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Socially Acceptable Distortion of Competition: EC Policy on State Aid

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ABSTRACT: Through an analysis of decisions of the European Commission and judgements of the European Court of Justice, we examine the purposes for which the European Community will permit distortions of competition arising from state aid to the private sector.

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Responsibility for errors is our own.**

I. Introduction

Three articles of the EEC Treaty establish the framework for EC policy on state aid. Article 92 outlines the basic principles:

Article 92

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, in so far as it affects trade between Member States, be incompatible with the common market.

2. The following shall be compatible with the common market:

(a) aid having a social character, granted to individual consumers, provided that it 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...

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

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

(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) 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.

We begin by outlining the essential substantive and procedural elements of Community policy on state aid. We proceed to examine the definition of state aid and the evaluation of the effect of state aid on competition. This is followed by a discussion of the principle of

compensatory justification, which holds that a distortion of competition will be permitted only to accomplish some goal embodied in paragraph 2 or 3 of Article 92, and of applications of that principle.

Decisions taken under Articles 92(2) and (3) offer the prospect of revealing the circumstances in which the European Commission and the European Court of Justice are willing to accept distortions of competition to permit state aid. Identification of such circumstances will clarify the practical meaning of "distortion to competition" under the EEC Treaty and the purposes for which distortions to competition are permitted to accomplish other economic, social, and political goals and illustrate the changing relationship between competition policy and other Community policies.

II. Principles

A. Substantive Principles

Article 92(1) prohibits aid which distorts or threatens to distort competition, and affects trade between member states. EC policy on state aid to industry is thus supposed to be subsidiary to EC competition policy, and to be an instrument in the implementation of the principle in Article 3(f) of the Treaty that undistorted competition should prevail throughout the Community. It is only state aid that offends competition policy that is regulated under Article 92.

Article 92(2) specifies categories of aid that are compatible with the common market. It is for the Commission to decide whether or not this paragraph covers particular instances of aid.¹

1. Advocate General Roemer in Case 77/72 Capolongo v. Azienda Agricola Maya (1973) ECR 611 at 627, (1972) 1 CMLR 230 at 236. Emphasis in the original.

Already in paragraph (2) there are exceptions; a series of aids is there explicitly termed compatible with the Common Market. In this connection it is clear from the wording used ('exceptional circumstances', 'compensation for the economic disadvantages caused by the division of Germany') that in so far as a considerable margin of discretion does exist, its exercise certainly cannot be left to the national courts but rather that it ought to be implemented in a uniform manner throughout the Community.

Article 92(3) specifies types of aid that may be considered compatible with the common market. In the words of Advocate General Warner,²

...Article 92 does not impose a clear and unconditional prohibition on State aids. It imposes a prohibition tempered by the Commission's power to take economic, social and political considerations into account, and also by the powers given to the Council...

Thus the framework for implementation of state aid policy comprises a broad general principle prohibiting distortion of competition and certain exceptions from this prohibition on specified grounds.³ In the words of Advocate General Darmon,⁴ there is a

2. Case 78/76 Firma Steinike und Weinlig v. Bundesamt für Ernährung und Forstwirtschaft, (1977) ECR 595 at 582, (1977) 2 CMLR 688 at 699.

At ECR 609, CMLR 714-715 the Court accepts this argument:

...the incompatibility of aid with the Common Market as provided in Article 92 (1) is neither absolute nor unconditional. Article 92 (2) not only provides for exceptions but in addition both Article 92 and Article 93 give the Commission a wide discretion and the Council wide powers to accept State aid in derogation from the general prohibition in Article 92 (1).

3. Further types of aid may be specified by the Council under Article 92(3)(d). So far, this power has been used only in the case of shipbuilding. Current rules are contained in Directive 87/167 OJ 1987 L 69/55.

4. Case 248/84 Federal Republic of Germany v. E. C. Commission (1987) ECR 4013 at 4028 (1988) 1 CMLR 591 at 596.

"rebuttable presumption" that aid covered by Article 92(1) is incompatible with the common market and thus prohibited.

The practicalities of confining policy-making to such a framework are another matter. The rationale for the Article 92(3) exemptions is the pursuit of Community objectives.⁵ Where accomplishment of such objectives conflicts with the maintenance of competitive markets, policy may require the presumption in favor of competition to give way, or even to be reversed.

B. Procedural Concepts

Article 93 establishes procedures for implementation of the policy outlined in Article 92. It imposes on the EC Commission the duty to review aid programs. A preliminary examination must be carried out within two months, and the Commission must then decide whether or not to invoke the contentious procedure of Article 93(2). Article 93 authorizes the Commission to require that aid programs not compatible with the common market be altered or abolished. It imposes on Member States the obligation to inform the Commission, in advance of implementation, of plans to grant or alter aid. Failure to notify the Commission may result in proceedings being brought by the Commission against the member state concerned. Aid granted contrary to these rules may have to be repaid by the recipient. If a member state fails to comply with a Commission decision requiring alteration

5. See, for example, E. C. Commission, First Report on Competition Policy. Brussels, 1972, p. 113.

or abolition of aid, the Commission or any interested member state may refer the matter to the European Court.⁶

Commission decisions under Article 92 may also be challenged before the European Court by the member state concerned, the recipient or intended recipient of the aid involved and, in certain circumstances, by competitors of the latter. During such proceedings the European Court is concerned solely with questions of legality and procedural correctness. The Court has explicitly questioned the Commission's exercise of the discretion granted it by Article 92(3) only in extreme cases.⁷

However, the Court may intervene on the ground of procedural illegality, such as failure of the Commission to give adequate reasons for its decisions (as required by Article 190 of the Treaty). In practice, the effect of a requirement of adequate reasoning may not be greatly different from a review of the grounds for a decision.

Article 92 is not in itself directly applicable: it cannot be enforced in the national courts of member states. This means that the European Court has limited opportunities to deliver preliminary

6. Article 93 also provides a procedure under which a Member State may appeal to the Council of Ministers for a declaration that an aid program is compatible with the common market. Such decisions may only be made on grounds of exceptional circumstances, and the procedure appears to have fallen into disuse. An alternative mechanism may, in practice, be available via the preparation of a directive under Article 92(3)(d). See the E. C. Commission, Sixth Report on Competition Policy. Brussels, 1977, p. 112.

7. See Case 730/79 Philip Morris Holland BV v. E. C. Commission (1980) ECR 2671 (1981) 2 CMLR 321, to be discussed below. See also Advocate General Darmon in Case 248/84 Federal Republic of Germany v. E. C. Commission (1987) ECR 4013 at 4033 (1988) 1 CMLR 591 at 602.

rulings interpreting this provision for national courts. There is an indirect avenue for such interpretations: an interpretation of Article 92 may be necessary to determine whether there has been a breach of the Article 93(3) duty of prior notification, which is directly applicable.⁸

To the extent that opportunities for judicial intervention in this field are limited, the Commission enjoys the freedom to direct the development of state aid policy. A consequence of the fact that private enforcement of Article 92 before national courts is largely excluded is that the workload of the Commission is increased.

