion for deciding when state aid shall be compatible with the common market. The Treaty has provided a series of areas where state aid shall be authorised; these exceptions relate notably to social distress, natural disasters, social and regional cohesion, public services and transport infrastructures, cultural diversity and economic development. However, nothing prevents the Commission to elaborate on its own interpretation of the common interest, in what regards state aid.

Contrary to notably merger control, where the Commission’s guidelines have clearly established that the test for authorising or prohibiting a concentration should use a consumer welfare standard, state aid policy has not so far elaborated a clear welfare standard to judge upon authorising an aid measure. In the short run, state aid generally leads to harm to competitors, and not to consumers who may benefit from e.g. subsidised (and thus lower) prices. In the long run, however, state aid reduces the incentives to increase efficiency and innovate and harms consumers too. There is an additional geographical dimension to these effects, since governments act in a given territory. This adds complexity to measuring the effects of the aid measure, since consumers outside the region where the aid is given could be penalised already in the first stage (1).

In the context of the Lisbon Strategy, it might be useful to put forward principles as to when state aid best serves the objective of fostering growth and jobs. This way, Member States will be encouraged to partner with the objectives of the Strategy, by clearly understanding which types of aid are most likely to be authorised and by thus favouring these types of aid. More specifically, it can be considered that the common interest in relation to the objective of growth and jobs is best realised when state aid improves the functioning of markets, by correcting situations where markets fail.

3. Market failures as justification for state intervention in favour of growth and jobs

In economic terms, a market is said to work efficiently when it is not economically possible to improve the outcome of the market process for some stakeholders without harming some other stakeholders. A market failure is consequently a situation where the market does not lead to an economically efficient outcome.

Market failures have different origins, and notably: externalities (situations where actors do not take full account of the consequences of their actions on other actors in society); public goods (goods which are beneficial for society but which are not normally provided by the market given that it is difficult or impossible to exclude anyone from using the goods); imperfect information; coordination problems and market power. In such cases, market forces on their own are not capable to produce an efficient outcome. This is the reason why, for instance, fundamental research (which is to a large extent a public good) is typically not sufficiently provided by markets, which tend to focus on development activities that can be rapidly profitable.

Governmental action, which fully exploits the potential of the market economy to create efficiency, is more likely to reach the objectives of the Lisbon Strategy, and to bring growth and employment. To generate growth and jobs, a careful analysis of the performance of markets in the EU ought to be made. In general, less state aid and a sound competition policy shall reduce the market failure linked to market power. But in addition, governments may consider clearly identifying the situations when markets on their own do not deliver economic efficiency, and target state aid to these areas. In case of a market failure, the idea is to only intervene to improve the performance of the markets -in certain cases through state aid- and not to harm the market forces. One may even argue that governments may not want to intervene when there is no need to do so, because their own actions could then do more harm than they bring benefits, and could destroy efficiency.

When it is clear that markets are failing, and that state intervention can improve the functioning of the markets, this could be a justification for state aid relating to the Lisbon priorities (2). However, the existence of a market failure is not a sufficient condition for aid approval.

(1) For instance, competitors to the aid beneficiary could be constrained to increase their prices outside the territory where the aid is given, in order to be able to match the subsidised pricing of the aid beneficiary there.

(2) In addition, it is worth reminding that state aid that does not address a market failure, but rather social and regional cohesion or cultural diversity, can also be authorised, provided the advantages in terms of common interest outweigh the harm for competition.
4. Criteria necessary to authorising state aid

The success of the Lisbon Strategy depends inter alia on governments’ ability to design the most appropriate state aid measures and the Commission is willing to facilitate this process. In the refocused Lisbon Strategy, the common interest relates to fostering more efficient markets, leading to growth and jobs. From the Commission’s practice, it is possible to develop criteria outlining when state aid serves this common interest and should therefore be authorised.

Correcting market failures

The first element to foster growth and jobs consists in targeting state intervention towards correcting market failures. Demonstrating the presence of a market failure should be done effectively, so that it is fully appreciated whether intervention is justified. Paying lip service to vague market failures without conducting economic analysis is of limited valued here. In order to guarantee that a measure adds to the functioning of markets, it has to be targeted on a well-defined market failure. The central question to ask is why markets do not deliver an efficient outcome. Referring to broadly defined policy objectives is unlikely to be sufficient to isolate the reasons for the malfunctioning of the markets and hence, to ensure the effectiveness of the intervention. It is only when the sources of the market failure are identified that an effective policy instrument can be chosen and a sustainable effect on markets can be expected. To that extent, it is generally considered that aid to schemes in favour of R&D, innovation, training, risk capital and environmental activities typically feature market failure issues. Accordingly, well-targeted state aid measures in this field could have a positive impact on the market. By opposition, aid to individual firms in difficulties or without a clear horizontal objective may less clearly or not at all address market failures.

