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**Compatibility of State Aid and the Balancing Test:
Its Role in the Architecture of the System of State Aid Control**

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1. Introduction

One of the objectives of the State Aid Action Plan is to introduce a refined economic analysis of state aid. The purpose of this paper is to consider how the balancing test fits in the architecture of state aid control.

The “refined economic analysis” of the SAAP is embodied in a so-called “balancing test” which has been elaborated in the draft R&D&I Framework and the Guidelines on Risk Capital in SMEs. The balancing test consists of three stages, each answering the following respective questions:

1. Is the aid measure aimed at a well-defined objective of common interest? For state aid to be exempted it must pursue one of the policy objectives which are defined in Article 87(3) [or (2)].
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? This in turn is broken down into three subsidiary questions:
 - i. Is state aid an appropriate policy instrument? There may be other instruments that do not involve subsidies and which are equally good or even better at achieving the desired policy objectives.
 - ii. Is there an incentive effect; i.e. does the aid change the behaviour of firms? For aid to be exempted it must be capable of inducing firms to do things they would not otherwise do without government intervention.
 - 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? Even if the aid is appropriate and proportional, it may still generate significant distortions of competition that may harm other member states. These harmful effects have to be taken into account.

The balancing test adopted by the Commission has been criticised for a number of reasons: legal [e.g. Article 87(3) supposedly does not allow for this kind of analysis], economic [e.g. the test is too narrow] and procedural, the main of which are the lack of legal certainty and its inherent complexity.

Addressing the first two criticisms is outside the scope of this paper as others have done it more thoroughly. But given that the purpose of this paper is to consider the place of the balancing test in the system of state aid control, the third criticism has to be considered at the outset.

Undoubtedly, any test which does not depend on procedural criteria but on results which are not known in advance is bound to raise uncertainty. But this is not necessarily a negative development. Legal certainty is not the only concern in state aid control, nor the most important one. The most important concern is to prevent distortion of trade and

competition. Naturally, it is desirable that prevention of distortion of competition can be achieved with procedures that afford a high level of legal certainty to national authorities and undertakings. However, a reduction of certainty for the sake of avoiding competition distortions is a trade-off worth making.

The criticism about the complexity of the test is also largely misplaced. Attempting to remedy market failure through state aid is a difficult task simply because it attempts to predict the behaviour of market players. In essence, it asks how they are likely to behave with and without government intervention. Since these are two alternative states of the world, if one occurs, the other necessarily does not. The alternative state can never be known with absolute certainty. Moreover, there is a degree of endogeneity in government intervention because market players lobby in favour or against it and because they react accordingly.

Refusing to acknowledge these difficulties which are inherent in public policy and criticising the complexity of the balancing test is the policy equivalent of hiding one's head into the sand. If assessing the impact of state aid is as difficult as critics claim, then they must explain why it is legitimate for governments to grant aid without actually knowing what its impact may be and whether it will achieve its objectives. The argument that the economic assessment of state aid is difficult is more of an indictment of the laxity and ineffectiveness of current procedures. However, as is argued in this paper, there can be improvement in the way that the test is applied so that it fits better in the architecture of the system of state aid control.

The paper first reviews how the test has been elaborated in the draft R&D&I Framework the Risk Capital Guidelines. Indeed it is important to understand how it has been elaborated because it is the only way to form an opinion about how tough or easy the test is likely to be. This is because one of the aims of the SAAP is to “reduce and better target” state aid hard and because one of the aims of the system of state aid control in the EC is to guide member states to design state aid measures that are likely to be approved by the Commission. After that review, the paper compares the balancing test with other similar tests that have been recently proposed and which provide a sort of benchmark. The paper concludes with an evaluation of its likely contribution to the system of state aid control and how it may be improved so that its role can be strengthened.