III. The Definition of State Aid

The first policy issue that arises in the application of Article 92 is the definition of state aid. State aid has been found in the presence of

(a) interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which without being subsidies are similar in character and have the same effect;⁹

(b) the payment of a proportion of the costs of production by someone other than the purchasers;¹⁰

8. Case 74/76 Ianelli & Volpi SpA v. Ditta Paolo Meroni (1977) ECR 557 (1977) 2 CMLR 688.

9. Case 30/59 De Gezamenlijke Steenkolenmijnen in Limburg v. ECSC High Authority (1961) ECR1 at 19.

10. Opinion of Advocate General Lagrange, Case 30/59 De Gezamenlijke Steenkolenmijnen in Limburg v. ECSC High Authority (1961) ECR1 at 44.

(c) an advantage entailing a burden to public finances in the form either of expenditure or of reduced revenue;¹¹

(d) a grant from the State for no consideration;¹²

(e) assumption by the state of costs which normally fall on undertakings;¹³

(f) assumption by the state of part of the risk which is normally assumed by undertakings;¹⁴

(g) compensation from the state to a company or receipt of reduced revenue by the state;¹⁵

(h) the grant of resources or advantages by the state to encourage the attainment of economic or social objectives;¹⁶

The result often appears to be much the same whether the definition applied takes as its starting-point the effects for the recipient or the effects for the state: assistance provided by the state in a variety of forms is covered by Article 92.

11. Opinion of Advocate General Capotorti in Case 82/77 Openbaar Ministerie (Public Prosecutor) v. Jacobus Philippus Van Tiggele (1978) ECR 25 at 52 (1978) 2 CMLR 528, at 545.

12. Opinion of Advocate General Reischel in Case 61/79 Amministrazione delle Finanze Dello Stato v. Denkavit Italiana Srl (1980) ECR 1205 at 1235 (1981) 3 CMLR 694 at 702.

13. Advocate General Darmon in Case 248/84 Germany v. E. C. Commission (1987) ECR 4013 at 4027 (1988) 1 CMLR 591 at 596.

14. Commission Decision 90/70 of 28 June 1989 concerning aid provided by France to certain primary processing steel undertakings OJ 1990 L 47/28 at 35.

15. Commission Decision 82/73 of 15 December 1981 on the preferential tariff charged to glasshouse growers for natural gas in the Netherlands OJ 1982 L 37/29 at 33.

16. Case 61/79 Amministrazione delle Finanze Dello Stato v. Denkavit Italiana Srl (1980) ECR 1209 at 1228 (1981) 3 CMLR 694 at 711.

Most obvious is a direct payment of funds. Even if assistance does not come directly from public funds, it becomes a state aid if "paid for through levies that are obligatory as a result of government action."¹⁷ For regulated firms, a price increase may constitute a state aid if consumers are reimbursed for purchases under a social security system.¹⁸

A preferential tariff fixed by a public authority for a particular customer or class of customer can constitute state aid, if it results in the state receiving less revenue.¹⁹ A state loan or exchange rate guarantee constitutes aid, whether or not the state later has to make up a loss, since it allows favored firms to benefit from a reduced rate of interest.²⁰

17. Commission Decision 89/296 of 30 March 1989 ruling on a financial measure taken by the Federal Republic of Germany in respect of the coal industry during 1988 and a supplementary financial measure in respect of the coal industry during 1987. OJ 1989 L 116/52 at 52.

18. E. C. Commission, Sixteenth Report on Competition Policy. Brussels, 1987, p. 151.

19. Commission Decision 82/73 of 15 December 1981 on the preferential tariff charged to glasshouse growers for natural gas in the Netherlands OJ 1982 L 37/29 at 33. This decision was upheld by the European Court in Case 213/85 E. C. Commission v. Kingdom of the Netherlands (1988) 2 CMLR 287 and Joined Cases 67, 68, & 70/85 Kuckerij Gebroeders van der Kooy BV, Johannes Wilhelmus van Vliet, Landbouwschap and Kingdom of Belgium v. E. C. Commission (1989) 2 CMLR 804. However, a rebate which merely reflects cost savings does not constitute a state aid; Case 169/84 Compagnie Française de l'azote (COFAZ) S.A. v. E. C. Commission (1986) ECR 391 (1986) 3 CMLR 385.

20. Commission Decision 79/519 of 18 May 1979 concerning the 'special financing scheme for investments to increase exporting firms' production capacity' in France OJ 1979 L 1138/30.

Problems may arise in distinguishing the grant of state aid from the operation of ordinary fiscal measures, social security measures, infrastructure improvements, and so on. Here the guiding principle is²¹

Article 92 does not distinguish between the measures of State intervention concerned by reference to their causes or aims but defines them in relation to their effects.

This rule comes from a judgment²² in which the European Court held that aid is present where a particular industrial sector is exempted from the application of a general social security system, without there being any justification for the exemption in the nature or general scheme of the system. The Court confirmed the Commission's view that such exemption constituted an aid incompatible with the common market.

The issue has also sometimes appeared as one of determining the relations between state powers and Community powers. For example, monetary policy remains the province of member states. They may not, however, employ their authority in this area so as to provide preferential interest rates which amount to state aid.²³

21. Case 173/73 Re Aids to the Textile Industry: Italy v. E. C. Commission (1974) ECR 709 at 718 (1974) 2 CMLR 593 at 606.

22. Op. cit. For another case involving the distinction between fiscal policy and state aid, see Commission Decision 90/197 of 4 October 1989 on an aid granted in France to cereal farmers and producers, financed by reimbursement of specific fiscal and parafiscal charges OJ 1990 L 105/15.

23. Cases 6/69 & 11/69 Re Export Credits: E. C. Commission v. France (1969) ECR 523 at 539-540 (1970) CMLR 43 at 67-68.

There may also be difficulties in distinguishing state aid from state investment. Here the Commission's position is²⁴

...provisions of new capital to firms by governments are in the nature of aid ...where a private investor in a market economy would not have provided the financing in similar circumstances.

If the state provides capital in amounts and on terms that a firm could not obtain on the open market, state aid is present.

IV. Distortion of Competition and Effect on Trade

Where state aid is identified on anything other than a purely negligible scale, competition within the common market will inevitably be different from what it would have been if left to market forces. Nonetheless, Article 92(1) requires that at least the likelihood of a distortion of competition capable of affecting trade between member states be established. Effects on competition must also be examined to determine whether aid otherwise entitled to an exception under Article 92(3)(c) must be prohibited because of its effect on trading conditions.

