European State aid policy in search of a standard. What is the role of economic analysis?

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Abstract

In the early years of enforcement of antitrust and of State aid in Europe, given the integration objectives that the European Treaty pursues, fairness seemed the most natural standard to choose. In antitrust it took more than forty years to convince the Commission and the Courts of the soundness of the effect based approach. By enhancing the role of economic analysis, the objective of the 2005 State Aid Action Plan was to modernize State aid policy. Unfortunately the Commission did not go as far as suggesting that distortions of competition be noticeable before a State measure is declared incompatible. As a result, EU policy continues to be over extensive addressing cases where the distortions of competition are minimal. This is particularly the case for restructuring aid, where the effects of the aid on competition are hardly analyzed in the Commission decisions. In these cases the restoration of the healthiness of the firm is the final objective of the aid. However the Commission, while often authorizing the aid, tries to overcome moral hazard by attaching a number of very intrusive conditions to its authorization decisions (prohibition of reducing prices before a competitor does, introduction of capacity or sales caps, etc). These conditions reduce, not increase, the possibility of these companies to successfully restructure. Moral hazard can only be eliminated by not allowing the aid, not by constraining the company from competing. Finally when the anticompetitive effect of the aid is only indirect, restitution of the aid requires a very difficult calculation of the added value of the aid on the market equilibrium. A very complex calculation to be performed and hardly capable of being established by a Court. A new and different criterion should be devised for sanctioning indirect aid.

1. Introduction

When competition is discussed in political debates there is often a tendency to present it as an either or solution: either there is competition or there is not. This is why promoters of competition are often depicted as ultra liberals that for every problem have only the free market solution. This is not at all a true picture. The idea underlying competition advocacy is that inter-firm rivalry is vital to ensure that consumers enjoy freedom of choice, low prices, and good value for money, while also serving as an important driver of innovation and productivity improvement. Such rivalry is to be maintained as much as possible, accepting regulatory restrictions only in so far as they are strictly necessary to achieve public policy objectives. Competition therefore is not at all an either or option, but it is always a matter of degree, with regulation constraining the set of admissible conduct that competitors are allowed to follow. For example rivals cannot go as far as physically threatening competitors, or not complying with safety rules, environmental regulations, or the tax code, etc.

However, as Olson (1982)[1] argues, special interests all gain by a reduction in rivalry and are always willing to unite to impede the entry of outsiders. On the other hand, losers from such

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1 See Olson, Mancur (1982) *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, New Haven:Yale University Press.

restrictions are scattered across society, each losing a minimal amount. Only by organizing their own coalitions losers might be able to counterbalance the action of the protectionist lobbies. However such coalitions are difficult to come about since, contrary to the protectionist lobbies, each individual loses a very small amount from the lack of rivalry and does not have an interest to unite to avoid protectionism. Furthermore, special interests have a dominant interest in one subject, their income, while the rest of society pursues a number of differentiated goals. This is why the voice of consumers is seldom heard in the political debate.

In Olson's (1982) analysis, free trade, the opening of markets, thorough changes in the social order, political upheavals, wars and destructions are all events that tend to eliminate existing distributional coalitions, making it easier for competition to operate to the benefit of consumers and of society at large. However, the problem with these structural shocks is that, except for free trade, they are exceptional and cannot be relied upon as a disciplining device. Furthermore, free trade, which at first glance seems to be quite a general instrument, is not in itself effective with respect to non-tradables.

A portfolio of instruments is therefore needed for a ensuring a competition friendly environment. In this respect the European treaty is far sighted and goes much further than merely imposing a free trade regime. The treaty guarantees within the Union the respect of the four fundamental freedoms, i.e. the free movement of goods, services, labor and capital, it introduces antitrust provisions and it impedes anticompetitive subsidies. All these provisions were necessary to address private and government restraints that segmented national markets, thus potentially undermining the common market. No other international organization or even no other sovereign country has a similar portfolio of instruments aimed at achieving an integrated market.

The reason for all this was not simply the maximization of consumer welfare and efficiency. As Anderson and Heimler (2007)[2] argue, "it is important to note that the prominence given to competition and competition policy in the Treaty of Rome had as much to do with a desire to ensure peace through economic integration and intra-European trade as it had to do with the goals of economic efficiency and consumer welfare. After two world wars, both of them having originated in Europe, it was believed that economic integration was essential to avoid future conflicts. A mere free trade zone would not have been sufficient. Rather, the goal of the founding fathers of the European Communities was to create a set of rules that would constrain Member States from engaging in policies and conduct that could adversely affect other European Member States and would thereby ensure that the objectives of the Treaty were not undermined."

Given the economic integration objective, it is therefore not surprising that the concept of competition promoted by the first interpreters of the treaty was associated with the notion of fairness, rather than efficiency and consumer welfare.

In antitrust, the entry into force in 1989 of the merger regulation and the example of the enforcement practice of other competition agencies around the world led the Commission to a thorough rethinking of its substantive approach and to a progressive distancing of its enforcement decisions away from fairness. Today, more than 50 years after the treaty entered into force, fairness is no longer part of the European approach in antitrust and, at least in principle, consumer welfare and efficiency are the objectives pursued by the EC Commission

[2] Anderson, R and Heimler, A. (2007), "What has competition done for Europe? An inter-disciplinary answer", *Aussenwirtschaft*, 2007, Issue 4.

(with the only possible exception of absolute territorial restrictions).

Contrary to antitrust, State aid control is a unique EU feature. Furthermore in State aid control fairness is the most natural objective to pursue even today, since the rules are clearly meant to impede that competitors of the subsidy receiving firm are unjustifiably hurt. However, according to the relevant articles of the treaty, also competition needs to be distorted.

For many years, Commission decisions on State aid hardly contained an evaluation of market rivalry or a description of the way competition was being distorted by the aid. In fact, contrary to antitrust, the Commission and the Courts had not provided much incentive for economic experts to get involved with the substance of State aid cases and economists did not participate at all in the State aid policy debate. Around a decade ago when the Commission started thinking about the modernization of State aid policy the number of articles on State aid by economists were a handful. Besides an OECD roundtable on subsidies held in 2001[3] and two papers written a year or two earlier, one by Tim Besley and Paul Seabright[4] and the other one by Damien Neven and Lars Hendrick Röller[5], there was not much else.

With the 2005 State aid action plan (SAAP), the Commission has recently moved towards a more economic approach. Indeed the lack of a rigorous market analysis had often led the Commission to take decisions without much regard of the distortions of competition associated with State aid measures or to impose remedies in State aid cases without much regard of their effect on competition. A good solution, as the German Monopol Kommission (2006) suggests[6], would have been to carry out a competition analysis when an aid measure is defined as incompatible under article 87, paragraph 1 of the EC treaty, introducing as a standard that competition effects be noticeable. Unfortunately this is not the approach followed (or suggested) by the Commission. According to the relevant Commission guidelines and reports, the Commission carries out a competition analysis only when verifying when an incompatible aid can be exempted, and also here only at the balancing stage. As a result in many Commission decisions the competition and market analysis is completely missing.

In this paper, in order to identify ways of improving the Community practice, after a brief review of the Community State aid legislation in Section 2, I will refer to three cases, describe them and provide some critical comments. In particular, section 3 addresses the issue of restructuring aid and discusses the anticompetitive constraints that the Commission imposed on Alitalia in the course of the 1990's, delaying, not promoting, the restructuring of the company. Section 4 describes the Charleroi case, where reduced landing and take off charges to Ryanair, a low cost carrier, have been considered incompatible with EU State aid provisions, a decision that could be criticized under a competition/market analysis perspective. Finally section 5 describes a recent case against Italy where subsidies to promote the purchase of digital decoders have been considered incompatible with the common market, without considering that recovery of indirect State aid, the only sanction available, is very

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3 Oecd (2001), , "Competition Policy in Subsidies and State Aid", Policy Roundtables, Background Note, Available at: http://www.oecd.org/dataoecd/31/1/2731940.pdf

4 Besley, Timothy, and Paul Seabright (1999). "The Effects and Policy Implications of State Aid sto Industry: An Economic Analysis." *Economic Policy*, 34, 13–53.