3. The balancing test in state aid for R&D&I²

Not all aid cases of state aid to R&D&I will be subject to the balancing test. It is assumed that for most cases, compliance with the criteria and ceilings laid down in the Framework [and a future block-exemption regulation] will also satisfy the conditions of the test. This means that, in practice, most aid granted to SMEs or for research far removed from the market will not have to undergo the balancing test. Aid will be subject to a more detail assessment only when it exceeds EUR 5 million [although this amount is not yet fixed].

² Accessed at http://ec.europa.eu/comm/competition/state_aid/others/action_plan/rdi_frame_en.pdf

In addition, degree of the Commission's assessment will be proportional to the risk of distortion of competition. This means that the detailed assessment will not necessarily require that all the criteria be verified; the scope of the analysis will depend on the nature of each case.

The starting point of the balancing test is the identification of market failure that hampers R&D&I. The Commission expects proof of knowledge spillovers, imperfect and asymmetric information or coordination failures. Member states can illustrate the existence of market failure through benchmarking showing that other regions, markets or sectors experience higher levels of R&D&I. To show that state aid is an appropriate instrument, the Commission wants proof of the advantages of using a selective instrument such as state aid over other possible policy responses.

The next important step is to determine whether the aid has an incentive effect. The Commission considers that as a result of aid, R&D&I activity should be increased in size, scope, amount spent or speed. Where aid is granted to large firms or when the aid is closer to the market raising more competition concerns, the incentive effect will have to be identified by counterfactual analysis, comparing the levels of intended activity with aid and without aid.

At the same time, aid must be proportional; i.e. even if aid is necessary and has an incentive effect, it must not exceed the minimum amount required to carry out the R&D in question or it must not result in excessive distortion of competition. The amount of required aid is linked to the degree of market failure.

The essence of the balancing test is that the negative effects of aid (distortion of competition) must be limited. These effects can be categorized in the following:

- i. Disruption of the dynamic incentives of undertakings and crowding out of private investment.
- ii. Support of inefficient production.
- iii. Encouragement of exclusionary practices and enhancement of market power.
- iv. Impact on trade flows between member states.

There are three distinct ways in which R&D&I aid can distort competition in product markets:

i. R&D&I aid can distort the dynamic incentives of market players to invest (crowding out effect). In its analysis, the Commission takes into consideration the following elements:

- i. Aid amount. The significance of the aid amount will be measured with reference to total private R&D expenditure in the sector, and the amount spent by the main players.
- ii. Closeness to the market / category of the aid
- iii. Open selection process
- iv. Exit barriers
- v. Incentives to compete for a future market
- vi. Product differentiation and intensity of competition.

ii. R&D&I aid can create or maintain positions of market power. The Commission is unlikely to identify competition concerns related to market power in markets where each aid beneficiary has a market share below 25% [still to be confirmed] and in markets having a market concentration with Herfindahl-Hirschman Index (HHI) below 2000 [still to be confirmed]. In its analysis, the Commission takes into consideration the following elements:

- i. Market power of aid beneficiary and market structure.
 - ii. Level of entry barriers.
 - iii. Buyer power.
 - iv. Selection process.
- iii. R&D&I aid can maintain an inefficient market structure. The Commission considers whether the aid is granted in markets featuring overcapacity, in declining industries or in sensitive sectors.

Once the foreseeable positive and negative impacts of the state aid are identified, the final step is to compare them. For this purpose the Commission has said that it will not use the criteria set out above mechanically but will make an overall assessment based on the proportionality principle. It will attach different weights to the different criteria depending on the facts of each case.

The balancing test in state aid for Risk Capital³

As in the case of aid to R&D&I, the measures that fall below the thresholds defined in the Guidelines are presumed to satisfy the compatibility test. A more detailed compatibility assessment will be necessary for risk capital measures which do not satisfy all the conditions laid down in the Guidelines, notably investments exceeding EUR 1.5 million. The analysis of compatibility of the measures will be based on a number of positive and negative elements. No single element is determinant, nor can any set of elements be regarded as sufficient on its own to ensure compatibility.