A 1970 judgment involving a French subsidy scheme established that Article 92 requires only a qualitative evaluation of the effect of an aid scheme on competition.²⁵ The aid scheme in question was designed to secure the reorganization of the French textile industry. It involved the imposition of a tax on all sales of textile goods in France, whether the goods were of domestic or foreign origin.

24. Commission Decision 87/418 of 4 February 1987 concerning aid to a Belgian steel pipe and tube manufacturer OJ 1987 L 227/45 at 47. See Case 323/84 Intermills SA v. E. C. Commission (1984) ECR 3809 (1986) 1 CMLR 614.

25. Case 47/69 Re aids to the textile industry: France v. E. C. Commission (1970) ECR 487 (1970) CMLR 351.

Proceeds from the tax were distributed to a research institute and to a trade association, to finance its industry reorganization program.

While the Commission did not object to the goals of this aid, it objected to the fact that foreign producers were taxed to provide a benefit that went mainly to French firms. In 1968 the Commission issued a decision requiring France either to abolish the program or alter the way it was funded. France challenged this decision before the European Court.

Among several arguments, one involved the relatively small size of the tax. The Advocate General's discussion outlines the terms of the debate:²⁶

As for the level of tax, whose rate, initially fixed at 0.20 per cent, now stands at 0.44 per cent....the French government is of course right to assert that such low rates could lead only to a small increase in prices... However, it could well be asked whether the situation should really be assessed in such quantitative terms. No doubt the French and Italian versions of Article 92 lend some support to this assessment, since they use the terms 'dans une mesure contraire à l'intérêt commun' and 'in misura contraria al comune interesse', i.e., 'to a degree contrary to the common interest.' The German and Dutch versions of the Article use words showing that the criterion is a qualitative one, since they state that the measures of aid should not disturb trading conditions in a 'manner' (in einer Weise, 'zodanig') contrary to the common interest.

This view limits the extent of the inquiry into the distorting effects of state aid required of the Commission.²⁷

26. Case 47/69 (1970) ECR 487 at 501; (1970) CMLR 351 at 358-359.

27. Case 47/69 (1970) ECR 487 at 502; (1970) CMLR 351 at 359.

If we consider the matter from a qualitative point of view ...there is no doubt...that imposing handicaps on foreign producers to the detriment of their competitive position, especially as a result of tax measures taken within the framework of a system of aid, would constitute such a disturbance [in trading conditions]. The extent to which such negative effects are translated into reality is therefore irrelevant.

In its judgment, the Court confirmed that aid which did not disturb trade between member states would not be prohibited²⁸

A system of aid may be contrary to Community rules and yet be acceptable, because it does not substantially disturb trade between States; nevertheless its disturbing effect may be aggravated by a method of financing which would render the system as a whole incompatible with a single market and the common interest.

but also indicated that the rate of tax was not the essential element in finding a distortion of competition.²⁹

[The Commission] has therefore rightly decided that this aid, whatever might be the rate of tax, had the effect, because of its method of financing, of disturbing trade to a degree contrary to the common interest, within the meaning of Article 92(3)(c).

The *de minimis* rule retains relevance. The aid must be of sufficient scale to have a real rather than a purely theoretical effect on the market.³⁰ But that effect is to be evaluated in qualitative rather than quantitative terms.

28. Case 47/69 (1970) ECR 487 at 495; (1970) CMLR 351 at 363. See also the Opinion of Advocate General Reischl in Case 40/75 Société des Produits Bertrand S.A. v. E. C. Commission (1976) ECR I (1976) 1 CMLR 220, for a similar argument.

29. Case 47/69 (1970) ECR 487 at 496; (1970) CMLR 351 at 364.

30. See, for example, the Opinion of Advocate General Reischl in Case 40/75 Société des Produits Bertrand S.A. v. E. C. Commission (1976) ECR I at 17 (1976) 1 CMLR 220 at 230.

Re aids to the textile industry: Italy v. E. C. Commission³¹

illustrates what is required to establish that there is an effect on competition of the kind prohibited by Article 92(1). An Italian law passed on 1 December 1971, among other things, reduced social security charges of firms in the textile and garment-making industry from 15 per cent to 10 per cent of family allowances, for a period of three years. The resulting savings for the industry were estimated to be about 0.8 per cent of sales. Due to administrative delays, this reduction came into effect as of June 30, 1973. In July 1973, the Commission issued a decision requiring Italy to eliminate the special reduction in family charges. Italy challenged this decision before the European Court.

One of the Italian arguments for dismissal was that the Commission had failed to establish that the reduction in social charges affected trade between member states and distorted or threatened to distort competition. Here the Advocate General maintained³²

One is here in a field where the difficulties of positive proof must often be insurmountable. Once it is clear that the natural consequence of the grant of an aid to an industry in a member-State must be to increase that industry's competitiveness *vis-à-vis* its competitors in other member States the inference can... properly be drawn that the aid does (or would if introduced) distort competition and affect trade between member-States.

By definition and the express wording of Article 92(1) (which covers only aid favoring certain undertakings or the production of

31. Case 173/73 (1974) ECR 709 (1974) 2 CMLR 593.

32. Case 173/73 (1974) ECR 709 at 728 (1974) 2 CMLR 593, at 603-604.

certain goods) aid increases the competitiveness of the recipient. The position being urged is therefore very nearly a "per se" rule: if aid is granted, the conclusion that the aid distorts competition is almost automatic.³³

The Italian textile industry is in competition with textile undertakings in the other member-States, as is shown by the substantial and growing volume of Italian textile exports to other member-States of the Common Market. The modification of production costs in the Italian textile industry by the reduction of the social charges in question necessarily affects trade between the member-States.

Philip Morris Holland BV v. E. C. Commission,³⁴ a decision concerning a Dutch investment subsidy program, also makes clear that EC policy on state aid does not require complicated market analysis. The Netherlands Act of 29 June 1978 provided for sufficiently large investment projects to receive subsidies up to a maximum of 4 per cent of the value of the investment. The exact amount of aid was to depend on the number of jobs created. Section 6 of the Act provided that the aid would not be granted if the Commission found it to be incompatible with the Common Market under Articles 92 to 94 of the Treaty. The Commission approved this scheme as a general system of aid, subject to prior notification of individual grants.

One such grant involved a project of Philip Morris International to close a cigarette factory at one location in the Netherlands, while expanding capacity at another (for a net increase of capacity of 11,100 million to 16,000 million cigarettes per year). The implied change in employment was either 5 (according to the Commission) or 475 (according to Philip Morris Holland).

33. Case 173/73 (1974) ECR 709 at 721 (1974) 2 CMLR 593, at 608.

34. Case 730/79 (1980) ECR 2671 (1981) 2 CMLR 321.

At this time, there was substantial Community trade in cigarettes. The Netherlands was one of the largest importers and exporters of cigarettes. Philip Morris, the second-largest group of tobacco manufacturers in the world, expected the investment program to give it half of Dutch manufacturing of cigarettes, and expected to export more than 80 per cent of its production in the Netherlands to other member states. Based on this information, the Commission concluded that³⁵

The Netherlands Government's proposed aid is likely, therefore, to affect trade and distort competition between Member States by favouring the undertaking within the meaning of Article 92 (1) of the EEC Treaty.

