European union state aid control economics essay

European Union Agreement signed in Maastricht in November 1993 and this agreement generated the European Union. EU aims to modernize the European economy and to be able to compete with strong players like USA in the world market by making inventions, encouraging trade investments and at the same time making the European education system suitable to meet the needs of information society. To reach these targets EU accepts using state aids if necessary. This paper aims to represent European Union State Aid practices and State Aid Control by benefiting from concepts of efficiency, equity, welfare, public interest, compatibility and market failure. State Aids expresses any aid from state resources to public enterprises and private enterprises. State Aids emerges as a kind of cohesiveness policy. Generally the main purpose of the EU state aid policies is to help the achievement of common market. In addition EU aims to correct any imbalances by helping less favoured regions and providing structural measures to industrial sectors which are faced with difficulties.

Key words: European Union, State Aid, Competition, Trade

JEL classification: K20, K21, L53, P45

Historical Process of European Union

Ä°n the first middle of the 20th century, Continental Europe had become desolated by the Second World War. During the war people who against the totalitarian regimes wanted to end this hatred and decide to generate the conditions of peace. Between1945 and 1950, a group of states man including Robert Schuman and Winston Churchill traced a new structure which depends on common interest and guaranteeing equality between countries by legal regulations.

Robert Schuman proposed to establish European Coal and Steel Community in 1950; the idea was firstly put forward by Jean Monnet. Nations -which have been fight once- would come together with the establishment of this community and as the raw materials of war, coal and steel become tools of peace and reconciliation in a symbolic way.

The agreement proposed in 1950 and signed in 1951 in Paris. The main purpose of the agreement was making peace between the winner and looser nations of Europe and brings them together by an economic way. After that agreement in March 1957 the establisher six nations of European Coal and Steel Community (Belgium, Federal Republic of Germany, France, Italy, Luxembourg and Netherlands) decide to establish European Economic Community which is a more broad based common market including every goods and services. Custom procedures had been removed in July 1968 and instead there had generated common policies especially about trade and agriculture in 1960s. (Fontaine, P. (Ed.). (2010). AB Nedir?)

As a result of the success of this initiative Denmark, Ireland and United Kingdom decided to join the community in 1973. Therefore the number of member nations increased from 6 to 9. At the same time new social and environmental policies started to be implemented.

The economic recession which has seen in the early 1980s make Community member to establish the Common Market. At the beginning of 1993 it has been started to implement. In addition European Union Agreement signed in

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European Union started to present the Euro as a currency unit for non-cash financial transactions in 1999. Three years later Euro issued in 12 countries that are named as Euro Zone. Now Euro is a main currency in all over the world like American Dollars (Fontaine, P. (Ed.). (2010). AB Nedir?).

European Union adopted new Lisbon Strategy to modernize the European economy and to be able to compete with strong players like USA in the world market. Lisbon Strategy aimed to make inventions, encourage trade investments and at the same time make the European education system suitable to meet the needs of information society.

A country aiming to join the European Union must have working a market economy and capacity to compete with pressure of competition in union and difficulties of the market according to Copenhagen Criteria[1].

European Union is a union of 27 members now. Turkey made application for membership in 1987. In 1999 accepted as candidate by member states. Then Turkey's full membership negotiations have started in 2005.

Beyond being a confederation of countries European Union is a unique structure but it is not a federal government too. It is a new formation and does not enter any legal category.

Negotiations are known as primary legislation and primary legislation underlies the secondary legislation which has impact on the daily lives of citizens. Basically secondary legislation consists of regulations and directives adopted by the EU institutions. In addition to the general policies these laws are the result of decisions taken by three EU institutional triangles that is consists of council of EU, European Parliament and European Commission.

European Council represents national governments, European Parliament represents citizens and European Commission looks for EU benefits and is an independent organization from EU governments. Members of EU Commission are assigned for a period of 5 years with an agreement between the Member States, depends on the approval of European Parliament. The Commission is responsible to the Parliament, however uses its authority independently with a certain extent. Because its duty is to protect the common interest, the commission should not be instructed from any EU member (Fontaine, P. (Ed.). (2010). AB Nedir?).

It is the duty of commission to ensure the implementation of regulations and instruction in the member nations and if the commission finds it necessary it has the right to convey any member to the Court of Justice. The commission promulgates the decisions as is the administrative unit that was made by European Council. It has broad authority to conduct the common policies of European Union like research, development, technology, foreign investment and regional development.

European Union has economic, social, financial and regulative duties in a wide range of political area. These political areas:

Cooperation policies in regional, agricultural and social areas (it is known as adaptation policies)

Innovation projects that are bearing the wide range of technologies like environmental protection, research, development and energy (Fontaine, P. (Ed.). (2010). AB Nedir?).

