

The EU's State Aid Modernisation – taking stock of its initial results

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Executive Summary

- > The State Aid Modernisation that was completed in July 2014 has established the rules that apply to public subsidies in 2014-2020.
- > The new rules are based on 'common compatibility principles', which require that aid addresses market failure, is necessary and proportional, and does not cause excessive distortion of competition.
- > The institutional centrepiece of the Modernisation is the new General Block Exemption Regulation (GBER) that enables Member States to grant state aid without prior notification to the European Commission.
- > Member States can thus avoid the administrative cost of notification, while the Commission can direct its efforts to the most serious cases.
- > However, the increased use of the GBER has also made state aid measures less visible.

Competition policy is one of only four policies that fall within the exclusive competence of the European Union. It has the important role of preventing distortions in the EU's internal market, prohibiting corporate practices as well as public measures which exclude or discriminate against competitors and harm consumers. Public authorities may not grant subsidies to confer a competitive advantage to firms, industries or regions.

Although public subsidies, or 'state aid' as they are called in the EU, are considered to be in principle 'incompatible with the internal market', their prohibition is not absolute. Occasionally, public authorities may be justified to intervene in the market to support investments in, say,

research and knowledge production, environmental protection, training or employment of disadvantaged workers. Because it is not always obvious when state intervention may be necessary to remedy market failure, EU rules require Member States to notify to the European Commission any aid they intend to grant and request the Commission's prior authorisation.

The Commission is the sole authority in the EU with powers to determine the compatibility of state aid with the internal market. These extraordinary powers are conferred to the Commission directly by the Treaty and enable it to prohibit Member States from granting aid without having to initiate the normal infringement procedure. Competition policy is the only policy area where the Commission enjoys such powers. Over the years, the Commission has adopted numerous regulations and guidelines that define the various types of state aid that it considers to be compatible with the internal market. Since 2005, the Commission has embarked on a process of reforming its state aid rules. This process culminated in July 2014 in the adoption of several new regulations and guidelines. A full list of all the documents that came into force in July 2014 can be found on the Commission website (see *Further Reading*).

The new rules were adopted within the framework of the so-called State Aid Modernisation (SAM) launched in May 2012. The main purpose of the SAM was to streamline the various state aid rules, focus Commission action on the most distortionary types of aid and relieve as much as possible Member States from the administrative burden of notifying every state aid measure, regardless of its size and impact on the internal market.

State aid rules are indispensable for the proper functioning of the internal market. Member States grant more than EUR 140 billion of aid to their industries (including railways). This amount, which is roughly equal to the total

budget of the EU, has the potential to cause serious disruption to the functioning of the internal market. Therefore, two years after the new framework of rules was adopted is an opportune time to take stock of what has been achieved so far.

Policy reform can be evaluated from two broad perspectives. It can be evaluated on the basis of general principles that apply to all policies such as economic efficiency, equity, etc. Or, it can be evaluated against the objectives that the policy itself seeks to achieve. The analysis in this paper follows the latter perspective. The achievements of the SAM are assessed against the goals it set for itself.

Much has been written from an *ex ante* point of view about the aims of the SAM and how it was introduced and promoted by the Commission. However, so far, there has been no attempt to identify and assess its results from an *ex post* point of view.

Objectives of the State Aid Modernisation

The State Aid Modernisation Communication (COM (2012) 209 final) set the following objectives:

- “(i) to foster sustainable, smart and inclusive growth in a competitive internal market;
- (ii) to focus Commission *ex ante* scrutiny on cases with the biggest impact on internal market whilst strengthening the Member States cooperation in State aid enforcement;
- (iii) to streamline the rules and provide for faster decisions.”

The objective of fostering growth in a competitive market was to be achieved through state aid control that would “facilitate the treatment of aid which is well-designed, targeted at identified market failures and objectives of common interest, and least distortive (good aid)”. In addition, state aid control would “help Member States to strengthen budgetary discipline and improve the quality of public finances – resulting in a better use of taxpayers’ money”, contribute to “more effectiveness in public spending (use of state aid only where it represents a “real added-value” and leads to “cost-effective and growth enhancing aid”).