After declining to find the aid qualified for one of the exemptions provided for in Article 92(3) (we discuss this aspect of the decision below), the Commission ordered the Netherlands to refrain from granting the aid. Philip Morris challenged this ruling before the European Court on several grounds. One was that the Commission's economic analysis was not sufficient to justify a finding of distortion to competition:³⁶

...that, in order to decide to what extent specific aid is incompatible with the Common Market, it is appropriate to apply first of all the criteria for deciding whether there are any restrictions on competition under Articles 85 and 86 of the Treaty. The Commission must therefore first determine the 'relevant market' and in order to do so must take account of the product, the territory and the period of time in question. It must then consider the pattern of the market in question in order to be able to assess how far the aid in question in a given case affects relations between competitors.

35. Commission Decision 79/743 of 27 July 1979 on proposed Netherlands Government assistance to increase the production capacity of a cigarette manufacturer OJ 1979 L 217/17 at 18.

36. (1980) ECR 2671 at 2688 (1981) 2 CMLR 321 at 339. A point in this judgement was that Philip Morris had to the right to bring an action against a decision of the Commission addressed to a member state of the Community.

Philip Morris Holland wanted the Commission decision to be set aside, because it did not contain the described analysis. The Court said simply³⁷

...the aid which the Dutch Government proposed to grant was for an undertaking organised for international trade ... The aid in question was to help to enlarge its production capacity and consequently to increase its capacity to maintain the flow of trade including that between member States. On the other hand the aid is said to have reduced the cost of converting the production facilities and has thereby given the applicant a competitive advantage over manufacturers who have completed or intend to complete at their own expense a similar increase in the production capacity of their plant.

The Court considered that these facts justified the Commission's decision that aid would threaten to distort competition. As to the effect of the aid on trade between Member States, we again find what seems to be a per se rule:³⁸

When state financial aid strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade the latter must be regarded as affected by that aid.

However, all state aid will strengthen an undertaking, compared to undertakings that do not receive equivalent aid. Taken at face value, therefore, the Court's position means all state aid to enterprises that compete in intra-Community trade affects that trade in the sense required to apply Article 92 of the Treaty. This is very much consistent with the indication in France v. Commission that it is

37. (1980) ECR 2671 at 2689 (1981) 2 CMLR 321 at 340.

38. Ibid.

a qualitative rather than a quantitative evaluation of the effect of state aid that is required of the Commission.

While the analytical requirements imposed on the Commission as regards state aid are relatively mild, the Commission must state its reasons clearly. This is clear from several judgments of the European Court. One such case³⁹ concerned the proposed equity participation of a Dutch regional development authority in the spinoff of Leeuwarder, a paperboard processing firm, from a parent firm that had been in persistent financial difficulties.

A 1982 Commission decision found the proposed purchase of shares to constitute a state aid, and declared it incompatible with the common market. This decision was challenged, on several grounds, by Leeuwarder and by the Dutch Government. Among other things, they argued⁴⁰

...that the Commission, contrary to Article 190 of the Treaty, failed to give a sufficient statement of its reasons for adopting the decision with regard both to the conditions laid down in Article 92(1) and to the refusal to apply article 92(3).

The Court began by stating the established principle⁴¹

...that the statement of reasons for a decision adversely affecting an undertaking must be such as to allow the Court to review its legality and to provide the undertaking concerned with the information necessary to enable it to ascertain whether or not the decision is well-founded.

39. Joined Cases 296 and 318/82 Kingdom of the Netherlands and Leeuwarder Papierwarenfabriek BV v. E. C. Commission (1985) ECR 809 (1985) 3 CMLR 380.

40. (1985) ECR 809 at 822 (1985) 3 CMLR 380 at 394.

41. (1985) ECR 809 at 823 (1985) 3 CMLR 380 at 396.

Applying this principle to the Leeuwarder decision, the Court concluded⁴²

Even if in certain cases the very circumstances in which the aid is granted are sufficient to show that the aid is capable of affecting trade between Member States and of distorting or threatening to distort competition, the Commission must at least set out those circumstances in the statement of reasons for its decision. In this case it has failed to do so since the contested decision does not contain the slightest information concerning the situation of the relevant market, the place of Leeuwarder in that market, the pattern of trade between Member States in the products in question or the undertaking's exports.

On this and other grounds the Court voided the Commission's decision. Even though the Commission need not conduct a detailed analysis of the impact of an aid measure on competition, it must explain the analysis it does make.

In this same spirit, in another instance⁴³ the Court annulled a Commission decision partly on the ground that the Commission gave no concrete indication of the way in which competition was damaged and partly because the Commission had not explained why the activities of the aided company would have such an adverse effect on trading conditions that its disappearance would have been preferable to its rescue.

Advocate General Slynn took a similar view in another case:⁴⁴

42. (1985) ECR 809 at 824 (1985) 3 CMLR 380 at 396-397.

43. Case 323/84 Intermills SA v. E. C. Commission (1984) ECR 3809 (1986) 1 CMLR 614.

44. Case 223/85 Rijn-Schelde-Verolme (RSV) Machinefabrieken en Scheepswerven NV v. E. C. Commission (1987) ECR 4617 at 4648-4649 (1989) 2 CMLR 259 at 270-271. As the Court reversed the Commission on other grounds, it did not address this argument.

...I am of the opinion that the contested decision does not satisfy the requirements of Article 190 as interpreted by the Court in respect of the two related issues of the aid's effect on trade and competition and its compatibility with the common market. In the first place it contains practically nothing on the relevant market or RSV's share of that market... Secondly, the Commission says nothing to substantiate the assertions in the decision that the relevant market was suffering from overcapacity. ...the Commission does not explain why it felt able to approve the aid notified in December 1980...but did not feel able to approve the 1982 arrangements which were, so far as the Commission was aware, designed to cover unanticipated further costs of the same operation. There may be good reasons for this, but if there are they should be spelled out.

Such rulings have clearly had an effect on Commission practice.

Its decisions now routinely contain market and trade statistics that serve to support conclusions concerning the impact of aid on competition and on trade among member states.

V. The Principle of Compensatory Justification

The idea runs throughout the Treaty that distortions or even restrictions of competition may be permitted, provided that they are necessary to secure objectives compatible with Community values other than maximization of competition. Article 85(3) permits exemption of certain restrictive agreements from the prohibition of Article 85(1). Article 90(2) permits certain relaxations of such prohibitions in the case of public undertakings entrusted with tasks of public interest.⁴⁵

The Philip Morris⁴⁶ case allowed the Court to endorse a similar principle in the context of Commission practice concerning state aid.