The Commission considers that there is no general risk capital market failure in the Community. It does, however, accept that there are market gaps for some types of investments at certain stages of enterprises' development. These gaps result from an imperfect matching of supply and demand of risk capital and can generally be described as an equity gap.

The Commission considers that the main source of market failure relevant to risk capital markets, which particularly affects access to capital by SMEs and companies at the early stages of their development and which may justify public intervention, relates to imperfect or asymmetric information.

Imperfect or asymmetric information may result notably in:

- i. Transaction and agency costs: potential investors face more difficulties in gathering reliable information on the business prospects of an SME.

³ Accessed at http://ec.europa.eu/comm/competition/state_aid/others/risk_capital_guidelines_en.pdf

ii. Risk aversion: investors may become more reluctant to provide risk capital to SMEs.

Evidence of market failure must be based on a study showing the level of the equity gap with regard to the enterprises and sectors targeted by the risk capital measure. The relevant information concerns the supply of risk capital and the fundraising capital, as well as the significance of the venture capital industry in the local economy. The evidence could also include the following elements:

- (a) development of the fundraising over the past five years, also in comparison with the correspondent national and/or European averages;
- (b) the current overhang of money;
- (c) the share of government aided investment programs in the total venture capital investment over the preceding three to five years;
- (d) the percentage of new start-ups receiving venture capital;
- (e) the distribution of investments by categories of amount of investment;
- (f) a comparison of the number of business plans presented with the number of investments made by segment (amount of investment, sector, round of financing, etc.).

The Commission considers that state aid to risk capital measures may constitute an appropriate instrument within the limits and conditions set out in these guidelines. However, risk capital provision is essentially a commercial activity involving commercial decisions. In this context, more general structural measures not constituting state aid may also contribute to an increase in the provision of risk capital, such as promoting a culture of entrepreneurship, introducing a more neutral taxation of the different forms of SME financing (for example new equity, retained earnings and debt), fostering market integration, and easing regulatory constraints.

Where member states have considered other policy options and the advantages of using a selective instrument such as state aid have been established and submitted to the Commission, the measures concerned are considered to constitute an appropriate instrument.

State aid for risk capital must result in a net increase in the availability of risk capital to SMEs, in particular by leveraging investments by private investors. The lack of incentive effect means that some enterprises funded through publicly supported measures would have obtained finance on the same terms even in the absence of state aid (crowding out). The Commission considers that aid in the form of risk capital satisfying the conditions laid down in these guidelines ensures the presence of an incentive effect. The need to provide incentives depends on the size of the market failure related to the different types of measures and beneficiaries. Therefore different criteria are expressed in terms of size of investment tranches per target enterprise, degree of involvement of private investors, and consideration of notably the size of the company and the business stage financed.

Therefore, the Commission will also take into account the following additional criteria showing the profit-driven character of investment decisions and the commercial management of the measure, where relevant:

i. Commercial management.

- ii. Presence of an investment committee.
- iii. Size of the measure/fund [the budget for investments into target SMEs should be of a sufficient size to take advantage of economies of scale in administering a fund and the possibility of diversifying risk via a pool of a sufficient number of investments].
- iv. Presence of business angels.

The need to provide incentives depends on the size of the market failure related to the different types of measures, beneficiaries and development stage of the SMEs. A risk capital measure is well-designed if the aid is necessary in all its elements to create the incentives to provide equity to SMEs in their seed, start-up and early stages. State aid will be inefficient if it goes beyond what is needed to induce more risk capital provision. In particular, to ensure that aid is limited to the minimum, it is crucial that there is significant private participation and that the investments are profit-driven and are managed on a commercial basis.

The Commission will consider that the following elements positively influence the assessment of proportionality as they represent a best-practice approach:

- i. Open tender for managers.
- ii. Call for tender or public invitation to investors.

