

State aid and distortion of competition

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It is a great honour and a pleasure to be here with you and I would like to thank the Competition Commission for its generous hospitality and for hosting this great event.

I would also like to use the opportunity to express my esteem for the great work the Commission, its chairwoman, the other board members and its staff have been doing to fight obstacles to competition in Pakistan and to put the authority on the map as a strong and effective competition enforcement agency.

The European Commission is one of the very few competition authorities that have powers allowing it to vet the granting of government subsidies to companies (or “State aids” as we call them in the EU). Over the years, State aid control has become an important instrument in the Commission’s competition toolbox.

I am therefore happy to have an opportunity to discuss EU State aid policy with you today.

Perhaps it is useful to start by clarifying what we mean by the concept of “State aid”. This term is very similar to the WTO concept of “subsidies”. It covers all forms of financial transfers from state bodies to public or private companies that give these companies an advantage over their competitors.

State aid control is a very interesting, challenging line of business. It raises as many complex technical issues as antitrust or mergers control. In addition, though, State aid control is politically sensitive, as it is touching upon one of the core competences of governments of sovereign states, namely the power to tax and to spend the proceeds as these democratically elected governments see fit.

I would like to cover three main topics in my introduction:

- Why do we have State aid control in the EU?
- How is State aid control carried out in the EU?
- What have been the effects of EU State aid control

Effects of State aid - Rationale for EU State aid

Let us turn to the first question: what is the rationale for State aid control in the EU?

Apart from the fact that subsidies can be a waste of tax payers money, there are two main reasons why we control state aid in the EU.

The first reason is that subsidies have a potential to be economically very harmful. Intuitively we can all understand why subsidies can harm our economy by distorting competition.

If a government subsidizes company "A", and not its competitors, this company will be able to take a larger share of the market than it would have had in the absence of that subsidy. So company "A" would do quite well on that market, even if it was far less efficient than its competitors who did not receive any aid.

If company "A" would have easy access to subsidies, it would feel less of need to compete on merit. It would not have a strong incentive to improve the efficiency of its operations or to invest in product or process innovation. If the market in which company "A" was operating would be an expanding market, its competitors might not mind so much, as there would be sufficient room for everyone to earn a decent profit. However, if company "A" were to operate in a declining market, the subsidies could very well enable it to drive much more efficient competitors out of the market altogether.

There are also other dangers. For example, if company "A" knows that it will always be able to rely on a government bail out if things go wrong, this company will be less inclined to adopt difficult measures required to become more efficient. It may also encourage that company to take excessive risks in the knowledge that profits will be privatised, whilst losses would be "socialised". This is what is referred to as the problem of "moral hazard".

Even subsidies that are not directed at individual companies, but at

broad input categories (such as energy, capital or labour) can be harmful. Such subsidies will distort price signals and make that the prices for the subsidised inputs, as perceived by economic actors, will deviate from real cost-based prices. This leads normally to a sub-optimal combination of production inputs.

The fact that subsidies have the potential to distort competition in a very significant manner may provide governments with a good reason to introduce State aid control, but why should this be done by the EU, rather than by national governments? And this brings me to the second reason why we have State aid control in the EU, namely to protect the internal market.

When Member States decided to create a common market without any barriers to trade, they understood that they needed to introduce strong disciplines to ensure that competition and trade within the internal market would remain fair and undistorted. They also understood that fair and free competition can be distorted not only by the abusive behaviour of public or private companies, but also by government interventions, such as subsidies. This is why they were keen to put in place effective safeguards to prevent individual governments from giving domestic companies undue advantages over competitors from other Member States.

We can easily see therefore that there are many potential downsides to subsidies.

However, at the same time, as the recent banking crisis showed all too well, markets do not always function in an optimal manner, nor does free and unregulated competition always deliver desirable outcomes.