5 Neven, Damien J. and Röller, Lars-Hendrik (2000), "The Political Economy of State Aid: Econometric Evidence for the Member States". In: D. J. Neven/L-H. Röller (eds.): *The Political Economy of Industrial Policy in Europe and the Member States.* Berlin: Ediiton Sigma, pp. 25-38.

6 German Monopolies Commission (MonopolKommission) (2008), "The more economic approach in European State aid control", translated version of Chapter 6 of the biennial report 2006/2007. SSRN Working Paper available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1332765

unlikely to take place. In all these cases, including the digital decoder case, the Commission decisions were certainly correct on legal grounds (according to consolidated practices), but can be questioned on substance, i.e on their effect on competition.

2. The EC policy on State aid, the optimal institutional setting and the new economic approach

Article 87, paragraph 1, of the EC Treaty defines the incompatibility of State aid with the common market:

“Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market”.

In order for a measure to fall within the scope of application of article 87, paragraph 1, five cumulative criteria must therefore be met: 1) the use of State resources; 2) the measure must confer an advantage to certain firms; 3) the advantage must be selective; 4) the measure must distort competition and 5) affect trade between member States.

Without going into the details of State aid policy[7], it is important to underline that the Commission and the European Courts, similarly to antitrust, have provided a wide definition of what is an advantage to firms, defining as State aid not just a financial transfer from the State, but any advantage that affects directly the budget charges of a firm. Furthermore, given the fact the government ownership was widespread in Europe (at least until the late 1990's), the Commission had to devise ways to define when investment decisions in government owned firms were incompatible with State aid legislation. The main instrument developed so far is the private investor principle, introduced already in 1981[8] , according to which no State aid is involved if it can be shown that the capital investment by the State would also have been made by a private investor at market conditions, an easy standard to declare, but a difficult one to enforce in a rigorous way. Indeed in the case of Government ownership what matters is not the profitability of the incremental investment, but the profitability of maintaining the company in the market. In order to overcome such difficulties, many shortcuts have been taken by the Commission, for example that when a private investor participates to the capital investment at the same conditions than the government it is not State aid, a short cut not always appropriate, as we will see later in the Alitalia case.

According to article 87, paragraph 1, in order for an aid to be incompatible, it is not sufficient that it favors certain firms or certain activities (selectivity), but it is also necessary that it distorts competition. However, even if according to settled case law[9] State aid measures are defined in terms of the effects they produce, not in terms of the objective they pursue implicitly or explicitly, distortions of competition have always been presumed from selectivity. As a result State aid decisions are not accompanied by a market analysis nor by a thorough analysis of the distortionary effects of the measure.

[7] There are a number of textbooks on EU State aid policy. See for example Hancher, L., Ottervanger, T.R and Slot, P.J. (2006), *EC State Aid* , Sweet&Maxwell; Flett, J. (2008), *EC State Aid Law*, Kluwer; Nicolaides, P. (2008), *State Aid Policy in the European Community: Principles and Practice*, Kluwer.

[8] Commission decision (ECSC) 2320/81 OJ L228/14 (the Steel Aid Code)

[9] See for example Judgment of the Court of 2 July 1974. Italian Republic v Commission of the European Communities. Family allowances in the textile industry. Case 173-73. ECR 709, paragraph 13.

State aid control would be much more efficient and effective if the Commission would have to prove that the effects on competition are noticeable before an aid measure is considered incompatible. Many irrelevant cases would not be even notified and the Commission could devote its scarce resources to the analysis of the most important cases, a development very similar to the one undertaken in antitrust with Regulation 1/2003. Procedures are already set up to provide the right incentives to member States to notify State aid cases. The risk of under enforcement is therefore minimal.

Article 88 of the Treaty imposes on member States the duty to notify to the Commission all aid measures that they intend to introduce. The degree of control exercised by the Commission is very thorough. Members States have to notify all measures including those that are declared compatible by article 87, paragraph 2, even though in these instances there is no discretion to be exercised by the Commission:

“The following shall be compatible with the common market:

(a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;

(b) aid to make good the damage caused by natural disasters or exceptional occurrences;

(c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division”.

If member States fail to notify a State aid measure, the measure is illegal and a national judge can annul it. As a result governments tend to notify to the Commission all incompatible State aids.

The reason for the notification is to get an exemption according to the criteria listed in article 87, paragraph 3. There are five very general reasons for exemptions over which the Commission has a wide power of discretion:

“(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;

(b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;

(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;

(d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;

(e) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission”.

From this list it appears that there are both economic and non-economic considerations that may lead the Commission to exempt an otherwise incompatible State aid measure. The analytical process for an exemption can therefore be quite complex especially if the analysis of the different trade offs is rigorously performed. In any case, the treaty does not explicitly identify the standard that the Commission has to follow in its exemption decisions. Like in antitrust, the Commission and the Courts have identified in the course of the years the analytical framework to be followed, first with individual decisions, then with block exemption regulations, guidelines, communications and reports.

State aid policy and the quality of regulation

Contrary to antitrust enforcement where the analysis is only made in terms of competition, the Commission will exempt otherwise incompatible State aid on the basis of a trade off between the positive effects that the aid may provide with respect to the attainment of other public policy objectives (listed in article 87, paragraph 3) and the negative effects of the aid in terms of distortions of competition. In this respect, the analysis in State aid control is very similar to that required for assessing the competition impact of regulation. As for regulation, the restrictions of competition need to be minimized provided that the public interest objective is achieved. Similarly a State aid measure is declared compatible when it represents the minimum necessary for the attainment of the public interest pursued.

Indeed the executive summary of the 2001 OECD roundtable on subsidies[10] suggests that:

"(i)deally, the control of subsidies would form part of a broader system of controls on the quality of government intervention in the economy. … A typical example of these quality controls are regulatory review processes which ensure that each intervention has a well-defined objective, that the different ways of meeting the objective have been considered and that the alternative approaches have been properly assessed for their costs and benefits".

Like with regulation, such assessment of the quality of subsidies can only be assured if this quality-control process takes place at a level of government large enough to encompass the geographical scope of the market affected by the intervention under consideration. Furthermore, in order to avoid capture by special interest, the rules to be applied should be clear and very difficult to change, so that a constitutional provisions or some international rules may be necessary to impose a rigorous discipline. As article 87 shows, the possibilities for allowing State aid measures are quite wide, so that entrusting a supranational body for enforcement is quite effective for ensuring a more independent approach, even if the market affected is only national.

The full decentralization of State aid control to national competition authorities, a step taken in antitrust with Regulation 1/2003, is not yet part of the agenda of European State aid reform. This is unfortunate. The creation of national State aid authorities could help the Commission analyze the effect of the measure on competition already under article 87, paragraph 1, strengthening the substantive part of State aid decisions. Indeed, as Nicolaides (2003)[11] argues, while it is important that the Commission maintains a centralized decision making function for consistency and legal certainty, national independent authorities entrusted with a partial State aid responsibility could be very important in adding a greater discipline to the whole process, measuring "the economic impact of State aid they propose to grant and to demonstrate how it corrects market imperfections", serving a disciplinary function at the decision making stage of State aid. Jenny (2006)[12] adds that under a political economy perspective decentralization would help bridging the gap " between Member States' politicians and the general public, on the one hand, and the Commission, on the other hand,

[10] OECD (2001), Secretariat Background paper.