45. The same idea underlies the case law of the European Court, which recognizes that certain exceptions from basic Treaty prohibitions, other than those expressly laid down in the Treaty, may be permitted on the basis of 'mandatory requirements.'

46. Case 730/79 Philip Morris Holland BV v. E. C. Commission
((1980) ECR 2671 (1981) 2 CMLR 321.

The principle of compensatory justification holds that the grant of aid falling within Article 92(1) will be permitted only when necessary to accomplish one of the goals of Article 92(3). As stated by the Commission in the Tenth General Report on Competition Policy:⁴⁷

Exemptions to incompatibility included in Article 92(3) must be strictly interpreted, notably, aid may only be granted when the Commission can establish that it will contribute to the attainment of the objectives specified in the exemption which, under normal market conditions, the recipient firms would not attain by their own actions.

and elsewhere⁴⁸

To grant an exemption where there is no compensatory justification would be tantamount to allowing trade between Member States to be affected and competition to be distorted without any benefit in terms of the interest of the Community, while at the same time accepting that undue advantages accrue to some Member States.

State aid that distorts competition will be permitted only to accomplish Community goals and only in the presence of market failure. If market forces would accomplish the goal without state aid, and state aid will distort competition, then state aid will not be permitted.

In Philip Morris, the applicants argued that the Commission's role should be much more limited than implied by the principle of compensatory justification. Philip Morris objected to the Commission's position that state aid should be approved only if the

47. Commission Decision 79/743 of 27 July 1979 on proposed Netherlands Government assistance to increase the production capacity of a cigarette manufacturer OJ 1979 L 217/17 at 18; E. C. Commission Tenth Report on Competition Policy. Brussels, 1981, p. 149.

48. Decision 81/626 of 10 July 1981 OJ 1981 L 229/12 at 13; the same language appears in innumerable Commission decisions.

market, unaided, would not produce the desired effect. It urged the Court to interpret the Treaty as requiring approval of state aids that fell within the categories outlined in Article 92(3), without regard to the ability of the market to achieve the desired goal.

This position was rejected by the Court.⁴⁹ As later summarized by the Commission,⁵⁰

State aids are in principle incompatible with the common market. The discretionary power of the Commission should only be exercised when the aids proposed by Member States contribute to the achievement of the Community objectives and interest set out in Article 92(3) EEC. The national interest of a Member State or the benefits obtained by the recipient of aid in contributing to the national interest do not by themselves justify the positive exercise of the Commission's discretionary powers.

The principle of compensatory justification requires an analysis of the situation in each case. A result is that aid granted under general schemes for an entire sector or branch of an industry is acceptable only on condition that significant individual grants are notified to the Commission.⁵¹

It is now the well-established policy of the Commission to accept such general aid schemes subject to one of two conditions, namely that the Member State concerned informs the Commission of either a regional or sectoral plan of application, or where this is felt not to be possible, that it notifies significant individual cases of application.

Subject to this condition, particular applications of general aid schemes are evaluated according to the same standards as specific aid schemes.

49. Case 730/79 Philip Morris Holland BV v. E. C. Commission (1980) ECR 2671 (1981) 2 CMLR 321.

50. E. C. Commission, Tenth Report on Competition Policy. Brussels, 1980, p. 151.

51. Commission Decision 81/626 of 10 July 1981 OJ 1981 L 229/12.

VI. Acceptable Justifications

Acceptable justifications for state aid may be categorized by reference to Community policies, which may require what would otherwise be unacceptable distortions of competition:⁵²

...in authorising derogations from the prohibition of State aid the Commission must strive to co-ordinate national policies toward aids on the basis of common criteria and in terms of the general interests of the Community.

Policy requirements, like those of sub-paragraphs, often overlap. It would be unrealistic to expect that each policy can be neatly matched with a particular sub-paragraph within Article 92(3). Order emerges only when the application of policy to disorderly reality is examined.

A. Sectoral Policies

The approaches of the Commission to sectoral aid are basically of two kinds. First, such problems may be approached within the framework of a common policy for which the Treaties provide a specific legal basis (such as those for coal and steel, agriculture and fisheries). Here the approach of the Commission to the grant of state aid has been determined by the general requirements of each policy.

For example,⁵³

...Quite important Commission positions on agriculture or transport will not be considered here, since they cannot be separated from the context of the common policies specific to these sectors and within which the purpose aimed at can be more clearly understood.

52. Opinion of Advocate General Capotorti in Case 730/79 Philip Morris Holland BV v. E. C. Commission (1980) ECR 2671 at 2702 (1981) 2 CMLR 321 at 335.

53. E. C. Commission. First Report on Competition Policy. Brussels, 1972, p. 132.

Binding rules have been enacted regarding aid to the coal and steel industries, the agricultural and fishing industries, transport by rail, road, inland waterway and sea.⁵⁴

The second approach constitutes the response of the Commission to state interventions in specific sectors. Here the principal concern of the Commission has been to prevent the grant of state aid from exacerbating existing problems or transferring them from one member state to another. Principles have been formulated regarding aid to the textile, man-made fibre, and automobile industries, as well as air transport.⁵⁵ These principles are not legally binding.⁵⁶

The general policy of the Commission regarding sectoral aid was defined in a communication to the Council of 25 May 1978.⁵⁷ At

54. Rules governing aid to the steel industry are contained in Decision 3484/85 OJ 1985 L 340/1, and rules on aid to the coal industry in Decision 2064/86 OJ 1986 L 177/1. Regulation 1107/70 JO 1970 L 130/1 governs aid to rail, road and inland waterway transport. Regulation 797/85 OJ 1985 L 93/1 governs aid for improving the efficiency of agricultural structures, and Regulation 355/77 OJ 1977 L 51/1 governs common measures to improve the conditions under which agricultural products are processed and marketed. Regulation 101/76 OJ 1976 L 10/19 deals with state aid in the fisheries sector.

55. The Commission first notified member states of principles regarding aids to the textile industry in 1971, and these were updated in 1977. Guidelines to aid the automobile sector, requiring prior notification and annual reports, were introduced in 1988. COM(84) 72 governs air transport.

56. See the view of Advocate General Darmon in Case 310/85 Deufil GmbH & Co. KG v. E. C. Commission (1987) ECR 901 at 914 (1988) 1 CMLR 553 at 556. This is in contrast to the binding directives on shipbuilding; see Directive 87/167 OJ 1987 L 69/55, which was enacted by the Council of Ministers under Article 92(3)(d).

57. Com(78) 221.

this time, sectoral policy was seen as a tool to ease industries with persistent excess capacity through a transitional period:⁵⁸

(i) aids should not be given where their sole effect would be to maintain the *status quo*...;

(ii) ...while rescue measures may be needed in order to provide a breathing space during which longer-term solutions to a company's difficulties can be worked out, they should not frustrate any necessary reductions in capacity...;

(iii) since it is a common feature of the industries concerned that capacity is excessive, aids should not be given to investment projects which would result in capacity being increased. ...