The Union reserves over 120 billion euro for these policies annually as budget. The majority of this budget is being paid by member states and this budget is a small part of common wealth of European Union.

State Aids expresses any aid from state resources to public enterprises and private enterprises. State Aids emerges as a kÄ±nd of cohesiveness policy. Generally the main purpose of the EU state aid policies is to help the achievement of common market. In addition EU aims to correct any imbalances by helping less favoured regions and providing structural measures to industrial sectors which are faced with difficulties.

Regional competition and employment subjects are very important in the cohesiveness policies. The purpose is to increase the competition, employment and charm of the underdevelopment areas. The only way to accomplish is to foresee the economic and social changes and contribute innovation, entrepreneurship, protection of environment and accessibility of comprehensive labour markets, the ability to adopt and development (Fontaine, P. (Ed.). (2010). AB Nedir?).

Common Market

Common market has been established in January 1993. Healthy competition policy of EU is based on the Treaty of Rome. And it is the vital rational of rules of free trade. Policies of the common market is being implemented by

Commission and the Commission is responsible for the reputation these policies with the Court of Justice simultaneously.

The reason of having this policy is to prevent the free competition of any agreement between the commercial activities, any aid from public authorities or any unfair monopoly in the common market.

Any agreement that is not compatible with the EU agreement must be proclaimed to commission by interested parties or firms. The commission has the right to impose punishment to parties which violate the competition rules or stand without required notification. Receiving any illegal state aid or not notificating such an aid can be claimed to give back by the commission. If one firm is being dominant because of an acquisition or a merger, this situation must be notificated to the commission (Fontaine, P. (Ed.). (2010). AB Nedir?).

State Aids in the European Union

The main economic target of EU is to generate a barrier free internal market between member states. The most effective equipment used by the union is competition rules to achieve this target. In addition to this the main target of competition policy of European Union is to generate a well-functioning internal market of Europe which dominated by market forces by preventing acts that are accepted as breaking competition. Competition can be broken by private enterprises and by giving incentives by member states to intervene the economy. As mentioned above, EU legislation on State Aid prohibits State Aids approves these aids as having impact on competition and incompatible with the internal market. State Aids do not have any specific description in terms of legislation of EU. However the basic provisions of state aids have been determined in Treaty of European Community (Treaty of Rome) article 87, 88, 89 and in Treaty of Lisbon article 107 and 108. The article 87 of Treaty of Rome prohibits any aids given by member states and their resources, providing advantages to a specific firm or production of a specific good. In this way the article aims to prevent negative effects on competition, competitive area and trade between member states.

The task of monitoring state aids is given to European Commission to protect competition and trade. However Treaty of Rome gives permission clearly to some exemptions of state aid if there is a benefit to European Union. It should be noted that state aid precautions can be effective tools in some situations to reach common goals of union. In general it can be said that state aids can increase competitiveness of European Union by correcting market deficiencies and improving the functioning of market.

We look at State Aid Policy of EU in the Treaty of Rome. According to the article 87(1), an aid can be named as State Aid by providing the following four conditions:

Transfer of Resources : There must be an intervention by the State or through State Resources

Economic Advantage : It must confer an advantage on the recipient

Distortion of Competition : It must distort or threaten to distort competition

Effect on Trade : It must be liable to affect trade between member states.

Especially third and fourth conditions are related to concept ‘ selectivity’ which is very important for the definition of State Aid in terms of granting an advantage to a certain company, production of specific products or development of a specific region (Friederiszick, H. W., Röller, L. H., & Verouden, V. (2006). European State Aid Control: an economic framework.)

Economic parties which receiving aid must be in an economic activity and must operate in a trade market between member states. It is not important for recipient to be in a profit seeking activity or not. The important thing here is being in an economic activity.

Compatibility Criteria

We look at Compatibility Criteria about State Aid Policy of EU in the Treaty of Rome. Despite the negative presumption of Article 87(1) , state aid can be taken into account as compatible with the common market if one or more exemptions of Article 87(2) and 87(3) are fulfilled.

The following may be considered to be compatible with the common market:

Aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious unemployment

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

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

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

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.

Paragraphs ‘ a’ and ‘ c’ settle the legal base for counting regional investment aids compatible. Paragraph ‘ a’ points out regions with income levels per head significantly below the EU average and paragraph ‘ c’ is related to regions with income and employment levels below the average of the member states (Friederiszick, H. W., Röller, L. H., & Verouden, V. (2006). European State Aid Control: an economic framework.).