To achieve the objective of fostering growth, the Commission proposed to:

- define “common principles applicable to the assessment of compatibility”;
- undertake “revision and streamlining of state aid guidelines, to make them consistent with those common principles”;

- pursue a “more systematic assessment of the potential negative effects of State aid - notably in terms of distortions of allocative and dynamic efficiency, subsidy races and market power”.

In relation to the objective of focusing Commission *ex ante* scrutiny on cases with the biggest impact on the internal market, the Commission proposed to: “review the de minimis Regulation” and to “extend the General Block Exemption Regulation”. In relation to the objective of streamlined rules and faster decisions, the proposed actions were: “better explanation of the notion of State aid” and revision of the “Procedural Regulation with regards to complaint-handling and market information tools”.

The SAM was launched in 2012 and the new framework of rules and procedures was largely completed by July 2014. This missing piece was the paper on the *Notion of State Aid*. It was eventually published on 19 May 2016.

Assessment of the initial results of the SAM

A search of the data base of the Commission’s Directorate-General for Competition (DG COMP) indicates that between 1 July 2014 and 22 May 2016, DG COMP dealt with 700 state aid cases. Most of these cases were assessed on the basis of the guidelines that expired on 30 June 2014.

Further refinement of the search criteria reveals one R&D case, one risk finance case, six cases of regional aid, other than regional aid maps, of which four concerned outermost regions, and 49 cases of environmental and green energy aid, of which 20 concerned windfarm projects in Germany. It appears then that the Commission has dealt in depth with about 25-30 cases of these types of aid in the first two years of the SAM.

Aid for environmental protection and green energy, regional development, research and risk finance accounts for close to 85-90% of all horizontal aid that is granted in the EU. In other words, in the period from July 2014 to May 2016, the visibility of how the most important state aid guidelines are implemented is extremely low. This may be caused by two different factors: *first*, the search engine does not appear to pick up all the relevant cases; *second*, the low visibility may be the result of the spectacular success of the Commission to induce Member States to use the General Block Exemption Regulation (GBER) (Regulation 651/2014). The purpose of the GBER is precisely to relieve Member States from the obligation to notify new state aid measures. Commission officials have mentioned in conferences that about 87% of all state aid measures implemented by Member States have been

adopted in compliance with the GBER. However, the other side of the coin of the success of the GBER may be that little is now publicly known about the quality of the measures implemented by Member States and the extent of their conformity with the letter as well as the spirit of the GBER. The Commission certainly has a much better view of what Member States do. But the important point is that this knowledge is not public. To the extent that such knowledge contributes to the design and uniform application of state aid measures across the EU, the relative decrease in the public availability of such knowledge can be assumed to have a non-negligible negative effect on cross-border competition and investment.

What is not yet known

Without a large empirical study, it is not possible to know whether the SAM has reached its objectives of fostering “sustainable and smart growth” in the internal market. Similarly, the Commission has examined many state aid measures since July 2014, but there is no evidence that those were the ones with “the biggest impact on the internal market”. So far there is no plan to test the impact of SAM as a whole on the European economy.

However, an innovation that was introduced in 2014 was the requirement for *ex post* evaluation of the effectiveness of schemes with budgets exceeding EUR 150 million per year. It is understood that the Commission has so far approved about 30 *ex post* evaluation plans. Their results will not be known until 2018-2019. It is likely that the findings of these evaluations will feed into the new rules that will be adopted for the period 2021-2027.

What is well known

The scope of the GBER has been expanded significantly. As mentioned above, close to 90% of all state aid measures implemented by Member States are now based on GBER provisions. This is a major success for the SAM, as increased use of the GBER relieves the Commission from having to deal with routine or insignificant cases. It also relieves Member States from the administrative cost of notification.

All the rules (regulations and guidelines) now assess the compatibility of state aid according to the same principles – the so-called common assessment principles. This innovation has three major advantages: *first*, it makes the enforcement of the rules more uniform across all types of aid; *second*, it enables Member States to gain more experience on how state aid is assessed by learning from practice across the spectrum of the various types of aid; *third*, the common assessment principles have solid

theoretical foundations and make the previous procedure, which was often formalistic, more rigorous.

Cooperation between the Commission and Member States in state aid enforcement has expanded through the establishment of the SAM working group and through bilateral meetings.