Operating Aid

Operating aid is assistance that "has a direct effect on production costs and on the selling price."⁵⁹ It is regarded as artificially maintaining excess capacity, and has traditionally been considered particularly objectionable. Such aid, it is feared, may discourage firms from undertaking the restructuring activity necessary to solve their problems. Operating aid is opposed even if the result is closure of the prospective recipient.⁶⁰

58. E. C. Commission, Eighth Report on Competition Policy. Brussels, 1978, p. 126. Similar language appears in innumerable Commission decisions.

59. Commission Decision 82/744 of 11 October 1982 concerning Italian national Law No 423/81 of 1 August 1981 on measures for agriculture OJ 1982 L 315/23 at 24.

60. Commission Decision 88/174 of 17 November 1987 concerning aid which the Land of Baden-Württemberg of the Federal Republic of Germany has provided to BUG-Alutechnik GmbH, an undertaking producing semi-finished and finished aluminium products OJ 1988 L 79/29 at 31.

...through the grant of DM 2 million the Land prevented economic market forces from having their normal consequences - the disappearance of a loss-making uncompetitive undertaking - kept the undertaking in business artificially and facilitated its take-over by a large integrated aluminum group. This aid is therefore of a rescue nature and favours the recipient undertaking and its purchaser compared with other undertakings competing in the sector, by an artificial improvement of its profitability.

Recently, however, the Commission has indicated a willingness to abandon its traditional hostility toward operating aid, in the context of regional aid programs directed toward the most depressed areas of the Community.⁶¹ This development is discussed below.

Restructuring Aid

Aid designed to resolve structural problems is more likely to be found acceptable than aid aimed at cyclical or conjunctural problems⁶²

As to the exception in Article 92 (3)(c) for aid to facilitate the development of certain economic activities or certain economic areas, Noviboch produces and markets quality ceramic sanitary ware on a fairly modest scale, with 269 employees. ...its output is currently 20 to 30 % lower than that of its predecessor...

The restructuring stemming from the winding-up of Boch has therefore contributed to the reorganization of a Community industry suffering from surplus production capacity...

...the aid in the form of a subscription of Bfrs 400 million of share capital granted in connection with the setting-up of Noviboch therefore qualifies for exemption under Article 92(3)(c).

The amount and intensity of aid must be justified by the restructuring effort involved, taking account of general structural problems of the

61. OJ 1988 C 212/2.

62. Commission Decision 87/423 of 11 March 1987 concerning aid which the Belgian Government has granted to a ceramic sanitary ware manufacturer at La Louvière OJ 1987 L 228/39 at 40.

region where the investment is to take place.⁶³

As noted above, one of the grounds for appeal in the Leeuwarder case was the claim that the Commission had inadequately explained its unwillingness to find the Dutch investment compatible with the common market, as provided in Article 92(3). The Court agreed:⁶⁴

...the statement of reasons with regard to the failure to apply the exemptions provided for in Article 92 (3) is inadequate. In that respect, it is declared in the statement of reasons for the decision that it had not been established that the conditions for the application of any of the exemptions were satisfied... Although that statement is conclusively supported with regard to the exemptions provided for in Article 92 (3) (a) and (b)..., that is not the position with regard to the exemption provided for in subparagraph (c) thereof, in respect of which the statement of reasons for the decision does not indicate that the Commission considered all the essential elements of fact or law which could have justified the granting of that exemption.

The following paragraph of the Court's decision outlines the facts taken into account by the Commission, and the additional facts which, in the Court's view, the Commission should have taken into account (emphasis added):⁶⁵

63. Commission Decision No. 2320/81 of 7 August 1981 establishing Community rules for aids to the steel industry OJ 1981 L 228/14 at 16.

64. Joined Cases 296 and 318/82 Kingdom of the Netherlands and Leeuwarder Papierwarenfabriek BV v. E. C. Commission (1985) ECR 809 at 825 (1985) 3 CMLR 380 at 397.

65. Ibid.

The contested decision merely states in the first place that the Netherlands aid 'would not "facilitate the development of ... certain economic areas" within the meaning of that provision'... and in the second place that 'developments in the paperboard-processing industry show that to maintain production capacity through the grant of State aid would not be in the common interest' and that 'furthermore, the paperboard-processing industry's future prospects rule out the conclusion that the aid envisaged would not adversely affect trading conditions to the extent contrary to the common interest'... However, there is no indication whatsoever in the decision that the Commission took into consideration the essential fact, which might have caused it to make a different assessment, that the aid in question was accompanied by a restructuring of the recipient undertaking which, by diverting its production to high-quality products, led to a reduction in its production capacity and in its market share.

The Court's comments at this point indicate the importance of a linkage between aid and restructuring for the possibility of exemption under Article 92(3)(c).

Rescue Aid

In a letter to the Member States of 24 January 1979,⁶⁶ the Commission elaborated on the conditions under which rescue aid would be regarded as compatible with the common market. Rescue aid must be designed to keep a firm in business while the causes of its difficulties are discovered and a remedy is worked out. Compatible rescue aid will have the following characteristics:

- (1) it is provided in cash and must bear normal interest rates;
- (2) it is provided only for the time needed to draw up recovery measures (generally six months or less);
- (3) it does not have adverse effects on industrial activity on other Member States;
- (4) it is notified to the Commission in advance.

66. For discussion, see Commission Decision 87/585 of 15 July 1987 on aid granted by the French Government to a producer of textiles, clothing and paper products - Boussac Saint Freres OJ 1987 L 352/42, at 48.

The judgment in Intermills S.A. v. E. C. Commission,⁶⁷ which involved a Belgian program of aid to a paper manufacturing firm, is illustrative of the issues raised by rescue aid.

Intermills SA operated five factories in Wallonia. State aid was linked to a restructuring program that included a reduction in output, conversion from mass production to high valued-added specialty papers, closure of two factories, and creation of three independent companies to manage the remaining factories. The aid took the form of investment by the Walloon Regional Executive in Intermills and in the three manufacturing companies, and a low-interest loan to finance an investment program by the manufacturing companies.

The Commission's decision emphasized the requirement of compensatory justification:⁶⁸

...the Commission must be satisfied that there is a specific compensatory justification forthcoming from the particular recipient: the grant of aid must be required to promote the attainment of one of the objectives set out in Article 92(3). Where this cannot be shown, it is clear that the aid does not contribute to the attainment of the objectives specified in the exemption clauses but serves to increase the financial strength of the undertaking in question.

