

THE DEFINITION OF STATE AIDS IN THE EUROPEAN UNION

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INTRODUCTION :

- Importance of State aids for newly liberalized sectors

-State aids can be a danger for the success of the liberalization

-State aids can become necessary because of the liberalization

- Complexity of the definition in these sectors

-A competitive market

-A reserved market

-A public service

-A public operator

- Control of state aids by European institutions follows a 2-step procedure:

-Definition: is the transfer a state aid in the meaning of the article 87?

-Derogation: if the transfer is an aid, can it benefit from the derogations exposed by the treaty ?

Article 87 :

1./ 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, insofar as it affects trade between Member States, be incompatible with the common market.

Distortion of trade and competition:

- Justification :

-Competition: There are no reasons to forbid state aids if they have no effect on competition

- Trade:

If the aid only has internal effects , it doesn't concern the European Union.

Externalities of the aid on foreign countries can lead to a negative sum game between member states.

- Practice of the European institutions:

-These criteria are not central in the analysis of European institutions

« As a general rule, it may be assumed that all public aid distorts or threatens to distort competition »

« the requirement of an effect on trade between Member States is easily satisfied » (Advocate general Altmark)

- European Council called for a reinforced evaluation of these distortions

Possible improvements:

- Trade:

Imperfect competition should be a condition for the affectation of trade (Besley and Seabright). With perfect competition there are no possibilities of rent shifting.

- Competition:

No general results which would permit to determine when an aid will distort competition.

Effects of the aid will depend on:

- Nature of the costs affected by the aid
- firm's objectives
- asymmetric information

Economic Advantage :

When a transfer from the state will be an investment and not an aid?

- To answer this question one has to apply the test of the private investor in market economy (PIME)

This test can be used for other purposes:

- Lending
- Credit
- Guarantee
- Investment of public firms
- Transactions between a public firm and its affiliates

- Practice of the commission

Comparison between the investment's internal rate of return and the minimal rate that would be required by a private investor.

- Critics:

-Tribunal (WLG-march 6,2003): the determination of the minimal rate is subjective

The determination of the internal rate of return is also subjective

-Harbord and Yarrow (1998):

The theoretical model used by the commission is not the good one. The commission would have to use the theory of real options.

- Discrimination between public and private firms

Would a private firm pass the test of PIME?

-No, if the model used by the commission is not the good one

-Even if the model is the good one : No, if private firms do not always behave optimally.

Are Investments of private firms always optimal?

-No, if the managers are irrational

-Even if they are rational: No, if there are problems of asymmetric information for example between managers and shareholders: empire building [Jensen (1986)]; “quiet life” [Bertrand Mullainathan (2000)].

- Transactions between a firm and its affiliate

“The provision of logistical and commercial assistance by a public undertaking to its subsidiaries, which are governed by private law and carry on an activity open to free competition, is capable of constituting State aid within the meaning of Article 92 of the EC Treaty if the remuneration received in return is less than that which would have been demanded under normal market conditions” (decision of the court July 11, 1996; case C-39/94)

“there is no question of State aid to SFMI-Chronopost if (...) it is established that the price charged properly covers all the additional, variable costs incurred in providing the logistical and commercial assistance, an appropriate contribution to the fixed costs arising from use of the postal network and an adequate return on the capital investment (...)”(decision of the court;3 July 2003)

Would private firms charge the fully distributed cost?

- The “transfer pricing guidelines” of the OECD recognize several methods to determine the transfer pricing, and not the only Fully Distributed Cost.
- in the case DPAG (March 20, 2001; 2001/354/CE) the Commission has considered that a firm can fix a price equal to the incremental cost

Test of the PIME introduces a discrimination between private and public firms

What is the sense of a “private investor” test which would not be passed by a private investor?

Compensation for Service of General Economic Interest

Compensations are not state aid if several conditions are fulfilled

Altmark (decision of the court; July 24, 2003) :

- Public service obligation is clearly defined
- Compensation is calculated on transparent and objective manner
- No overcompensation
- When an undertaking is not chosen through a public procurement procedure, the level of compensation is determined on the basis of the costs of a **typical and well run undertaking**.

Can we know, after this decision, when a compensation won't be an illegal aid?

- With an open tender:

-Compensations fixed by a negative auction are not considered like state aids.