State aid is the right instrument

State intervention to correct market failures can take many forms and state aid is only one of them (1). Member States may deem it necessary to carefully examine what policy instrument is the best response to the market failure, and make sure that their intervention will really improve the matter.

In approving state aid measures, the Commission may want to know whether the Member State concerned has explored other and less competition-distorting policy instruments.

Incentive effect

A second important element for designing and authorising state aid for the Lisbon Strategy, is that the aid measure is effective and can bring the expected results. State aid can change the incentives of the aid beneficiaries and therefore induce a change of behaviour, possibly then resolving the market failure and leading to a better outcome.

For instance, it is well accepted that there is a market failure related to the funding of small innovative firms like start-ups, because investors do not have sufficient visibility to precisely assess the risk level and the pay-off potential of these firms. Transaction and agency costs result in making the investment in these firms unprofitable. By giving aid to the investor (e.g. a risk capital fund), it is however possible to compensate these specific costs related to a well-defined market failure, which then makes the investment profitable and induces the investor to approve a funding that would otherwise be turned down.

The success of the aid measures relates to the incentive effect it creates for the beneficiary of the aid in changing behaviour in a desired way. State aid that clearly fails to produce incentive effects will not have beneficial effects while possibly maintaining their distortive impact. The design of the aid measure should aim at maximising the incentive effect. To that extent, guarantees or conditional aid measures may sometimes have a better leverage than direct grants.

Proportionality

A third and related criteria relates to the proportionality of the aid meaning that all its components are necessary for the aid to achieve the desired effect and that it is well targeted to the problem addressed. This criteria is also linked to the choice of state aid as the right policy instrument. For this to be assessed one could for instance analyse the counterfactual: what would be the market outcome without state intervention? Sometimes market failures are temporary; they tend to have different degrees of severity, depending on the type of undertaking concerned. Often, the market itself is able to design the appropriate corrective mechanisms. In order to be acceptable, an aid measure may therefore have to be limited in time, or to differentiate between, for instance, large and small companies, or between regions. Also, the amount of the aid should be designed as to precisely match the intensity of the market failure. In short, the design of the state aid measure should be thought through, before it can be approved by the Commission.

(1) regulation, general taxation measures, direct state intervention are other possible options.
The positive impact of state aid for the Lisbon Strategy depends therefore on: i) how well a market failure is identified; ii) whether the incentive effect is sufficient and iii) whether it is proportional to the problem addressed. These criteria, taken together, show the ability of the aid to improve the functioning of markets. This positive effect has to be balanced against the negative impact of state aid on competition and trade.

Minimising distortions to competition

The fourth criteria that the Commission considers before approving state aid is to ensure that the distortion of competition is kept at a minimum. Even if a measure targets a well-defined market failure it could result in excessive market power, barrier to entry, foreclosure in the market at stake or in other markets, sometimes to the point that its overall impact is negative. National governments may not take into account European wide negative spillover effects. Before authorising state aid, the Commission will have to make sure that the distortion to competition is kept to its minimum and that it does not contravene to the common interest.

It makes sense to evaluate and measure the distortive effects of an aid. Not all forms of state aid are likely to distort competition or to affect trade in an appreciable way. The level of distortion of an aid depends on: i) procedural aspects of the granting process, ii) market characteristics and iii) the amount and type of aid instrument. The design of an aid measure should therefore not only take into account the effectiveness of the aid in terms of incentive effect and necessity; it should also take into account the possible harm to competition. The criteria for choosing the beneficiaries of a given aid measure should preferably follow an open, transparent and non-discriminatory procedure, in order to limit distortions of competition by unduly favouring some undertakings. In general, this means that a non-discriminatory scheme is preferable to aid granted to a single undertaking.

The level of distortion of competition depends on the nature of the recipients and on the market structures where they operate. Subsidising an already dominant company — in addition to questioning the existence of a significant market failure — seriously runs the risk of encouraging predatory and anti-competitive behaviours, and thus be very detrimental for competition. State aid in an oligopolistic market may also increase the risks of collusion between market players, e.g. by allowing the recipient to retaliate and discipline maverick players. Therefore, aid to large firms should, in particular, be critically assessed on an individual basis, due to their potential influence on the market. In addition, aid measures that facilitate market entry should be preferred over those that favour incumbents with market power. For instance, state aid in recently liberalised sectors, like in the telecommunications sector or postal sector may prevent the benefit of liberalisation to materialise if it targets incumbents to the detriment of newcomers.

The amount and intensity of aid is also clearly a factor in the degree of harm to competition. If the aid amount is small or the aid intensity is low, the distortion of competition is likely to be limited. State aid support to activities far away from the market will be less detrimental than support to activities closer to the market or to competitive activities. Depending on the form of the aid (e.g. direct subsidy, tax reduction or guarantee) the measure of the aid amount and intensity may differ. In addition, some forms of aid may be less prone to damage competition (ex: refundable loans may be entitled to higher intensity levels than direct grants). Investments in infrastructures can often remedy market failures better than subsidies to firms, without distorting competition.