In this instance, the Commission found a justification for certain aid, based on Article 92(3)(c):⁶⁹

67. Case 323/82 (1984) ECR 3809 (1986) 1 CMLR 614.

68. Commission Decision 82/670 of 22 July 1982 OJ 1982 L 280/30, reproduced in [1986] 1 CMLR 614 at 619-623, Paragraph 16.

69. Paragraphs 20-21.

...the Community's paper industry has in the past had to face strong competition from manufacturers in non-Community countries producing under particularly favourable natural conditions. This competition threatens to grow in the near future...

It is in the Community interest that the paper industry should adapt to the new situation in particular by reducing the share of bulk-production paper in its output and converting to special papers.

The Commission, however, distinguished between aid in the form of low-interest loans and aid in the form of capital investment. In the Commission's view, low-interest loans were directly related to the conversion toward specialty paper, and hence justified under Article 92(3)(c). Capital investment, however (2,350 million Belgian francs in an enterprise whose capital and reserves were 1,250 million Bfrs) was intended mainly to allow the firm to meet its debt-servicing obligations. The Commission was not willing to permit this "rescue aid," and ordered that it be stopped.

Intermills SA applied to the European Court to set aside the Commission Decision. It argued, among other things, that the Commission had not adequately explained why it was appropriate to distinguish aid in the form of low-interest loans and aid in the form of capital investment. The Court agreed.⁷⁰

...the settlement of an undertaking's existing debts in order to ensure its survival does not necessarily adversely affect trading conditions to an extent contrary to the common interest, as provided in Article 92(3), where such an operation is, for example, accompanied by a restructuring plan. In this case, the Commission has not shown why the applicant's activities on the market, following the conversion of its production with the assistance of the aid granted, were likely to have such an adverse effect on trading conditions that the undertaking's disappearance would have been preferable to its rescue.

On this ground, the Court voided the Commission's decision.

70. (1984) ECR 3809 at 3832 (1986) 1 CMLR 614 at 646.

Conditions in the relevant industry or market determine whether or not sectoral aid is permissible. It follows that developments in such conditions are capable of affecting the treatment of state aid under Article 92. For example, in 1973 the United Kingdom notified the Commission of its intention to assist the offshore supplies industry by making interest relief grants. The Commission did not object to the scheme at that time, because it was designed to promote development of new technology in a field where there was little or not intra-Community trade.⁷¹ By 1976, however, sales on the United Kingdom market had increased to such an extent that the Commission felt that the aid threatened to distort competition. Moreover, the Community offshore supplies industry had developed to such an extent that no exception could be made under Article 92(3)(c).⁷²

A 1987 decision delineates the narrow range within which Article 92(3)(b) may be found to justify rescue aid:⁷³

71. Commission Decision 79/496 of 2 May 1979 on the United Kingdom scheme of assistance in the form of interest relief grants in favour of the offshore supplies industry (offshore supplies interest relief grant, OSIRG) OJ 1979 L 127/50.

72. Ibid.

73. Commission Decision 88/167 of 7 October 1987 concerning Law 1386/1983 by which the Greek Government grants aid to Greek industry OJ 1988 L 76/18 at 21.

In the terms of Article 92(3)(b) aid, in order that it may be considered compatible with the common market, must be in the nature of a remedy for the perceived serious disturbance in the economy of the Member State concerned. Since ...it will then be a matter of granting aid to companies which, although basically viable, have run into difficulties threatening their survival, it follows that the operation must not result in their being left in a stronger competitive position vis-à-vis industries in other Member States than would otherwise occur had those difficulties not arisen in the first place. Accordingly the aid must not promote expansion of production capacity nor must it merely shift the problem without finding a genuine solution to the social and industrial problems facing the Community as a whole or even aggravate the situation still further in the medium or long-term future.

Article 92(3)(b) permits rescue aid, provided the aid actually helps find a solution to the underlying problem, rather than making it worse, postponing solution, or shifting it elsewhere in the Community.

B. Regional Policy⁷⁴

The Commission's practice regarding regional aid originated in a concern to limit the adverse effect of national action on competition in the common market. Regional policy reflects a desire to balance support for the kind of unregulated decision making that characterizes a market system with the promotion of economic integration:⁷⁵

The issue here is the necessary balance between free competition and solidarity. The importance of the latter depends upon the particular case; it is more likely to outweigh considerations of competition in the situations of crisis described in subparagraph (a) than in the cases provided for in subparagraph (c) relating to aid intended to assist the development of certain activities or certain economic regions.

74. See Commission Communication of 23 June 1971 JO 1971 C111/7; Resolution of the Representatives of the Governments of the Member States, meeting within the Council, on general systems of regional aid, of 20 October 1971 JO 1971 111/1; Communication of the Commission on regional aid systems, OJ 1979 C 31/9; Commission Communication of 1988 OJ 1988, C212/2.

75. Opinion of Advocate General Darmon, Case 248/84 Federal Republic of Germany v. E. C. Commission (1987) ECR 4013 at 4031 (1989)

1 CMLR 591 at 600.

The Commissions objection to regional aid is in part quite specific to its regional nature:⁷⁶

In so far as the aid induces firms to choose another location, this also constitutes a distortion of competition...for the institution of a system ensuring that competition in the common market is not distorted...implies that firms should be allowed to make up their own mind where to locate and that their choice should therefore not be swayed or guided by financial inducements.

and

Trade is also affected by the influence which the aid has on the location decisions of aided firms. When ... a firm relocates from one Member State to another, both the relocation itself and the production at, and the supply of output from, the new location change trade patterns between Member States.

In other respects, the Commission's objection to regional aid is quite general:⁷⁷

The aid in issue in the present case distorts competition because it calculably improves the recipient's return on his investment, thereby strengthening his financial position compared with competitors who do not receive such assistance.

Level of Regional Development

A 1986 Commission decision, involving a Federal Republic of Germany regional aid program, makes clear that the standard for regional aid is the level of regional development relative to the Community as a whole, not relative to the average of the state proposing the aid:⁷⁸

76. Ibid.

77. Commission Decision 87/15 of 19 February 1986 on the compatibility with the common market of aid under the German Federal/Land Government Joint Regional Aid Programme (Joint Programme for the improvement of regional economic structures) in six labour market regions OJ 1987 L 12/17 at 21.

78. Ibid. at 22. See also Case 248/84 Federal Republic of Germany

v. E. C. Commission (1987) ECR 4013 at 4042 (1988) 1 CMLR 591 at 608.

In applying the principles set out above in its scrutiny of regional aid schemes, the Commission must satisfy itself that the regions concerned are suffering from problems which are serious enough, in comparison with the rest of the Community, to justify the grant of aid at the level proposed.

The only circumstances in which the effect on trading conditions caused by regional aid can be regarded as not against the common interest are where it can be shown that the aided region suffers from difficulties that are relatively severe by Community standards, that without the aid market forces would not eliminate these difficulties, that the level of aid is in proportion to the difficulties and that the grant of aid does not unduly distort competition in particular sectors.