[11] Nicolaides, P. (2003), ,"Decentralised State Aid Control in an Enlarged European Union: Feasible, Necessary or Both?", *World Competititon*,26(2) 263–276.

[12] Jenny, F. (2006), "The State Aid Action Plan:A Bold Move or a Timid Step in the Right Direction?", *Competition Policy International, 2: 79-81*

by promoting a public and transparent debate at the national level that would show that the Commission trusts national institutions and wants to cooperate with them. This will undoubtedly make State aid policy better understood and increase its effectiveness. It would be a particularly important result at a time when there is renewed, if misguided, interest in industrial policy measures and the promotion of "national champions" in many Member States"

In any case State aid policy is a very important pillar of the EU system of regulation. It is not an isolated policy instrument, which makes it even more powerful. In other words there is not just State aid control to discipline governments. For example, in an industry in which some governments subject firms to a certain regulatory standard, should other governments not do the same, firms in that jurisdiction may be favored. In such instances, EU harmonization directives (that have the objective of creating a level playing field in the internal market) would be issued and they would solve the problem.

The problem of the EU approach in State aid is that member States only look for the European Commission approval and do not have much incentives to look for alternatives to State aid. For example, lets assume that a State aid measure could be exempted if it overcomes some regulatory restrictions that impede firms in one jurisdiction from competing at arms length with firms in other jurisdictions. While such a subsidy may be justified given existing regulatory constraints, it would be much more efficient to eliminate the anticompetitive regulation. Carrying out a competition impact assessment[13] of State aid decisions at the national level could allow policy makers to identify the most efficient course of action and would put State aid policy in a wider perspective.

As the OECD Secretariat background paper to the roundtable discussion on subsidies in 2001 underlines, under a competition perspective, "a subsidy should be structured in such a way as to, as far as possible, preserve competitive forces. … In general, therefore, a government intervention through subsidies should not act to discourage output, quality, innovation, cost efficiency or return on investment. Since a subsidy whose level increases with a certain action tends to encourage that action, the level of subsidies should not be increasing as the firm reduces output, reduces quality, increases costs, or lowers return on investment"[14]. This also implies that the conditions imposed by the Commission when allowing a subsidy should not block competition either. State aid decisions are like any other regulation that should attain its public policy objectives in the least restrictive of competition way as possible.

Article 87, paragraph 1, and distortions of competition

According to article 87, paragraph 1, of the treaty, for a State measure to be an incompatible aid, competition should also be distorted. In practice selectivity is all what matters since competitors are hurt by a measure they do not receive. In this sense distortions of competitions are presumed to exist and in the Community case law there is not much consideration to the relevant market where the advantaged firms compete nor to the degree and the type of rivalry[15].

[13] See on this OECd (2007) *Competition Assessment Toolkit*, Paris. Available at http://www.oecd.org/dataoecd/15/59/39679833.pdf

[14] The background paper has been written by Biggar, Darryl, R. (2002) "Competition policy in subsidies and State aid" and is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=318774.

[15] In 1981 in its eleventh report on competition the Commission writes that a selective aid would always distort competition (and therefore there is no extra burden of proof), a statement partly reversed by the Court of

The European case law in State aid in this respect is very different from antitrust where presumptions that competition is distorted are used only in a subset of circumstances (hard core cartels). In State aid the presumption that selectivity leads to a distortion of competition is universal. The definition of incompatible State aid under article 87, paragraph 1, is therefore quite wide.

Procedurally, once incompatibility is identified, the Commission has to examine whether the State measure can be exempted according to the criteria identified in article 87, paragraph 2 and 3. In the exemption decisions under article 87, paragraph 3, (in article 87, paragraph 2, decisions there is no discretion the Commission can exercise) competition issues are addressed by the Commission only at the balancing stage, after the Commission has shown that the aid provides some overall benefits. If distortions of competition are not too strong, the net effects originating from the aid continue to be positive and it can be exempted. If there are no overall benefits originating from the aid, as it happens in many circumstances, the measure cannot be exempted and is declared incompatible with the common market even when the distortions of competition are unnoticeable.

The broad interpretation of the concept of state aid and the low level of proof required mean that the European Commission must also follow up cases that are hardly relevant. As a result, the German Monopol Kommission suggests that "the objective likelihood that an aid measure will noticeably distort competition … should be examined in the state aid control procedure" under article 87, paragraph 1, not only when evaluating whether to allow an incompatible aid[16].

The exemption of incompatible State aid

EC policy in State aid was driven, at least in its early years, by specific circumstances. Like what happened in antitrust with the article 81, paragraph 3, exemption of otherwise anticompetitive agreements, in the early years of application the Commission was overflown with notifications of State aid measures by member States. As a result, Council regulation 994/98 empowered the Commission to declare by means of regulations that certain categories of aid do not fulfill the criteria of article 87, paragraph 1, or that they are compatible with the common market and exempted from the notification obligation.

The *de minimis* regulation[17] excludes that aid below a given amount[18] affects trade between member States or distorts competition. Indeed only *de minimis* regulation directly addresses competition, but it does so in a very mechanical way: all measures that fall below the *de minimis* threshold, irrespective of the market involved, do not fall within the area of

Justice in 1985 (Judgment of the Court of 13 March 1985, Kingdom of the Netherlands and Leeuwarder Papierwarenfabriek BV v Commission of the European Communities. Joined cases 296 and 318/82,.European Court reports 1985 Page 809) that requires the Commission at least to summarize the circumstances that in a given case would distort competition. According to the Court a decision "which does not contain information concerning the situation of the relevant market, the place of the undertaking receiving the aid in that market, the pattern of trade between member States in the products in question and the undertaking's exports does not satisfy the requirement of a statement of reason"

16 German Monopolies Commission (MonopolKommission) (2008), "The more economic approach in European State aid control", translated version of Chapter 6 of the biennial report 2006/2007. SSRN Working Paper available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1332765

17 Commission Regulation (EC) No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to de minimis aid, Official Journal L 379 of 28.12.2006

18 EUR 200000 (cash grant equivalent) over any three fiscal year period

application of article 87, paragraph 1 and therefore do not need to be notified to the Commission.

As for exemptions, a General Block Exemption Regulation (GBER), which unifies most previously enacted regulations, was adopted in August 2008 and it authorizes subject to conditions the following types of aid:

- aid in favor of small and medium-sized enterprises (SMEs),
- aid for research and innovation,
- regional development aid,
- training aid,
- employment aid,
- aid in the form of risk capital,
- environmental aid,
- aid promoting entrepreneurship.