Finally, state aid should not result in crowding out of private initiative. Public bodies may act as commercial entities in a number of markets. State aid to them may be justified, e.g. in case of a given market failure preventing the optimal provision of products or services. However, the amount of aid should be well tailored and should not have as a result that private entities operating on the same market are consequently unable to compete with public entities, with the result that the market does not develop and/or is not competitive.

Balancing the positive and the negative elements

The final act relates to the Commission's decision making in balancing the positive and negative impacts of the aid measure. Only if these four criteria are fulfilled — i) targeting of market failure, ii) creating the right incentives, iii) necessity of the aid and iv) distortion of competition to the least possible extent — can a lasting contribution of the aid measure be expected. A measure targeting the Lisbon objectives of growth and jobs shall be declared compatible only if the overall balance is positive, indicating a better functioning of the markets without significant negative effects on the functioning of markets and hence, an increase in European welfare is induced by the measure.

5. Putting the principles into practice

As announced in the State Aid Action Plan, the Commission is looking for comments on the right principles that should guide its reform. Some
principles have been put forward in the precedent paragraphs, with a specific focus on the objective of increasing economic efficiency. However, such principles will only have an impact if they are implemented in the rules and practice of state aid policy.

State aid control operates at two levels. First, the Commission may receive notifications for individual aid or for aid schemes, so that it can decide if the measure is state aid and shall nevertheless be authorised. In the process, the Commission has explained that it intends to consistently follow the general principles and criteria to balance the positive and negative impacts of a state aid measure, in line with the jurisprudence of the Courts. Second, the Commission establishes ex ante rules, which set out when some measure may qualify as state aid, and under which conditions the Commission may authorise the aid. Such rules may also specify which measures do not have to be notified, using Block Exemption Regulations. It makes sense that the assessment of state aid measures is in line with their likely degrees of distortion to competition.

The criteria developed above are to some extent already reflected in the present rules, however without always being explicit — since they are rather based on practical experience. The reform of state aid policy could be an opportunity to clarify the rules and to simplify them as well. In addition, the Commission could work at improving the practice and procedures of state aid, to make them more efficient and to reduce the administrative burden. There are, however, limitations to the degree of sophistication that the Commission’s assessment can reach in practice.

First, most of the aid measures are awarded within aid schemes. In these cases the beneficiary is not known at the time of notification, limiting the potential for the Commission to analyse in-depth the effect of the aid scheme on individual markets. Ex-post monitoring and obligations to notify individually for some groups of beneficiaries are possible elements of an improved assessment by the Commission.

Second, there are limitations to the possibility of quantifying the effects, both positive and negative, of an aid measure. Balancing the benefits and the distortions of competition will always incorporate some form of qualitative judgement. The reform of state aid policy should advance the economic thinking underlying the Commission’s decision-making process and could try to develop a more rigorous approach towards the design of aid measures, in partnership with Member States. In any case, the simple attempt to try and justify state aid through economic analysis has the potential to improve the clarity and transparency of state aid policy.

Third, the concept of market failure has to be made tangible before it can be applied. The sources of the market failure have first to be identified clearly and to be put into context. Not all problems identified in the market are automatically market failures. Before advocating for state intervention, it should be clarified what a normal result of the market is and what a real market failure is. Then, not all market participants may be affected by the market failure in the same way. Typically, large established multinationals are generally less affected than start-ups. This implies that diversity among beneficiaries have to be taken in consideration. In the future, the Commission may want to develop methodologies and guidelines in that respect, if Member States have not done it already. In any case, experience and past practice already provide useful examples of well-targeted measures.

Finally, the reform offers the opportunity to improve the design of state aid instruments, notably by making more explicit and understandable the various rules. Current state aid guidelines are built on years of experience and they have developed conditions (intensity levels, types of recipients, bonuses etc…) to optimise the efficiency of the aid, and to limit its detrimental effects on competition. In revising the rules, state aid reform could attempt to be more specific about such provisions as aid intensity bonuses, differentiation according to the recipient, intensity levels to obtain the expected results, demonstration of an incentive effect, etc.

**Conclusion**

It is an on-going challenge to develop economic principles into state aid policy and to gear it towards supporting the Lisbon Strategy for growth and jobs. There is today a unique opportunity to make state aid policy as coherent and understandable as the rest of competition policy. In its reform of state aid policy, the Commission has to further develop principles and criteria to support an effective design and authorisation of state aid measures. The *State Aid Action Plan*, in that respect, could mark the beginning of a new development in state aid policy. The success of such a process will however require a partnership with Member States and their full support, because they are ultimately in charge of designing the state aid measures that could contribute to growth and employment. In addition, a successful contribution of state aid policy to the Lisbon Strategy will require improving the procedures of state aid to make it more efficient and less cumbersome.