Markets can sometimes "fail". They sometimes produce outcomes that are inefficient. Economic literature provides plenty of examples of different types of so-called "market failures". The most obvious example is probably the failure of market prices to internalise externalities. This is

most obviously the case in the environment, but also in R&D investment or company spending on the training of employees.

In addition, markets may sometimes fail to deliver results that society considers to be desirable or fair. One obvious example is the failure of markets to produce a socially desirable level of regional income equality.

The existence of market failures provides a rationale for government intervention in the market. Governments can intervene in many ways, and the granting of subsidies to companies can, in some cases, be an effective way to overcome such market failures.

EU State aid control system

The founding fathers of the EU recognised this duality. This is why they included provisions on the control of subsidies in the competition chapter of the original Treaty of Rome. According to article 107 of the Treaty, subsidies that distort competition are prohibited unless, they are targeted at specific objectives of EU interest and distortions of competition and trade are kept to an acceptable level.

The Treaty places the responsibility for the control of State aids in the hands of the European Commission as an independent supra-national authority. Member States are required to notify any aid they intend to grant to the Commission. The Treaty also gives the Commission the power to order a Member State to recover any aid that was granted in violation of State aid rules. And the Commission regularly uses this power at the moment. I can reassure you that this is an effective deterrent.

In the past, the Commission's approach to the control of State aid was relatively legalistic and formalistic. However, as in antitrust and mergers, the Commission has gradually moved towards a more effects-based approach and increasingly relies on a substantive economic analysis in the assessment of aid measures notified by Member States.

In recent years, the central objective of our state aid control system has been to eliminate "bad State aid measures" – namely aid measures that are considered to be very distortive – and to encourage Member States to reorient their aid systems to so-called “horizontal measures”, which target specific market failures, such as environmental aid, aid to promote R&D, training, regional development, etc.

Let me now give you a brief overview of the way in which we examine aid measures.

In our assessment of State aid measures, we basically ask ourselves three questions:

- (1) Is aid measure aimed at clearly defined objective of common interest ?
 - a) Does it address a market failure (environmental aid)?
 - b) Does it contribute to equity objective (regional aid)?
- (2) Is the aid well-designed to deliver the objective?
 - a) Is a subsidy an appropriate instrument?
 - b) Will the aid change firm's behaviour (“incentive effect”)?
 - c) Could the change of behaviour be achieved with less aid (Proportionality)?
- (3) Are the distortions of competition and trade limited so that the overall balance is positive? When assessing this question, we take into account a number of factors, including :
 - a) Access to aid (Selection process of beneficiaries)
 - b) Aid characteristics (amount of aid, duration, repetition)
 - c) Market power of beneficiaries
 - d) Market characteristics (structure, capacity utilisation,

exit/entry barriers)

- e) Dynamic incentives of companies (incentive to invest, innovate, ...)

I think these three questions are relevant questions. And not just relevant in the specific EU internal market context, but also for anyone who is concerned about the effectiveness and efficiency of public support to enterprises.

Of course the Commission does not have the resources to make a detailed competition assessment of each individual aid measure contemplated by our 27 Member States. Over the years we have therefore codified the above assessment criteria in a set of guidelines and regulations covering different categories of aid. All of these are published, as are our reasoned individual State aid decisions. This transparency provides predictability and legal certainty for MS and undertakings.

Effectiveness of EU State aid control

The question we can ask ourselves is whether EU State aid control has also been effective?