As described by the Commission in the recently published Vademecum on Community law on State aid[19], "*(*T)the GBER consolidates into one text and harmonises the rules previously existing in different regulations. It also enlarges the area covered by notification exemptions by five types of aid which have not been exempted so far (environmental aid, innovation aid, research and development aid for large companies, aid in the form of risk capital and aid for enterprises newly created by female entrepreneurs). The GBER applies only to transparent aid, i.e. grants and interest rate subsidies, loans where gross grant equivalent takes account of the reference rate, guarantee schemes, fiscal measures (with a cap) and repayable advances under certain conditions. Aid is only allowed if it has an incentive effect. The GBER provides different criteria for the verification of the incentive effect with ranging complexity: (i) for certain types of measures, incentive effect is presumed; (ii) for SMEs, the incentive effect is present if the application for aid was submitted prior to the start of the project; (iii) and for large enterprises, in addition to the above, the Member State would have had to verify basic conditions of the documentation."[20]

The new economic approach in State aid policy

All recent developments in State aid originate in the 2005 State Aid Action Plan (SAAP)[21], the document in which the Commission suggest a more refined economic approach in State aid in order to "ensure a proper and more transparent evaluation of the distortions to competition and trade associated with state aid measures."[22] However in SAAP, instead of suggesting a more thorough analysis of the market where the aid is or will be producing its effects, the Commission limits the economic approach to "the reasons why the market by itself does not deliver the desired objectives of common interest and in consequence evaluate the benefits of state aid measures in reaching these objectives." In other words, instead of strengthening the economic analysis of the distortions of competition originating from State aid, the Commission suggests to use economic analysis to identify market failures that are meant to be

19 Available at: http://ec.europa.eu/competition/state_aid/studies_reports/studies_reports.cfm

20 Page 19 and 20 of the Vademecum

21 European Commission (2005) *State aid action plan.* Less and better targeted state aid: a roadmap for state aid reform 2005–2009 (Consultation document) COM(2005) 107 final

22 SAAP, paragraph 22.

overcome by the aid. Indeed, writes the Commission, "(I)in those cases, identifying the market failure at stake will help evaluate better whether state aid could be justified and acceptable, would represent the most appropriate solution, and how it should be implemented to achieve the desired objective without distorting competition and trade to an extent contrary to the common interest."[23]

According to the SAAP, selectivity is sufficient to define an incompatible State aid, like in the past. The strengthened economic approach should only help the Commission in its exemption capacity.

This was already clear from the Community framework for State aid for research and development and innovation where the Commission first proposed its three-stage balancing test for the evaluation of State aid measures. The first two steps address the positive effects of State aid and the third is addressing the negative effects and resulting balancing of the positive and negative effects:

"(1) Is the aid measure aimed at a well-defined objective of common interest (eg growth, employment, cohesion, environment)?

(2) Is the aid well designed to deliver the objective of common interest i.e. does the proposed aid address the market failure or other objective?

(i) Is State aid an appropriate policy instrument?

(ii) Is there an incentive effect, i.e. does the aid change the behaviour of firms?

(iii) Is the aid measure proportional, i.e. could the same change in behaviour be obtained with less aid?

(3) Are the distortions of competition and effect on trade limited, so that the overall balance is positive?"[24]

In the particular case of aid to research and development, the analysis of the Commission would go as follows: the prerequisite of the aid is a market failure (knowledge spillovers; imperfect and asymmetric information; coordination failures), then there has to be a positive effect on R&D&I originating from the aid and finally R&D&I aid should not: "(1) distort the dynamic incentives of market players to invest (crowding out effect); (2) … create or maintain positions of market power; (3) … maintain an inefficient market structure"[25].

According to the Commission, this balancing test is applicable to the design of State aid rules as well as for the assessment of specific cases. In a recent draft paper, "Common principles for an economic assessment of the compatibility of State aid under article 87.3"[26], the Commission clarifies the substantive test it will apply when evaluating whether a State aid measure should be authorized. In particular "a balancing exercise naturally requires a common framework to evaluate and compare the different elements being weighted. Such framework is provided by the analysis of the impact that State aid has on the welfare of all stakeholders and in particular on the welfare of the recipient, its competitors, consumers but also input suppliers"[27]. It is thus first necessary to assess whether the aid is in the common

[23] SAAP, paragraph 23.
[24] European Commission (2006), "Community framework for State aid for research and development and innovation", *Official Journal of the European Union*: C 323/5
[25] European Commission (2006), "Community framework for State aid for research and development and innovation", *Official Journal of the European Union*: C323/22
[26] Available at http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf
[27] Paragraph 11.

interest (elimination of market failures). Then whether the aid is well designed to achieve it. Finally whether it leads to an unacceptable degree of distortion of competition and of trade between Member States.

As a result, once a measure is defined as State aid under article 87, paragraph 1, a competition analysis can only be performed in the final part of the exemption test and only if the aid provides some general interest benefits. In other words, the analysis of the effect of the aid on competition is only done when the suitability, necessity and adequacy of State aid is to be assessed under the criteria of article 87, paragraph 3.

Many measures would never arrive at the balancing stage. For example if the aid does not remove a market failure or is not necessary to this end, the Commission would stop its analysis and declare the aid incompatible.

The whole process would be different with a competition analysis in the initial appreciation of State aid, when it would be most important since it would be one of the necessary conditions for a measure to be defined as incompatible State aid in terms of article 87, paragraph 1. At that stage, if there is no distortion of competition, meaning no effect on the competition process, even a selective measure would not be considered State aid. Many cases of very little significance would not have been opened and a few others would have been reversed.

3. Restructuring aid and the Alitalia case

Aid for restructuring has been one of the most controversial issues in State aid. The major reason is that subsidies for firms in financial distress are by definition selective and "are applied only to those firms with the lowest quality or highest costs. Furthermore such subsidies are correlated with the size of the loss of the assisted firm, weakening the incentives on the firm to minimize that loss"[28].

There is therefore a strong tendency by the Commission to declare restructuring aid incompatible with the treaty. At the same time however, since these measures benefit large companies with thousands of employees, there is a strong political incentive for granting them. Therefore it has been mainly on restructuring aid that the contrast between the Commission and member States has been more frequent. The reason is that these aids allow inefficient firms to remain active in the market and, more importantly, to maintain excessive capacity in an industry, hurting all competitors, often localized in other member States. The first Report on Competition Policy by the European Commission of 1971 emphasized the exceptional nature of restructuring aid, an unchanged guiding principle since then.

On the other hand, keeping a large company alive through a restructuring aid, especially if this aid is *una tantum*, may be justified on competition grounds because it allows a large competitor to remain in the market, thus keeping industry profit from increasing (in a Cournot setting). Furthermore, since a firm may get bankrupt also because of the existence of restrictive regulations both in product and in factor markets, restructuring aid may be a way to ease the transition to a more competition friendly environment. Finally, under a macroeconomic perspective, avoiding the bankruptcy of a large competitor may help to avoid the disappearance of many small suppliers at the local level, maintaining an employment base often much larger than that of the aided firm. The political pressures in favor of restructuring aid can therefore be quite strong.

[28] OECD (2001), page 34.

In order to resist this political pressure, the Commission had to clearly define its enforcement approach. The 2004 Commission guidelines on restructuring aid[29] confirm the "one time – last time" principle. Rescue and restructuring aid should be given to specific firm only once every ten years and cannot be provided to firms that have not repaid previous unlawful aid. The guidelines explain that "(R)rescue aid is by nature temporary and reversible assistance. Its primary objective is to make it possible to keep an ailing firm afloat for the time needed to work out a restructuring or liquidation plan. The general principle is that rescue aid makes it possible temporarily to support a company confronted with an important deterioration of its financial situation reflected by an acute liquidity crisis or technical insolvency. Such temporary support should allow time to analyze the circumstances which gave rise to the difficulties and to develop an appropriate plan to remedy those difficulties. Moreover, the rescue aid must be limited to the minimum necessary. In other words, rescue aid offers a short respite, not exceeding six months, to a firm in difficulty. The aid must consist of reversible liquidity support in the form of loan guarantees or loans, with an interest rate at least comparable to those observed for loans to healthy firms and in particular the reference rates adopted by the Commission. Structural measures which do not require immediate action, such as the irremediable and automatic participation of the State in the own funds of the firm, cannot be financed through rescue aid"[30].

The restoration of the profitability of the firm is the final objective of restructuring aid. Therefore the Commission maintains that it will approve the aid only if the member State can show that there is a high probability that the aid will succeed in bringing the firm back into profit. According to the Guidelines "(T)the provision of rescue or restructuring aid to firms in difficulty may only be regarded as legitimate subject to certain conditions. It may be justified, for instance, by social or regional policy considerations, by the need to take into account the beneficial role played by small and medium-sized enterprises (SMEs) in the economy or, exceptionally, by the desirability of maintaining a competitive market structure when the demise of firms could lead to a monopoly or to a tight oligopolistic situation. On the other hand, it would not be justified to keep a firm artificially alive in a sector with long-term structural overcapacity or when it can only survive as a result of repeated State interventions"[31].