The general principle behind the Commission’s compatibility assessment is to balance the positive impact of the aid measure (pursuing an objective of common interest) against its potential negative effects (distortions of trade and competition).

As mentioned above Commission looks at competition and trade aspects of state aids for making an efficient control. At this point it is known that state aids cause more distortions in markets which are more competitive than others. Clearly if market shares of the firms are small and if there is firms with low profit margins, state aids in this market (given to a specific firm or a group of firms) may have greater distortive effect.

The Economics of State Aid Control: Basic Concepts

The economics of state aid is related to these fields of economics: Public Economics, The Economics of Competition and International Trade Theory.

State Ads must be looked at the window of Public Economics to analyze the purpose and effectiveness of state intervention in the national economy. As mentioned earlier the economics of competition is slightly related to state aids to analyze the impact of state aid on competition. European Commission pays attention to state aid to study its policies in an international context.

European Union intends to raise welfare of the EU citizens by using state aids as in other ways. Economists developed social welfare functions in the early years of 20th century. Social welfare function seen as an indicator of total utility of society. Some researches, studies and practices showed the economists that there are two theorems of welfare economics.

First theorem says that all competitive markets make Pareto[2]Efficient allocation of goods and services. Second theorem says that any income distribution and allocation of resources can be reachable by competitive markets. First theorem points out efficiency concept while second one does that for equity concept.

Economists recognizes government intervention in some market failure situations on the basis of efficiency like externalities, public goods, information asymmetries/ missing markets, imperfect competition/ market power. State Aids can be seen as necessary in some cases as an intervention of government.

If we look at this topic from the basis of equality, it is not incorrect to say that the mission of governments is to product more fair and equitable outcomes. State aids or any government intervention can be accepted if most fair and optimal resource allocation will be gained after that. Because individual is the reason for being governments and unions. And government intervention and state aids can be accepted for happiness and welfare of individuals (Friederiszick, H. W., Röller, L. H., & Verouden, V. (2006). European State Aid Control: an economic framework.).

Briefly if we think distribution of income as a cake; we can ‘ make cake better’ by increasing the efficiency of an economy and thereby ‘ pushing the welfare frontier outward’ or we can ‘ divide the cake better’ by distributing the available resources in a way that maximizes the preferences of society for equity and redistribution. Therefore the welfare frontier can be moved along.

Limits of State Aid

A state aid can be measured as effective and provides equity to reach a better welfare point. However for this welfare function there will be some significant problems to be solved.

Firstly it is very hard to measure the size of market failure resulting with state aid. For example; let’s think a research and development activity which imposes positive externalities. Socially desired output exceeds personal output with a subsidy which is a desirable condition. But there will be uncertainty about the size of economic inefficiency resulted by subsidy.

Besides that; benefits gained from a state aid must exceed its costs. State Aids are costly and benefits and these costs must be compared by taking into account the opportunity costs. After that making the decision will be appropriate.

As mentioned above frequently the biggest harm of state aids is the condition of distorting competition.

Lastly one of the failure of governments is inefficient decision making problem which is a result of deficiencies in providing information can be a bottleneck of success of state aids in terms of efficiency and equity. Principal agent problem between politicians and bureaucrats distorts the political decision making process. Additionally principal agent problem between citizens and politicians is the biggest handicap of representative democracy. As we know this problem occurs when parties have different set of goals. In this context principal agent problem can cause different outcomes of EU state aid than desired ones. With all these consequences one can understand that a state aid can be possible reaching the best desired point (efficient, remedial distributional outcomes/ income distribution) with perfect information (Friederiszick, H. W., Röller, L. H., & Verouden, V. (2006). European State Aid Control: an economic framework.).

Rationales for European State Aid Control

It is mentioned above that European Union has targets like helping undeveloped areas to develop, serving European Union's common interests, protecting cultural heritages and increasing employment. It is needed to have an efficient control mechanism for reaching these targets with a more efficient and equitable way.

More specifically we can mention three basic rationales of EU state aid control.

Cross- Border Externalities: If governments do not take into account the side effects of their intervention, there will emerge cross- border externalities. Member states can try to take advantage of international oligopoly profits by means of state aids even when they compete each other.

National Commitment Problems: These problems are generally related to soft budget constraints. Because governments can not establish regulations about transparent budget rules, private firms can be affected from this, negatively. If firms do not have enough incentives to be efficient, it can not be provided the social/ optimal efficiency and one can not mention about any increase in welfare.