When deciding whether to authorise the grant of public funds for measures designed to promote risk capital, the Commission will seek to limit as far as possible the following categories of risk:

- i. The risk of crowding out: The presence of publicly supported measures may discourage other potential investors from providing capital. This could, over the longer term, further discourage private investment in young SMEs and thus end up widening the equity gap, while at the same time creating the need for additional public funding.
- ii. The risk that advantages to the investors and/or investment funds create an undue distortion of competition in the venture capital market relative to their competitors that do not receive the same advantages.
- iii. The risk that an oversupply of public risk capital for target enterprises not invested according to a commercial logic could help inefficient firms stay afloat and could cause an artificial inflation of their valuations, making it all the less attractive for private investors to supply risk capital to these firms.

Alternative tests

In order to evaluate the Commission's balancing test it is instructive to consider what kind of other tests have been proposed. These alternative tests provide us with a benchmark against which to consider the breadth and depth of the Commission's test and appreciate whether it is reasonable or too cumbersome.

The OFT test⁴

⁴ See OFT, European State Aid Control, November 2005, OFT 821, accessed at "<http://www.of.gov.uk/NR/rdonlyres/F346B4FF-4C97-4970-BD95-70E9EB56ADBE/0/OFT821.pdf>"

The OFT believes that not all state aid cases should be subjected to detailed economic analysis. There is a need to focus on most distorting cases in order to save administrative resources at the EU level and relieve member-state administrations from the burden of notifications. In addition, the OFT is of the view that current rules allow distorting aid to be approved simply because they satisfy the criteria laid down in the regulations and guidelines. The purpose of more detailed economic analysis would be to prevent approval of distorting aid that formally complies with regulations or guidelines. The Commission would retain its current role as the sole entity assessing state aid, but national competition authorities would be given the possibility to offer formal advice.

The OFT is in favour of keeping the structure of Article 87 and in particular the criteria of Article 87(1) for classifying public measures as state aid. It follows that a more detailed analysis would have to be carried out under Article 87(3).

Such an analysis would involve a two-phase investigation. Phase 1 assesses the likelihood of distortion of competition. Phase 2 carries out detailed investigation of the effects of aid.

Phase 1 would consist of three steps each focusing on the following questions:

- i. Does aid remedy market failure?
If yes, go to the following question.
If no, go to phase 2.
- ii. Are there objective selection criteria linked to market failure?
If yes, has recipient small market share? If yes, apply relevant guidelines.
If no, go to phase 2.
- iii. Are there many eligible firms? If yes, apply relevant guidelines.
If no, go to phase 2.

Phase 2 defines the relevant market and assesses the impact of aid on market operators. The factors that are taken into account are the amount of aid, project size, effect on costs, market concentration, size and symmetry of firms, product differentiation and entry & exit barriers.

Charles Rivers Associates test⁵

CRA has outlined its test in a study they carried out for DG Economic and Financial Affairs. The test is made up of five steps.

Step 1: Is there significant market failure? Without some kind of market mal-functioning there is no need for government intervention.

Step 2: Is aid appropriate? Although the market may not function perfectly, it does not follow that state aid is capable of remedying the problem. So it must be shown that the aid instrument and amount of aid are capable of correcting the market failure.

⁵ R. Nitsche, P. Heidhues, Study on Methods to Analyse the Impact of State Aid on Competition, European Economy, Economic Papers, no. 244, February 2006, DG Economic and Monetary Affairs, European Commission.

Step 3: What are the relevant markets and relevant products? To identify the effects of state aid on competitors it is first necessary to define the relevant markets and products that will be affected by the aid.

Step 4: Counterfactual analysis. The analysis in this step aims to establish what would have happened to competition and how the market would have evolved in the absence of aid.

Step 5: Decision and possible conditions attached.