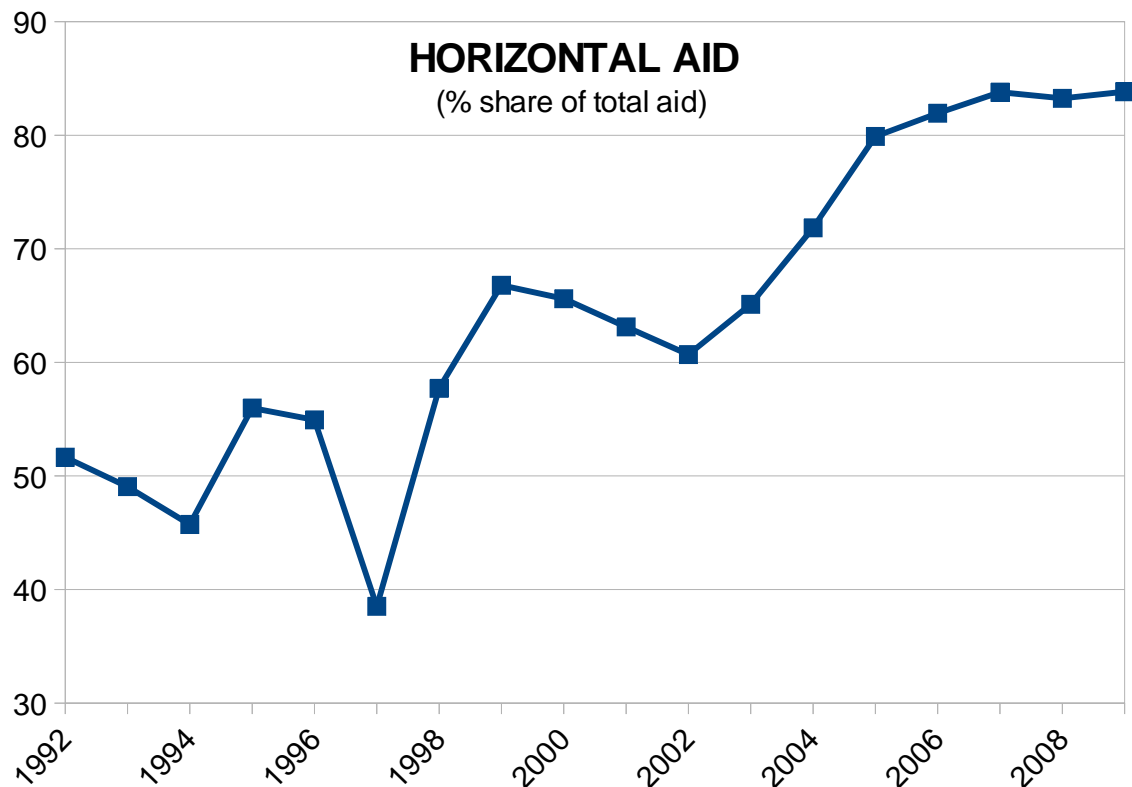
This is a difficult question. And personally, I think not enough has been done to measure the effectiveness of EU State aid control policy. It is certainly an area in which we should do more work.

But anyway, let us look at a few elements.

As I mentioned, the main objective of our policy is to limit “bad aid” and encourage Member States to reform their state aid systems and move towards more horizontal aid focusing on clearly defined market failures.

The data available suggest that, at least with respect to this objective, EU State aid policy appears to have been quite successful. As the graph