What is gradually becoming known

Ex post monitoring of implemented state aid measures by the Commission is increasingly covering more measures. Currently, the size of the sample of monitored measures appears to be about 7%. So far, however, most monitored measures are still those that were adopted in the previous period (2007-13). The measures that fall under the post-2014 rules will be monitored as of 2017. The results of the *ex post* monitoring are not yet public, nor is it clear how and whether this monitoring has contributed to reducing the rate of ‘irregularities’ and other design mistakes by Member States.

With respect to the goal of faster decisions, formally the Commission must deal with a notified measure within two months. However, cursory analysis of the actual time length between the date of notification and the date of final decision suggests that the Commission needs about seven to eight months to approve measures. This analysis does not take into account the time length of pre-notification contacts.

It seems that the time needed for approval of notified measures has actually increased by 40% to 60% in relation to the period 2007-2013 when the average period of approval was thought to be about five months. The apparent increase in the time needed by the Commission to authorise aid may be caused by two factors: *first*, Member States notify now more complex measures, as they can use the GBER for many more categories of otherwise routine or simpler measures; *second*, since July 2014, notification involves detailed assessment of state aid on the basis of the ‘common compatibility principles’. Detailed assessment is a cumbersome process, requiring analysis of a large amount of information on market conditions, the need and proportionality of aid and the likely impact of aid on competitors.

Unexpected consequences of the increased use of General Block Exemption

The increased use of the GBER is not costless. There are at least three consequences that can be identified.

First, it is not clear how Member States understand and implement the GBER. This is notwithstanding the fact that officials who meet at EU level (e.g. SAM working group) naturally tend to have convergent views, that the Commission publishes explanatory answers on questions concerning the GBER (e.g. GBER FAQ) and that the purpose of the *ex post* monitoring is precisely to check that Member States apply the GBER properly. However, the monitoring covers only a small minority of state aid measures. Moreover, it is not completely random. The Commission naturally chooses to audit large or novel measures. But it cannot be inferred that other measures are designed and implemented correctly. The cumulative impact of small errors may be significant. The Commission may retort, with some justification, that the GBER has been deliberately drafted to be easily understood and applied. This is certainly true. However, the number of definitions has grown exponentially from 20 in the previous GBER (Regulation 800/2008) to 140 in the current GBER. This implies that the possibility for mistakes due to misinterpretation has also increased. In this respect, the previous system, whereby most measures were checked by the Commission, had the advantage of detecting any mistakes of interpretation before measures were implemented and of allowing Member States the flexibility to vary their particular measures, knowing that their variation was in conformity with the rules.

Second, where Member States have doubts, they can ask the Commission for clarification. The contacts between a Member State and the Commission remain private and bilateral, as the Commission's answers are not necessarily spread to other Member States. Admittedly, some of these answers find their way into the frequently asked questions on the GBER. However, not all questions are included in the FAQ document which is posted on DG COMP's website. Also, the FAQ document is not so frequently updated. More importantly, the FAQ document provides generic answers to general questions. The public understanding of state aid rules and of the range of possible public measures to which they can apply depends even more on the Commission's assessment of specific cases and identification of faulty programme designs and ineligible objectives, procedures or costs. The FAQ document does not identify errors or mistakes.

Finally, increased use of the GBER has reduced legal certainty in several ways: *first*, Member States are less sure about the legality of a significantly larger number of their state aid measures; *second*, there is the legal conundrum of whether aid recipients can claim legitimate expectations if they receive aid on the basis of the GBER. Although EU courts have repeatedly stated that legitimate expectations can be entertained only on the basis of assurances given by

EU institutions, it is not clear what their position would be in relation to GBER-related aid since, by definition, such aid is not supposed to be notified to the Commission; *third*, GBER-related aid should in principle be actionable before national courts. In this regard, national courts would have to determine whether the aid is legally granted, which implies that they would have to interpret the provisions of the GBER. This may inadvertently lead to uneven application of the GBER across the EU; *lastly*, Member States have not stopped notifying measures to the Commission. Because the Commission does not wish to proceed to full-blown assessments, it sends 'comfort letters' to Member States, assuring them of the compatibility of the aid on the basis of the information submitted to it. The legal value of such comfort letters has been extensively debated in the literature. They may provide some assurance to Member States but since they are a symptom of the increased reliance on the GBER, they too have contributed to lowering the common understanding of the application of state aid rules.