Internal Market Rationale: The competition will increase by means of integrated European Markets. In addition to this there will be taken appropriate steps for economic development by means of restructuring firms. However state aids without efficient control mechanism harm EU internal market. Because if firms do not compete or do not need to compete in consequence of state aids they receive, benefits from giving state aids can not be provided; on the contrary competition could be distorted. The point to be considered here is that the aid also must provide free circulation of goods and services if and only if under the conditions of competition (Friederiszick,

H. W., Röller, L. H., & Verouden, V. (2006). European State Aid Control: an economic framework.).

To make compatible its laws and regulations with European Union, Turkey established Competition Authority in December 1994.

De Minimis Rule

Treaty of European Community prohibits aids given by state resources, which are distorting competition or having impact to distort competition and affecting trade between member states. Nevertheless European Commission has the opinion that small aids do not have any potential distortive effect on trade and competition between member states. For this reason the Commission introduced a rule named as ‘ De Minimis Rule’ to decrease administrative burden on member states and the Commission itself.

According to the De Minimis regularization there is not any negative effect of aids below 200. 000 € (for a period of three years) on trade between member states and this will not cause distortion of competition (Ä°lhan, B. (2010). Avrupa BirliÄŸi Rekabet PolitikasÄ±nda Devlet YardÄ±mlarÄ± ve Türkiye’nin Uyumu. SayÄ±ÅŸtay Dergisi, 76, 101-132)

An Effect Based Approach to European State Aid Control

One of the most important points to draw attention to state aids is the concept of ‘ Common Interest’. For this reason it will be beneficial take into account competition when approaching the consumer welfare and efficient allocation of resources.

Some economists give great attention to these important points to evaluate state aids:

The State Aid addresses a market failure or other objective of common interest.

The State Aid is well targeted. It must provide an incentive effect.

The distortions of competition are sufficiently limited so that the overall balance is positive.

Economists will advocate state aids if they provide these specialties above. As we understand it is very important to distinguish ‘ good aid’ from ‘ bad aid’ (Friederiszick, H. W., Röller, L. H., & Verouden, V. (2006). European State Aid Control: an economic framework.).

In 2005 a new strategic plan named as State Aid Action Plan (SAAP) made by European Commission. The Commission suggested a more refined economic approach in state aid in order to ensure a proper and more transparent evaluation of the distortions on competition and trade associated with state aid measures by SAAP. With this suggestion, Commission proposes also using economic analysis to identify market failures that are meet to be overcome by the aid.

Commission proposes a three stage balancing test to achieve these targets. Clearly to distinguish ‘ good aid’ from ‘ bad aid’ Commission wants to use to evaluate aids before giving them.

The test consists of questions on the purpose of evaluation and specifying the necessity and qualification of aids.

Is the aid measure aimed at a well defined objective of common interest like growth, employment, cohesion and environment?

Is the aid well designed to deliver the objective of common interest, i. e. does the proposal aid address the market failure or other objective?

Is the state aid an appropriate policy instrument?

Is there an incentive effect, i. e. does the aid change the behavior of firms?

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

Are the distortions of competition and effect on trade limited, so that the overall balance is positive?

First two steps address the positive effects of state aids and the third one addresses negative effects. According to the Commission the results / answers acquired from these steps/ questions will determine the qualification and limits of a good and efficient state aid. This balancing test give an opportunity to focus on ‘ less and better targeted aid’ (Heimler, A. & Jenny, F. (2012). Oxford Review of Economic Policy, Volume 28, Number 2, 2012, pp. 347-367).

European Union State Aid Policy and State Aid Plans prepared with Lisbon Strategy

According to State Aids Action Plan, State Aids that are prepared within the context of Lisbon Strategy must concentrate on these priority areas below:

Targeting innovation and Research& Development to strengthen the knowledge society.

Generating a better workplace and encouraging entrepreneurship

Investing on human resources

Increasing the quality of services of general economic interest

Better prioritization scaling by means of simplification and combination

A result oriented regional state aid policy

Encouraging a sustainable future environmentally

Establishing infrastructures of modern transportation, energy, knowledge and telecommunication technology (Avrupa Komisyonu, State Aid Action Plan, Brüksel, 7 Haziran 2005, s. 8-12)

Conclusion

EU started its adventure with European Coal and Steel Community to overcome destructive effects of Second World War on European Nations. However the target of Single Market has not been accomplished yet. EU proceeded a great way to accomplish this target for half a century. And still makes a great effort to develop the union and to reach European Single Market.

The practice of State Aid and its control mechanism are parts of this effort to reach the target of Single Market. An efficient control mechanism will help EU to reach its goals. In doing so the balancing test suggested within the context of Lisbon Strategy will help to distinguish ‘ good aid’ from ‘ bad aid’.

European Union has passed a considerably long and successful process since the establishment and development of first communities.

It will be great acquisition for Turkey becoming a part of this union to accelerate economic and social development.