Furthermore, the Commission "will ensure that restructuring aid is limited to the minimum required to restore viability while limiting distortion of competition"[32] More specifically the guidelines suggest that in order not to distort competition some "compensatory measures" may be required. "These measures may comprise divestment of assets, reductions in capacity or market presence and reduction of entry barriers on the markets concerned. When assessing whether the compensatory measures are appropriate the Commission will take account of the market structure and the conditions of competition to ensure that any such measure does not lead to a deterioration in the structure of the market, for example by having the indirect effect of creating a monopoly or a tight oligopolistic situation"[33].

The actual application of these highly sensible principles to specific cases was unfortunately quite different. In particular, instead of adapting these compensatory measures to the form of

[29] Communication from the Commission — Community guidelines on State aid for rescuing and restructuring firms in difficulty Official Journal 244 , 01/10/2004 P. 0002 – 0017.
[30] Paragraph 15.
[31] Paragraph 8
[32] Paragraph 7.
[33] Pargaraph 39.

the aid, i.e. after having analyzed what type of firm decisions are affected by the aid (pricing?, investment decisions?, etc.), the Commission adopts very broad behavioral remedies, a sort of last-resort control for moral hazard, that are meant to impede too aggressive marketing strategies. However moral hazard cannot be reduced by introducing behavioral remedies on company's actions. Moral hazard is simply dependent on the fact that restructuring aid is granted. By limiting the competition possibilities of the restructuring firm, the possibility for it to successfully restructure is being reduced. Moral hazard remains intact.

The practice of imposing "wrong" behavioral remedies on the part of the Commission is not just history. The recent Communication from the Commission on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis[34] suggests that banks that have received an aid should not further distort competition. Among the compensatory measures envisaged to this end, the Commission suggests that anticompetitive practices like aggressive advertising and aggressive pricing be prohibited. In practice the aided company can only adopt reactive strategies, substantially curtailing its possibility to compete and hence to restructure.

The Alitalia case

In 1997 the Italian government decided (through IRI, a State owned holding company) to invest 2750 billion lire (around 1.5 billion EUR at today's lira/eur parity) in Alitalia, the Italian State owned national carrier in order to support a restructuring plan aimed at restoring the company financial viability during the period 1997-2000. The Commission, by decision 97/789/EC[35], considering that a private investor would not have undertaken that capital injection, concluded that it was indeed a State aid measure. Italy did not agree with the results of the private investor test and successfully challenged the Commission decision in Court. In 2001 the Commission took a new decision which provided a more convincing evidence that the private investor test was not met. Italy challenged also this second Commission decision in Court, and the Court of First Instance confirmed the legitimacy of the Commission decision on July 9 2008, eleven years after the notification of the capital investment to the Commission.

Besides the very long time required to reach a final decision (more than 10 years) which has very much to do with the slow pace of European judicial control, the interesting part of this case are the conditions that the Commission imposed on Alitalia in order to declare the aid compatible. Some of these conditions were sound under a competition perspective and fully in line with the yet not issued 2004 Restructuring guidelines. In particular the Commission required Italy " not to give Alitalia priority in any way over other Community companies, in particular as regards the allocation of traffic rights (including those for third countries in the European Economic Area), slot allocation, ground-handling assistance and access to airport facilities where preferential treatment would be contrary to Community law. Furthermore the Commission imposed to Italy to "appoint a coordinator who does not have any link whatsoever with Alitalia and acts completely independently of it" for the allocation of slots in coordinated or fully-coordinated Italian airports. These two measures, i.e that Alitalia not be favored in slot allocations and that the market regulator in air transport be independent from Alitalia, are quite appropriate since they reduce barriers to entry and enhance competition.

[34] Communication from the Commission - The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis – adopted on 13 October 2008. Official Journal C 270, 25.10.2008, pages 8–14.

[35] OJ L. 322, 25.11.1997, p. 44.

Probably they should have also been imposed to all member States and not just to Italy.

However the Commission in its decision limited significantly the freedom of Alitalia to compete in air transport markets imposing that: “until 31 December 2000 the available capacity of aircraft operated by Alitalia or by other carriers under agreements whereby Alitalia assumes the commercial risk for such capacity (wet-leasing, block-space, joint venture agreements, etc.) shall not exceed the following limits:

(a) the number of seats available shall not exceed 28 985, of which 26 350 shall be for Alitalia's own fleet;

(b) the increase in the number of available seat-kilometres for each calendar year … shall not exceed 2,7 %, on the understanding that no growth is to be authorised if the growth in the corresponding markets remains lower than 2,7 %. However, if the growth rate in the corresponding markets exceeds 5 %, supply may be increased above 2,7 %, by the margin of the increase beyond 5%”.

Furthermore “until 31 December 2000 Alitalia shall refrain from offering fares lower than those offered by its competitors for an equivalent service supplied on the routes which it operates;”

Finally, “Alitalia shall dispose of its shareholding in Malev (the Hungarian national carrier) by […] at the latest.”

All these requirements, setting a ceiling to the number of seats Alitalia is allowed to offer, impeding any autonomous price reduction and prohibiting any partial ownership of other European carriers, instead of helping Alitalia becoming a more effective competitor, blocked the restructuring possibilities of the company and were mainly directed to help its competitors (at least in theory), quite the contrary of what the Commission should have done once it approved the capital injection. In any case, these measures go much beyond what the Commission suggested in its 2004 guidelines on restructuring aid as appropriate remedies (divestment of assets, reductions in capacity or market presence and reduction of entry barriers on the markets concerned) in order to avoid distortions of competition.

Even assuming that the capital injection was indeed State aid in the sense that a private investor would have not invested at so low internal rates of return, there is no market analysis in the Commission decision, any analysis of pricing decision in air transport, nor any argued relationship between the aid and pricing of air transport services. For the Commission any State aid seems to produce competition sensitive effects, irrespective of whether the aid reduces marginal costs or not. In the Alitalia case, the capital injection did not affect decisions at the margin, so *prima facie* no behavioral remedy would have been necessary. But neither in the Commission decisions nor in the judgments of the Court there is any relevant analysis in this respect that could be presented here and discussed.

As for the private investor test, a few years later, in June 2005, Alitalia received a capital injection of 1.2 billion EUR. Since also a consortium of private banks (with Deutsche Bank as a leader) was participating in the deal, the Commission concluded that the private investor test was met by definition. In the 2005 decision, the Commission performs no analysis of the internal rate of return of the capital investment, even if the economic situation of the company had strongly deteriorated since 1997-2001, not improved.

As von Wiszacker (2002) argues, the problem with the private investor test adopted by the Commission is that it refers to an investment by a new investor, i.e. the profitability is calculated with respect of the aid as if it would be a stand-alone investment. This is not the right test for a company that the Government already owns. Indeed, "if the new capital increases the value of the old capital, then the return which the owner achieves overall as the result of the injection of new capital can be higher than the return which an outsider achieves from injection of new capital into the enterprise under the same conditions"[36] This should have been the calculation that the Commission should have conducted in the Alitalia case.

In 2008 a bankrupt Alitalia was privatized and strongly downsized[37]. The Commission is probably not responsible for the subsequent bankruptcy of Alitalia. However the remedies imposed on Alitalia in the 1997&2001 decisions did not help the restructuring of the company. Quite the contrary.