-Conditions are not specified (contestability of the market...)

- Without open tender: Existing problems remain

-Repartition of common costs

-Indirect benefits of the public service:

Court of Justice asked the calculation of these benefits (universal service obligation of France Telecom- December 6, 2001)

The Commission also recognizes the importance of these benefits (communication on public service broadcasting, case Crédit Mutuel decision of January 15, 2002). But in practice does not compute them.

- The costs of a well run undertaking

-Contradicts the precedent jurisprudence (FFSA)

-Two interpretations remain possible:

1) If the costs are not those of a well run undertaking, the compensation is a state aid and the aid is illegal

2) If the costs are not those of a well run undertaking, the compensation is an aid, but this aid can be authorised because of the derogation by article 86

Transfer of state resources

“It follows from the Court's case-law that State resources are not involved where the public authorities at no stage enjoy or acquire control over the funds which finance the economic advantage in issue” (court of justice Stardust-case C-482/99)

“financial resources are to be regarded as State resources within the meaning of Article 87(1) of the EC Treaty where those resources fell within the control of the State prior to their being transferred to the recipient” : (commission DPAG-case C-379/98)

With these definitions, some measures having the same economic effects than state aids are not state aids

- Fund which finances a public service

Preussenelektra: a provision which requires electricity supply undertakings to purchase “green electricity” to a higher price than market value and distributes the financial burden on those firms and on upstream network operators does not constitute state aid.

Is a fund which finances a universal service obligation a state aid?

- Cross subsidies

-Case UPS (March 20, 2002; case T-175/99):

« the mere fact that it used those funds to acquire joint control of an undertaking active in a neighbouring market open to competition does not in itself, even if the source of those funds was the reserved market, raise any problem from the standpoint of the competition rules (...)»

If the acquisition were financed by a state aid, the aid would have been illegal. There is an asymmetry between state aids and cross subsidies.

-Predation by DPAG (decisions of the commission; 2001/354/CE and 2002/753/CE):

First decision DPAG : Predatory behaviour of DPAG on business to consumers parcel market, Commission decides that the predation is financed by cross subsidies. DPAG has to pay a fine.

Second decision DPAG: Predatory behaviour of DPAG on business to consumers and B2B parcel market, here the commission decides that the predation is financed by state aids. DPAG has to reimburse the aid.

Again there is an asymmetry in the punishment of state aids and cross subsidies

Example :

Loss due to Predation=1000

Profits in the reserved area=1000

State aid=1000

Cost of the SGEI=1000

-First possibility : aid finances the predation, cross subsidies finance the SGEI.
The firm has to reimburse the aid and has to pay a fine

-Second possibility : cross-subsidies finance the predation, the aid finances the SGEI. The firm has to pay a fine

impossible to say what interpretation is the good one: the choice of the commission will be arbitrary.

Imputation to the State:

One has to verify if the firm can act independently from the state. In the case Stardust, the court proposed several indications:

- the body in question could not take the contested decision without taking account of the requirements of the public authorities
- its integration into the structures of the public administration
- the nature of its activities and the exercise of the latter on the market in normal conditions of competition with private operators
- the legal status of the undertaking (in the sense of its being subject to public law or ordinary company law),
- the intensity of the supervision exercised by the public authorities over the management of the undertaking

SELECTIVITY :

The aid is selective if there is a discrimination based on the sector, the territory or the category of enterprise.

Aid targeted to small and medium enterprises is illegal (CETM; Case T-55/1999). A decrease in tax for firms which realize an investment superior to a minimum level is illegal. Even if it seems general, this measure only benefits to a category of enterprises (Teritorio historico de alava; Case T-92/00)

With this definition, non-selective aids could also justify a co-operation between the member states of the European Union. But non selective aids are ineffective and expensive for rent shifting (Besley andSeabright)

Conclusion:

-Importance of state aids in newly liberalised markets (explains the multiplication of cases involving state aids issues)

-The main difficulties encountered in the definition of state aids are more likely to emerge in these sectors:

The financing of a public service

Cross subsidies

Investment of the state in a public undertaking

Transaction between a public firm and its affiliates

-It is necessary to have clear and effective rules to control these practices

-there is a need for more economic foundations in the control of state aid, and of more visibility and clarity of the rules governing state aids. This is one of the conditions for the success of the liberalization process.