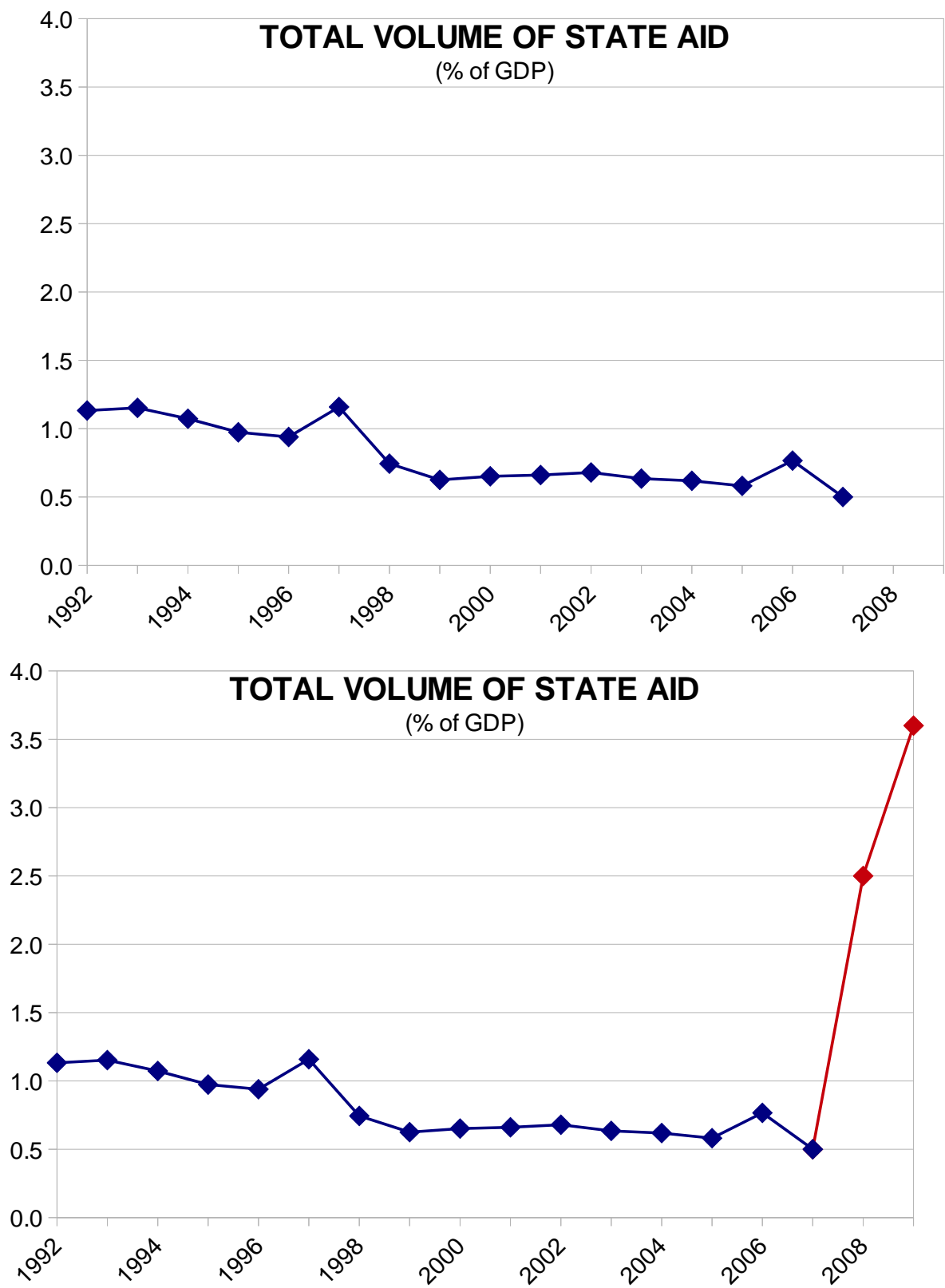
shows, the share of horizontal aid in the total amount of aid granted by Member States increased from around 50% in the early 1990s to well over 80% in recent years.



Also with respect to the second objective, namely to limit the total volume of State aid granted in the EU, we registered some success in the 1990s and early 2000s. The total amount of aid granted to industry and services declined from well over 1% of GDP in the early 1990s to around 0.5% of GDP in 2008 (although some observers would attribute this decline more to the need of Member States to meet the budgetary criteria for membership of the Euro-zone than to the disciplines imposed by EU State aid control).

However, the progress made until 2008 towards limiting the volume of State aid in the EU was undone by the banking crisis in 2008. As you can see, in the wake of the financial crisis, the total amount of aid increased sharply from 0.5% of GDP in 2007 to 2.5% and 3.6% in 2008 and 2009. The increase is entirely due to the consequences of the financial crisis. Indeed, if the crisis related aid to the banking sector is

excluded from the figures, the total volume of aid would still be at around 0.5% of GDP.