4. Locational aid and the Charleroi case

The competition analysis to be performed under article 87 is not extended to accommodate the rivalry of States providing State aid for companies willing to move there. Such an extension would practically eliminate the necessity of State aid control at least with respect to locational aid. The argument would go as follows: since States compete for companies to be localized in their territory, they should be allowed to offer to them all sorts of services and competitive advantages: good infrastructure, good schools, good health services, etc.. All these are not considered State aid, even if they are provided for free. On the other hand State aid is prohibited, even if it might help under resourced countries overcome their comparative disadvantage. An argument against State aid control is that competition for locations will be won by the region offering the most advantages (real and financial) to companies willing to locate there.

This argument cannot be dismissed *prima facie* and has some value. For example it could be argued that in the United States where there is no State aid policy, individual States operate under a strict balanced budget constraint and are mostly responsible for their own finances. In such instances, even if States grant aid to companies, the voting mechanism and the reduction in the tax base originating from people leaving a bankrupt State can well discipline them, even in the absence of State aid control at the Federal level.

However the argument is based on the assumption that the length of the political and the economic cycle is the same. Should it be so, policy makers of a fiscal disciplined State would not find it attractive to grant ineffective State aid for fear of them not being re-elected. However, the political cycle is much shorter than the economic cycle and policy makers maintain a positive incentive to grant an excessive amount of State aid (in comparison to real advantages) even under a rigorous fiscal discipline. As a consequence, even in those jurisdictions like the US where individual States operate under a strict balanced budget constraint, the introduction of State aid control could therefore nonetheless be necessary to impede an excessive amount of aid from being granted.

This is the more so in Europe. Member States do not operate under a strict balanced budget constraint and especially now with the common currency any fiscal largesse (the Maastricht treaty budget parameters impose effectively a soft budget constraint) is transferred to other sovereign bodies, for example as a result of a weaker currency. The same is true for most local

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[36] See Von Weiszacker Christian (2002), "Expert economic opinion on reasonable remuneration for the transfer of the Agency for the Promotion of Housing Construction to Westdeutsche Landesbank", Case T-228/99 before the Court of First Instance of the European Commission, mimeo.

[37] For a thorough account of the Alitalia case see Osti, C. (2008), ""Alitalia: la dolorosa istoria. I puntata", *Mercato concorrenza regole*, X, 2: 317-27.

governments that also do not operate under a strict budget constraint and, in case of need, are bailed out by their national governments. Free riding can therefore lead to an excessive amount of State aid in Europe. The control of State aid is therefore necessary.

This does not mean that all locational aid is incompatible with the treaty provisions. In order for it to be classified as incompatible, it should distort competition on a relevant market.

The Charleroi case[38]

The case originated from a complaint to the Commission received in January 2002 that Belgium had granted a number of advantages to the Irish airline Ryanair for the operation of air services at Charleroi Airport, a secondary airport around 60 kilometers away from Brussels. In particular "the Walloon Region, the owner of the Charleroi airport infrastructure, had signed an agreement with Ryanair that involved a reduction of some 50 % in the amount of the landing charge compared with the amount fixed by the government and published in the Moniteur Belge"[39]. Furthermore the managing company of the airport, Brussels South Cherleroi Airport (BSCA) granted Ryanair some rebates over the expenditure incurred with the opening of the Ryanair base in Charleroi[40]. Finally the price for ground handling services for Ryanair was fixed by BSCA at EUR 1 per passenger, much below the EUR 10 per passenger charged for other users. In return of all this, Ryanair committed itself to base a number of aircraft at Charleroi and to operate each aircraft with a frequency of 3 flights a day over a 15-year period. According to the Commission, there was a risk that in both instances the principle of the private investor was not respected and, furthermore, that since these rebates were granted to one company only, Ryanair was placed "in a more advantageous position than its competitors flying out of Charleroi", implicitly suggesting that the relevant market over which the aid would produce its effects was indeed the Charleroi airport. .

In the 2004 decision, the Commission declared the reduction of landing charges by the Walloon Region and the reduction of ground handling charges by BSCA incompatible with the common market. All other rebates that had been granted to Ryanair were capped by the Commission at 50% of "start-up, marketing and one-shot costs", under the condition that, if they exceed that cap, had to be repaid by Ryanair to BSCA.

The background of the case is the liberalization of the air transport market in Europe which took place on January 1 1993 with the entry into force of the third air package[41]. As for ground handling services, they were liberalized in 1996[42]. While in principle air transport markets were fully liberalized across Europe, the fact that landing and take off slots were

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38 Commission decision of 12 February 2004 concerning advantages granted by the Walloon Region and Brussels South Charleroi Airport to the airline Ryanair in connection with its establishment at Charleroi (notified in Number C(2004) 516) (2004/393/EC)

39 Paragraph 7.

40 EUR 250 000 for hotel costs and Ryanair staff subsistence; EUR 160 000 for each new route opened up to a maximum of three routes for each based aircraft or a maximum of EUR 1 920 000; EUR 768 000 for participation in the cost of recruiting and training pilots and crews assigned to the new destinations served by the airport; EUR 4 000 for the purchase of office equipment ; free provision of 100 m3 of office space; 100 m3 of 'engineering store'; the right of access to the training room; and a minimum or zero contribution for the use of a hangar for aircraft maintenance

41 Council Regulation (EEC) No 2407/92 of 23 July 1992 on licensing of air carriers (OJ L 240, 24.8.1992, p. 1), Council Regulation (EEC) No 2408/92 of 23 July 1992 on access for Community air carriers to air routes (OJ L 240, 24.8.1992, p. 8) (as last amended by Council and Parliament Regulation (EC) No 1882/2003) and Council Regulation (EEC) No 2409 of 23 July 1992 on fares and rates for air ser vices (OJ L 240, 24.8.1992, p. 15).

42 Directive 96/67/EC

strictly controlled by incumbent national carriers weakened substantially the possibilities of competitors to enter in the most profitable routes where one or both airports in a route were slot constrained. As a result, low cost carriers entered the European market by offering services on secondary not slot constrained airports, which were close to major cities. Charleroi was one of such airports, being around 60 kilometers away from Brussels. Contrary to congested airports, Charleroi, like many others, had vast amount of excess capacity. For example, "before Ryanair set up at Charleroi, the airport received only 20000 passengers per year, an average of 50 per day. Thanks to the Charleroi-Dublin route, opened on 1 May 1997, Ryanair transported 178 000 passengers in 2000. In four years, it transported more passengers between these two cities than all the traffic in existence on the Brussels-Dublin route in 1997. In 2002, the airport received over 1,25 million passengers, almost 4 000 per day, for ten destinations across Europe. The volume of traffic increased by 1,455 % between 1997 and 2002"[43].

The Commission explicitly welcomed these market developments, but nonetheless considered that, by favoring an Irish company, Belgium had violated the State aid rules. Under a political economy perspective this is quite surprising. The fact that one jurisdiction had granted incompatible State aid to a firm of another jurisdiction should have raised some doubts on the part of the Commission that the aid was not anti-competitive. If Ryanair would have been a Belgian company, at least the political economy objective (the protection of national champions) and the State aid policy objective (favor national champions) would have coincided. In the circumstance of the Charleroi case, the political economy objective pursued by the Charleroi airport is unclear. More in general however, as Vickers (2005)[44] suggests, because of the development of low cost carriers in Europe, "large benefits have resulted for travellers, incumbent airlines have been spurred to make their own offerings more attractive to consumers, and single market goals have been advanced. That the state aid process led to intervention in such a case at least raises questions about policy priorities".