Summary of economic tests

Balancing test

1. Is there well-defined objective of common interest?
2. Is measure well designed?
 - i. Is aid appropriate policy instrument?
 - ii. Is there an incentive effect?
 - iii. Is aid proportional?
3. Are distortions of competition and effect on trade limited?

OFT test

Phase 1:

- i. Does aid remedy market failure?
- ii. Are there objective selection criteria linked to market failure?
- iii. Are there many eligible firms?

Phase 2:

- i. What is relevant market?
- ii. What is impact of aid on market operators?

Charles Rivers Associates test

Step 1: Is there significant market failure?

Step 2: Is aid appropriate?

Step 3: What are the relevant markets and relevant products?

Step 4: Counterfactual analysis.

Step 5: Decision and possible conditions attached.

Purpose of state aid control

To appreciate the role of the balancing test in the architecture of state aid control in the EC, it is first necessary to define the aims of that control. I believe it has two broad aims. The first is to support the achievement of a truly integrated internal market; i.e. to prevent distortions to trade and competition. It protects the interests of competitors who do not receive state aid. Since neither the Treaty, nor economic theory require an absolute prohibition of state aid, its control has to be selective. Indeed the role of the Commission is to determine the kinds of aid that are compatible with the objectives and criteria laid down in the Treaty.

The second aim of the system of state aid control is to guide member states to design their policies and state aid measures in such a way so that the Commission will be in a position to approve them. The results of this guidance are to afford a reasonable degree of legal certainty both to national authorities and undertakings and to prevent waste of administrative resources.

It has been suggested that the cost of designing and implementing state aid measures for public authorities represents about 5% of the amount of state aid granted. Another 5% is spent by undertakings in applying for state aid and complying with the conditions imposed by the Community and national authorities. These are significant amounts and indicate that the value of that guidance has to be seriously taken into account by any assessment of the system of state aid control.

Evaluation

The balancing test and the alternative tests reviewed in the previous section begin by asking whether aid has a legitimate purpose. This is absolutely correct because if aid is not intended to remedy some kind of market failure or promote some other kind of well-defined policy objective then there is hardly any justification for the government to intervene in the economy. And if the government intervenes without any well-defined purpose, then it is likely that the intervention is motivated by short-term political objectives of doubtful value for the long-term interests of the economy as a whole.

In this connection, it should be noted that there is a subtle difference between the balancing test and the other tests. The balancing test uses a broader criterion because it refers to “policy objectives of common interest”. The reason is that aid which is exempted under Article 87(3) may serve objectives other than the remedying of market failure. However, in the R&D&I Framework and the Risk Capital Guidelines the emphasis is, correctly, on market failure because it is not possible or efficient to attempt to raise R&D&I or encourage investment of risk capital in SMEs by giving aid, for example, to employment, and vice versa.

The next step of the balancing test is to ask whether state aid is an appropriate instrument. The test proposed by CRA asks the same question. The OFT test differs significantly in this respect. It tries first to find out whether the recipients are large companies, whether they operate in oligopolistic industries and whether the aid is granted to a few chosen

firms. It is in these situations that aid is likely to have its biggest and most distortive impact on competition and cross-border trade. Since state aid control in the EU is intended to protect the uninterrupted functioning of the internal market, the interests of the other member states and those of the Community in general, it makes sense to have a “filter” to identify the most problematic cases for the common interest.

In fact, this consideration could be taken a step further. This kind of filter should operate at the very first stage of economic analysis of state aid. Aid that is granted only to companies with insignificant market share or which are unlikely to engage in cross-border trade, should not be subject to Community scrutiny, irrespective of whether that aid is granted for a legitimate objective or not or whether it constitutes an appropriate policy instrument or not. If member states waste their public money on ineffectual policy instruments it is their problem as long as they do not cause any negative cross-border spillovers.