Unwelcome as it was, the banking crisis also showed that it would be very unwise to introduce a total prohibition of State aid. If it had not been for the willingness of governments to bail out the banks in 2008 and 2009, we may well have witnessed a complete meltdown of our financial system.

Some research has been done in recent years on the benefits of State aid control. Some examples to illustrate this:

In a 2003 study on Foreign Direct Investment, Charlton concluded that the EU State aid control regime may have limited wasteful subsidy races between EU Member States and regions to attract FDI by imposing geographical restrictions on investment aid, capping maximum allowable aid intensities and increasing transparency¹.

In a paper published in 2008, Mulas-Granado et al (2008) suggested that the conditionality imposed by EU State aid policy facilitated economic reform in transition economies of central and eastern European countries².

The sharp increase in the volume of State aid granted in the EU in response to the financial crisis has often been used as a proof of the weakness of the EU State aid control system. In a paper for the American Antitrust Institute on the role of the EU State aid control system in the banking crisis, De Vito came to the opposite conclusion. It is worthwhile quoting some extracts from that paper, as it summarises quite well some benefits of State aid control. In his 2011 paper, De Vito said the following: “The Commission worked ... to facilitate the orderly and transparent release of aid with the least anticompetitive outcomes ... The Commission placed meaningful limits on bailout measures in order to prevent healthy, less aided banks from becoming unduly dis-

¹ A. Charlton, Incentive bidding for mobile investment, OECD Working Paper 23, 2003

² C. Mulas-Granados et al., Reforming government subsidies in the new Member States of the EU, IMF Working Paper, 2008

advantaged. In addition, it explicitly dealt with the issue of moral hazard... Unlike the EU, where competition enforcers “sat at the head of the table” during the crisis, competition enforcers in other jurisdictions were absent from the table when crisis policy decisions were made... Therefore [lawmakers] should draw upon the most effective aspects of the EU model and, ultimately” incorporate competition policy and competition enforcers in future crisis proceedings”³.

Concluding remarks

I think we would all agree that the core task of competition policy is to eliminate undue distortions of competition in order to allow markets to function properly.

In the EU, we believe that markets can be distorted not only by the anti competitive behaviour of companies, but also by distortive State interventions, including state subsidies.

This is why the EU has integrated State aid control as key instrument in its competition toolbox. We need State aid control to protect competition in our economies, but also to maintain the integrity of the internal market. We also believe it allows us to improve the quality of public expenditure by ensuring that subsidies are properly targeted on market failures and proportional.

A final question I would like to address is whether the EU experience can also be relevant for other countries such as Pakistan?

Professor Spencer tried to answer that question in his report to the OECD’s Competition Committee⁴

He recommends countries or country groupings to adopt a State aid control policy implemented by an independent authority

³ J. DeVito, The role of competition policy and competition enforcers in the EU response to the financial crisis, AAI-Working Paper nr 11-01, 2011

⁴ OECD Competition Committee, Competition, State aid and subsidies, Background Note, 2010

He concedes that it would be unrealistic to expect sovereign governments to accept that independent bodies would control their power to tax and spend. But according to him, it would even be useful for competition authorities to provide opinions on the competition effects of subsidy measures adopted by governments.

He also mentions a number of criteria that should be used to assess aid measures:

- 1) Require demonstration that aid is targeted at market failure;
- 2) Require demonstration that there are no other more effective ways to address the market failure;
- 3) Limit magnitude and duration of aids, and the ability of the same recipient to be granted subsidies on a regular basis;
- 4) Conditionality for aid to companies in difficulty (for example divestment, own contribution, ...);

Finally, he believes that far more work should be done to improve transparency on the granting of subsidies to undertakings. Because transparency is essential to make sure that the true hidden costs of public subsidies to undertakings is brought out, that capture by governments by vested interests is revealed and that the tax payer can make up his or her mind whether subsidies granted by his or her government are providing value for money!