If the conditions in article 87, paragraph 1, are taken into consideration, there is no question that the State measure entails a price discrimination that favors Ryanair with respect to the other airlines serving the Charleroi airport. However it is not at all clear that these measures distort competition among airlines. Such price discrimination may well originate from a bargaining process between a large buyer of airport services (Ryanair being one of such companies, not the only one) and airports characterized by huge excess capacity, Charleroi being one of those airports. The price agreed, considering the great increase in traffic that resulted from the agreement, was beneficial for both parties and could not distort competition since Charleroi and other airports in the region continue to have vast amount of excess capacity. The airport, as the Commission decision acknowledges, had bargained with a large number of airlines before and after the agreement with Ryanair[45]. Furthermore Charleroi continues to be characterized by extra capacity and any other airline with similar characteristics could bargain with Charleroi or any other airport in the region to receive

43 Paragraph 49 of the Commission decision.

44 Vickers, J. (2005), "State aid and distortion of competition", Paper for the State aid conference, Office of Fair Trading

45 As detailed in paragraph 82 of the decisions, airlines with which BSCA negotiated included Virgin Express, Ryanair, Easyjet and Debonair), a large number of regional companies and some charter companies (Necker mann, Sunsnacks, Pégase, Sunair, Jet Air, Best Tours, Bosphorus), and the airport was able to develop charter flights in association with Thomas Cook, British World Airlines and Wastels Travel as well as flights to Algeria and Yemen.

similar if not better conditions[46].

The low tariffs Ryanair was able to negotiate with Charleroi airport should not have been considered incompatible State aid because they did not distort competition (to the contrary they enhanced the rivalry in the market, since most competitors of Ryanair are not in Charleroi as the Commission suggests but in Zaventem, the major Brussels airport). However, since the competition analysis is not carried out under article 87, paragraph 1, the Commission was forced by its own standards to apply the private investor test only and, since the test was not passed, conclude that the aid was incompatible with the common market.

As for distortions of competition, these words are not even mentioned in the Commission decision.

5. The recovery of unlawful State aid and the Italian digital decoder case

Under article 88 of the treaty, a State aid measure before being adopted is notified to the Commission that verifies whether it is compatible with EU State aid provisions. Once a decision is taken, member States follow the Commission indications. When member States do not notify a State aid measure to the Commission, the State aid is illegal and the Commission opens a procedure that may result in a declaration of compatibility or incompatibility. Should the illegal State aid measure be considered incompatible, the member State is required to recover the illegal State aid from the beneficiaries.

The goal of recovery is to remove the advantage that has been provided by the aid to a specific firm, eliminate the distortions of competition and restore the competitive situation that existed before the aid was granted. The Procedural Regulation[47] establishes an obligation on the Commission to order recovery of unlawful and incompatible aid and that the aid must be recovered according to national (not Community) rules (article 14).

The member State to whom a decision of recovery is addressed, as the Commission underlines in its notice on recovery[48] " is obliged to execute this decision. The ECJ has recognized only one exception to this obligation for a Member State to implement a recovery decision addressed to it, namely the existence of exceptional circumstances that would make it absolutely impossible for the Member State to execute the decision properly. According to Community Courts, absolute impossibility can however not be merely supposed. The member State must demonstrate that it attempted, in good faith, to recover unlawful aid and it must cooperate with the Commission in accordance with Article 10 of the EC Treaty, with a view to overcoming the difficulties encountered."[49]

The problem with all this is that the member State authority that should recover the illegal and incompatible aid is often the same authority that granted it. As a result, the incentive to recover is at best weak. Furthermore, since the procedures by which to recover State aid is strictly national, the Commission has 27 recovery practices to understand and to monitor, quite a difficult task. A possibility for a speed recovery is that the sums recovered are

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[46] For a thorough analysis of the Charleroi decision see Gröteke, F and Kerber, W. (2004), "The case of Ryanair -EU State aid policy on the wrong runway", *Ordo*, Vol. 55, pp. 313-332.

[47] Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Ar ticle 93 of the EC Treaty (OJ L 83, 27.3.1999, p. 1).

[48] Notice from the Commission (2007), " Towards an effective implementation of Commission decisions ordering Member States to recover unlawful and incompatible State aid" (2007/C 272/05)

[49] Paragraphs 18 and 19.

collected by a different authority than the one that granted the aid, for example the ministry of finance.

However, since there is no sanction for illegal and incompatible aid, but simply restitution, the incentive that member States face not to provide incompatible aid is at best weak. This is why decentralization of State aid enforcement to national independent authorities, as argued above, can have a positive disciplining effect on member States attitude towards subsidies. By creating an institution in charge of State aid at the national level, member States would no longer face the Commission only, but would have a point of reference also at the national level, reviewing legislation, giving advice, answering questions and helping with the analysis of competition effects.

Recovery presents a problem also with respect of who should be liable for giving back the illegal and incompatible aid. As the Commission suggests in the Recovery notice, "The unlawful and incompatible aid must be recovered from the undertakings that actually benefited from it. The Commission will continue its present practice of identifying in its recovery decisions, where possible, the identity of the undertaking(s) from whom the aid must be recovered. If, at the stage of the implementation, it appears that the aid was transferred to other entities, the Member State may have to extend recovery to encompass all effective beneficiaries to ensure that the recovery obligation is not circumvented."[50]

When the aid provides advantages to beneficiaries different from those that directly received it, the Commission has to calculate the reduction in the incentive of these beneficiaries to compete or the effect of the aid on prices and therefore on total profits. In such instances the amount to be recovered is not easy, if not impossible, to define.

The difficulties of a recovery decision by the Commission in the case of indirect aid will be made clear by discussing the Italian digital decoder decision.

The digital decoders case

In Italy, until very recently, the TV signal was broadcasted over the air with analogue technology free of any charge. There is no cable service of significant size. As a result consumers all have an antenna over the roof of their house through which all analogue signals could be captured. In the late 1990's two companies, Telepiù and Stream, entered the satellite broadcasting markets and started to offer pay TV services. They had a very small penetration ratio and were not profitable. In 2003 Murdoch's News corporation (Sky Italia) became the sole satellite broadcaster in Italy, reaching around 16% of Italian families in 2005[51] (in 2008 30% of Italian households subscribe to Sky Italia[52]). At around the same time of the creation of Sky Italia, it became clear that, in order to comply with a Constitutional Court judgement on matters related to the pluralism of information[53], two major analogue free to air channels (Rai 2 and Rete 4) had to be moved to the digital terrestrial band, whose signal can be received through the aerial antenna, but with the addition of a digital decoder.

In order to make sure that enough families had such a digital decoder when the move would become effective (the move has been made affective in 2009 first in some regions only), the government issued a decree in December 2003[54] that granted to consumers a subsidy (of 70

50 Paragraph 32.
51 AGCOM (2006), *Annual Report*
52 Agcom (2008), *Annual Report*
53 Judgement 7 december 1994, n. 420.
54 Interministerial Decree of 30 December 2003 on the grant for digital terrestrial television and for internet broadband access pursuant to Article 4(1) and (2) of Law No 350 of 24 December 2003 and paragraph 211 of

EUR) for purchasing or leasing a decoder that allows the reception of a non-encrypted digital signal at no cost to the consumer and the content provider. In order for the purchase to be subsidized, the decoder had to have an open platform, so as to allow consumers to view all channels with a single piece of equipment, an issue that was considered essential for not having consumers overspend and for avoiding an excessive number of decoders in the house.