Other SAM objectives

The 2012 SAM Communication also referred to strengthening "budgetary discipline", improving the "quality of public finances", "better use of taxpayers' money", "more effectiveness in public spending", use of state aid with "real added-value" and "cost-effective" aid. Although these terms are not further explained or elaborated in the Communication, they suggest that the new rules would lead to some kind of cost-benefit analysis of state aid. The common principles of compatibility, like their predecessor – the "balancing test" which was introduced by the 2005 State Aid Action Plan – weigh the positive effects of state aid against the negative effects in terms of distortion of competition. But it is important to understand that this balancing is not a proper cost-benefit assessment whereby the internal benefits (gains of the aid recipient) and the external benefits (other gains for society) of state aid are quantified and compared to the costs of state aid, including its own opportunity cost (forgone net gain in the best alternative use). This is how the cost-effectiveness of aid could be ensured.

For instance, under current rules, state aid is allowed when it is shown that a project experiences a 'funding gap', i.e. the initial investment cost exceeds the expected stream of net revenue from the project. The presence of a funding gap demonstrates the need for aid. The size of the funding gap shows how much aid is needed (proportionality of aid). If the project is, for example, a port in a poor region, it can contribute to increased trade in that region, and if there is no other port close by its impact on competition would be minimal and the Commission would approve the aid. The

funding gap method has placed the assessment of state aid on a technically more rigorous basis. However, the presence of a funding gap does not mean that the approved aid is money well spent. It shows that a project cannot be completed without aid, but it does not prove that the aid benefits the region or the economy at large.

Summary of SAM objectives and outcomes

SAM objectives	Assessment of outcomes
Contribution to growth	Unknown
Focus on measures with biggest impact on internal market	Unknown
<i>Ex post</i> evaluation of state aid	Not yet known
Greater use of GBER	Yes
Closer cooperation between Commission and Member States	Yes
Better understanding of the concept of state aid	Yes
Value for money	Only indirectly
Faster decisions	No
SAM unintended consequences	Assessment
Better understanding of application of state aid rules	Less
Legal certainty	Less

Since 2014, the Commission has prohibited quite a few measures for granting or proposing to grant aid that was unnecessary, excessive and, in two cases, for not contributing to an objective of common interest (Gdynia airport, Poland; Zweibrücken airport, Germany). Certainly, when aid is unnecessary, excessive or not able to generate benefits for society, it is money not well spent or it does not add value. However, it does not follow that, as the example above demonstrates, all approved aid adds value.

Conclusion

In at least two respects, the SAM has had a spectacular success. Through much greater use of the GBER, Member States can avoid the administrative cost of notification and, correspondingly, the Commission can direct its efforts to the most serious cases instead of having to process insignificant cases.

At the same time, the reduction in administrative costs and avoidance of unnecessary notification and control by the Commission may have had an unexpected negative impact. It has reduced the visibility of state aid measures and the public understanding of how they are implemented. It is not possible to estimate the magnitude of this possible negative effect. However, the SAM may still succeed in shedding more light on the actual effectiveness of state aid, as Member States have been asked for the first time to carry out *ex post* evaluations of their state aid schemes with budgets exceeding EUR 150 million. The first results of these evaluations are expected in 2018-19.

Lastly, the SAM has also advocated that state aid must add value. The Commission will need to clarify whether it intends to proceed to a cost-benefit analysis proper or whether it considers that such an analysis falls outside its mandate of ensuring the compatibility of state aid with the internal market. It could certainly be assumed that the *ex post* evaluation of the effectiveness of state aid may lead to a more thorough assessment of the overall impact of state aid on the European economy.

Further Reading

European Commission, *State Aid Modernisation (SAM) and its implementation*, available at: http://ec.europa.eu/competition/state_aid/modernisation/index_en.html, last accessed 30 June 2016.

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He gratefully acknowledges useful comments on an earlier draft by Eszter Hargita, Peter Staviczyk, the CEPOB editors and an official who wishes to remain anonymous.

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