There is another, probably more important, reason why I believe that the balancing test should start with well-defined thresholds to determine cases of Community concern. The reason is that markets hardly ever function perfectly. This does not mean that government intervention is always legitimate. On the contrary, it reveals the magnitude of the difficulty of designing intelligent public policies. But the point here is that if member states will have to prove market failure, it will be rather easy for them to do so. In this respect, the balancing test does not really impose any onerous burden on member states, nor will it result in rejections of any significant number of state aid measures.

The same consideration applies to whether state aid is an appropriate instrument and whether it has an incentive effect. The Economic Advisory Group on Competition Policy, in their commentary on the R&D&I Framework, observe that there many other things that government can do besides granting aid, such as improving scientific training.⁶ The Commission also identifies a number of alternative policy responses to market failure such as strengthening the culture of entrepreneurship. In principle, these views are valid. But this kind of measures take time to design, implement and gestate. I believe that member states will have little difficulty arguing that the state aid they wish to grant is an appropriate instrument for generating short-term results given its immediate impact on market players.

With respect to the incentive affect, it is clear that aid lacks such an effect whenever it is granted after the project starts or the investment takes place or when it aims to subsidise the every day operations of beneficiary firms, including their normal product development activities. In other cases, applicant firms are unlikely to have difficulty showing that their planned investment cannot be profitable without aid. This is simply because they can add costs to raise the quality of the product or can add time to the

⁶ EAGCP, Commentary on the European Commission’s Draft Community Framework for State Aid for Research, Development and Innovation, 3 July 2006. Accessed at <http://ec.europa.eu/comm/dgs/competition/eagcp.pdf>

minimum length of time that is needed for a project to be completed or can identify all sorts of risks ranging from competitors' reaction to technological changes.

My conclusion is that proof of market failure, the appropriateness of state aid and incentive effects will be rather easy obstacles for member states to surmount. They will not be decisive in rejecting proposed state aid measures. Therefore, they should be given less significance and should be at a later stage of the test. Again, if member states want to grant poorly designed state aid, it is their problem as long as they do not impose any burden on the rest of the Community. Therefore, more attention should be given at the outset to defining thresholds that identify cases where there is serious Community concern.

After determining the necessity and proportionality of aid, the balancing test and the other tests seek to assess the trade and competition impact of aid. They all look at factors such as market shares, the degree of market concentration, the existence of entry barriers, the extent of product differentiation, etc.

The Commission in its balancing test is explicit that the specific weights that will be attached to the various factors will change from case to case. This leaves national authorities with considerable degree of uncertainty as to whether the aid under investigation can be approved or not. This is a different uncertainty than that which emanates from the ex ante unknown outcome of the competition assessment and which depends on market conditions which are external to the assessor, i.e. the Commission. Here the uncertainty is caused by the subjective use of different weights by the assessor. Perhaps it is impossible to define with any precision before hand the relative importance that the Commission will attach to the various factors. But as it has done in the case of Article 81(3), it should provide examples that can illuminate its policy preferences and make its approach more transparent.

Conclusion

A more refined economic analysis of state aid is much needed in the system of state aid control of the EU. A number of tests have been proposed and the Commission has adopted a test that seeks to balance out the positive and negative effects of state aid.

The test will contribute to the control of distorting aid not by asking whether state aid is a well-designed policy but by offering guidance to member states on the kinds of aid that are more likely to harm intra-Community competition. For this purpose, more explicit thresholds of Community interest should be developed, the assessment of the impact of aid on competition should be elaborated and this assessment should come earlier in the test rather than last.

If the Commission does not elaborate further the procedure that will follow to assess the competition impact of state aid there will be a risk that member states will challenge before the Court of Justice every negative decision of the Commission. Indeed the Court

has acknowledged that the Commission enjoys wider discretion in applying Article 87(3) than 87(1). However, the Court has also annulled a significant number of Commission decisions for failure to provide adequate reasoning.

The balancing test must be tough if it is to contribute to achievement of the SAAP aims. But a tough test must be transparent.