Following a number of complaints by competitors that the aid was incompatible with the common market, the Commission opened an investigation against Italy and concluded it in January 2007, three years after the subsidy had been granted and a year after it was no longer available, that the aid was incompatible with the common market. The Commission noted that the measure met all the criteria of article 87, paragraph 1, because "it discriminated between, on the one hand, incumbent terrestrial broadcasters and cable network operators already on the market and, on the other hand, satellite operators and other terrestrial broadcasters which could not operate at the time."[55]

The problem identified by the Commission was that, although the subsidized digital decoders were going to be used for the reception of "non-encrypted signals at no cost for consumers", they could have also been used for providing pay-TV services. The State aid could therefore helped free to air broadcasters to develop a base over which to build their pay-TV services. The State measure "has created an incentive for consumers to switch from the analogue to the digital terrestrial mode. This has been to the advantage of broadcasters"[56]. According to the Commission the measure was selective because broadcasters that competed on the Pay-TV market, but, being present only on the satellite platform, could not have taken advantage of the State aid measure.

The analysis seems fully correct in an ex-ante setting. The problem is that in 2006 Italy changed its legislation allowing for the possibility that Sky Italia, the only satellite broadcaster in Italy, would receive the subsidy, under the condition that it opened up its platform to rivals. Since Sky operates under a proprietary technology and was unwilling to open its platform to competitors, it effectively never accepted any subsidy under the new legislation. As a result, opening up the subsidy also to satellite broadcasters would not have made any difference.

The argument did not seem at all relevant and the Commission argued in paragraph 110 of the decision that "(N)nor is it relevant that, after the amendments made to the 2006 Finance Act to allow the subsidising of all 'interoperable' decoders irrespective of the platform, Sky Italia did not switch from closed technology decoders to decoders that could be subsidised. In fact, this strategy could depend on many factors, such as previous investments by the company or opting to await the Commission's decision on the compatibility of this new measure", a highly speculative conclusion.

What all this proves is that also in cases when the Commission case is quite sophisticated and well argued, market developments and market responses are difficult to reconcile with State aid decisions.

The Italian decoder decision is very interesting also with respect of the issue of how to recover illegal and incompatible aid. In fact, after having concluded that the aid could not be exempted under article 87, paragraph 3 since there was no market failure that the aid was

Law No 311/ 2004 (2005 Finance Act).

55 Commission Decision of 24 January 2007 on State aid C 52/2005 implemented by the Italian Republic for the subsidised purchase of digital decoders (2007/374/EC), paragraph 35.

56 Paragraph 86.

trying to overcome, the Commission was obliged to order recovery.

The Commission excluded in the decision that the aid be recovered from producers of decoders. The recovery action had to be made against broadcasters offering "pay-TV services and cable pay-TV operators"[57]. The Commission acknowledged in paragraph 191 that "accurately calculating the amount of State resources that has actually benefited the recipients is fairly complex. This is because not only was the aid granted indirectly via the consumers but also it was linked to the equipment needed to receive the broadcasters' services rather than the services themselves". More practically the Commission suggests that "a discrete choice demand model could (econometrically) estimate the impact of different factors such as programme content and price on the choices of different types of consumers", a standard difficult to apply outside of an academic journal.

We have now to wait to know how Italy will implement the Commission decision and which econometric model its experts will apply to estimate the suggested discrete choice demand model and so identify only those consumers that purchased the decoder because of the aid. Given the complexity of the calculation, I doubt that any recovery will ever be collected.

6. Conclusion

The European Union is the first jurisdiction in the world that has introduced an active policy against State aid. The objective of the treaty, creating an integrated economic area within the Union, could not be achieved by free trade only, even by an extended free trade regime, i.e. the free movement of goods, services capital and people. Antitrust provisions were meant to impede private restraints of trade, while State aid provision to make sure that member States governments would not subsidize their firms to the detriment of competitors. Considering that the treaty entered into force on January 1958, it is a set of extraordinary forward looking policy instruments.

Treaty provisions on antitrust and on State aid were silent on the objective pursued and at the beginning fairness seemed the most natural choice. In antitrust it took more than forty years to convince the Commission and the Courts of the soundness of the effect based approach, the starting point of the new approach being the entry into force of the merger regulation in 1989 and the role economic analysis needed to play in the analysis of the circumstances when a merger would restrict competition. The example of other jurisdictions enforcement practices was an important reference point of the reform of European antitrust.

The degree of academic controversy over the economics of State aid policy is much lower since, with the exclusion of State aid overcoming market failures, fairness continues to be the most natural objective to pursue. However, the treaty already suggests that fairness should not lead to excessive inefficiency and according to article 87, paragraph 1, a State aid is incompatible with the common market only if it also distorts competition. Unfortunately, there is no requirement in the treaty nor in subsequent regulations that the distortion of competition required for a State aid measure to be incompatible with the common market be noticeable. As a result, the Commission intervenes also when the distortions of competition are minimal. For example in the Charleroi case, where Charleroi airport favored Ryanair with lower landing and take-off charges than other users of Charleroi facilities, the Commission reached a decision of incompatibility without considering the real impact of the aid on the larger air transport market. Had the Commission analyzed thoroughly the impact of the aid on

[57] Paragraph 188.

competition, the decision, where no account is given to the way the air transport market operates, would have probably been different.

The most controversial decisions on State aid are those related to the aid for the rescue and restructuring of firms in difficulty. The restoration of the healthiness of the firm is the final objective of restructuring aid. Therefore the Commission maintains that it will approve the aid only if the member State can show that there is a high probability that the aid will succeed in bringing the firm back into profit. The controversy is particularly strong when the aid is in the form of a capital injection in a State owned firm. In such cases, the private investor principle is particularly difficult to apply since what matters is the difference between the scrap value of a bankrupt firm and the value of a restructured firm. For example in the case of Alitalia, the Italian air carrier on the brink of bankruptcy for over ten years, a capital injection by a State holding company (IRI) in 1997 was challenged in Court and finally confirmed as a State aid measure in 2008, eleven years after it had been granted. In principle the length of the legal procedure would not have mattered, had the Commission not attached a number of very intrusive conditions to its authorization decision. These conditions reduced, not increased, the possibility of Alitalia to compete, contradicting the objective of restructuring aid. What is striking is that there is no market analysis in the decision and, more importantly, Alitalia is treated as a very efficient, rivals threatening company. As a result of the 1997/2001 Commission decision, Alitalia could not reduce prices unless its competitors did so, could not increase capacity and had to sell its participation in Malev, the Hungarian national carrier. These measures certainly did not help the restructuring of the company in the long run.

Finally, contrary to antitrust enforcement, there are no sanctions for granting incompatible State aid. There is only an obligation to restitute to the Government that granted it the unlawful aid, with deterrence only associated with reputation, hardly effective for a State that wants to subsidize its firms.

In the Italian decoder case, the amount to be restituted is very difficult to calculate since it requires the identification of only those consumers that would not have purchased the decoder at a higher price. The Commission decision contains a very ambitious proposal to use sophisticated econometric analysis to calculate the amount to be restituted, a standard difficult to implement in a Court. In my opinion, it is very unlikely that the aid would ever be restituted. In any case, since there was some empirical evidence that would have put into question the effect of the aid on competition, the Commission could have well concluded that the measure did not distort competition.

All these cases show that there is a role for economic analysis different from that identified by the Commission in its new economic approach. Economic analysis should help the Commission identify as State aid only those measures that noticeably distorts competition. The Commission would then intervene only when it is really necessary, getting rid of minor irrelevant cases. In this way economic analysis would play in State aid the same role as it does in antitrust.

The example of antitrust could also be followed at the institutional level, by having member States help the Commission in the investigation of State aid case. As Nicolaides (2003) and Jenny (2008) suggest having an independent institution helping the Commission (that would remain the sole decision maker) with notifications and complaints at the national level could increase the awareness of member State governments on State aid, bridging the increasing gap between the Commission, member State politicians and the general public on the necessity of State aid control. As a result of such enhanced subsidiarity, deterrence would increase and the quality of national legislation substantially improve.