The Commission has developed systematic procedures for the comparison of regional and Community development:⁷⁹

To ensure that its Community-related assessment is systematic and objective, the Commission has developed a method of determining, for a given Member State, general threshold levels of structural unemployment and *per capita* gross domestic product from which regional aid can be deemed acceptable. These thresholds are regularly reviewed in the light of the latest figures.

The thresholds for a given Member State are decided in the light of its relative position in comparison with the Community average. The thresholds for more developed Member States are more restrictive.

The kind of information considered by the Commission when evaluating regional aid schemes is illustrated by the Commission's discussion of a proposed measure of employment aid for Sicily:⁸⁰

79. Commission Decision 87/15 of 19 February 1986 OJ 1987 L 12/17 at 23. See Communication of the Commission on regional aid systems OJ 1979 C31/9.

80. E. C. Commission, Sixth Report on Competition Policy. Brussels 1977, p. 108.

Net per capita incomes range between 54% and 66% of the national average...between 35% and 42% of the Community average. ...The population of the three provinces has declined considerably. Between 1961 and 1971 ..., a net fall of between 4% and 12% was recorded...The population of Sicily as a whole declined by 1%...as against an increase of some 7% in the total population of Italy...Emigration rates from the [three] provinces ...for the period 1961-1971 were with a few exceptions higher than in any other Italian provinces. ...the employment situation is poor. In 1973 the percentage of persons in employment in Sicily amounted to only 25% of the total population, as against an Italian average of 32%.

On the basis of these considerations, the Commission found the aid program concerned to be compatible with the common market, even though it caused total aid to the affected areas to exceed the aid levels usually permitted.

Infrastructure Investment

A 1987 decision clarifies the import of Community policy toward state aids for a Greek business aid program, and in so doing provides insight into recent developments into aid related to infrastructure investment:⁸¹

With regard to the exceptions provided for in Article 92(3)(a), aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious under-employment, while Greece may be regarded as meeting these definitions, the concept of regional development to which this exception is linked is based essentially on the provision of aid for new investment or major expansions or conversions of undertakings involving large-scale investments of a physical nature and the costs associated with these. In the case of Law 1386/1983 the interventions of the BRO in respect of companies that have fallen into financial difficulties and the consequent restoration of their balance cannot be said to fall under the prescriptions of this exception.

Thus Article 92(3)(a) is seen by the Commission as permitting aid to investment programs that will support regional development. Rescue aid for individual companies does not fall within this category.

81. Commission Decision 88/167 of 7 October 1987 concerning Law 1386/1983 by which the Greek Government grants aid to Greek industry OJ 1988 L 76/18 at 20.

The Commission has increasingly stressed that regional aid will only be permissible under Article 92(3)(c) where it involves initial investment or job creation. An example would be infrastructure investment to allow a region to exploit natural resources.⁸²

The Federal Government stated that, in the labour market region of Miesbach, the emphasis of such aid was on small, mainly family, businesses. The Commission has established that this is also true of such aid in the tourist areas of the labour market region of Landsberg. In these circumstances, it can be assumed that in neither labour market region does the aid for developing tourism affect tourist trade flows to an extent contrary to the common interest, if at all. In arriving at this conclusion, the Commission has taken into account the fact that the parts of both labour market regions designed by the Federal Government as tourist areas have the natural amenities for tourism, but lack the facilities. Aid could enable the facilities to be improved and the natural amenities of the areas to be utilized. In these circumstances, aid for developing tourism may be deemed compatible with the common market under Article 92 (3) (c).

As for Article 92(3)(c), it justifies regional aid programs with a "pump-priming" or social investment function:⁸³

The exemption provided for in Article 92(3)(c) is applicable to aid which facilitates the development of certain economic areas without at the same time adversely affecting trading conditions to an extent contrary to the common interest.

The effect on trading conditions caused by regional aid can be regarded as not being contrary to the common interest where it can be shown that the aided region suffers from difficulties that are relatively severe by Community standards, that without the aid market forces would not eliminate these difficulties, and that the grant of aid would not unduly distort competition in particular sectors.

This clause permits aid in situations where the market would work too slowly, or not at all, to resolve the perceived problem.

82. Commission Decision 87/15 of 19 February 1986 OJ 1987 L 12/17 at 25, 26.

83. Commission Decision 88/318 of 2 March 1988 concerning on Law No 64 of 1 March 1986 on aid to the Mezzogiorno OJ 1988 L 143/36 at 40.

Developments Related to European Unification

The Commission showed considerable concern to secure the abolition of preferential rediscount rates prior to 1 July 1968, when the common market was to come into force.⁸⁴ One might expect to find corresponding concerns during the period preceding the completion of the internal market. Indeed, in the Sixteenth Report on Competition Policy, the Commission stated that ⁸⁵

The Community's efforts to complete a single unified internal market by 1992...lend added weight and importance to the enforcement of the competition rules, and in particular the rules on State aid.

This has meant a refinement of policy regarding regional aid. As the Commission has noted,⁸⁶

The entry of Spain and Portugal, coming after that of Greece, has made it necessary for the Commission to refine its methods and criteria for assessing regional aid in the so-called 'peripheral' regions of the Community....The economic and social problems of these areas, which are predominantly agricultural, industrially underdeveloped and have widespread underemployment, call for a certain rethinking of the Commission's policy toward regional aid.

More generally, the Commission now concentrates on issues that have become a matter of priority as a result of the Single European Act. Thus⁸⁷

The new Title V of Part Three of the EEC Treaty, Article 130A, requires the Community to 'develop and pursue its actions leading to the strengthening of its economic and social cohesion' and, in particular, to aim at 'reducing disparities between the various regions and the backwardness of the least-favoured regions'.

84. See the facts in Cases 6/69 & 11/69 Re Export Credits: E. C. Commission v. France (1969) ECR 523 (1970) CMLR 43.

85. E. C. Commission, Sixteenth Report on Competition Policy. Brussels, 1987, p. 135.

86. Ibid., p. 178.

87. Ibid.

In the promotion of Community economic and social cohesion, the Commission distinguishes between regional aid treated under Article 92(3)(a), which covers aid to chronically depressed areas, and that treated under Article 92(3)(c), which permits developmental aid that does not affect trading conditions to an extent contrary to the common interest.

The willingness to assist severely depressed areas has led the Commission to modify its long-standing hostility toward operating aid:⁸⁸

Article 92(3)(a) regions are those suffering abnormally low living standards or serious underemployment where the per capita gross domestic product does not exceed 75% of the Community average... the assessment is made relative to the Community average. Given the particularly severe development problems faced in such regions, the Commission has decided that it may allow operating aids in some circumstances.

Such a possibility remains foreclosed in less depressed areas:⁸⁹

Regions falling under Article 92(3)(c) are those with more general development problems in relation to the national as well as the Community situation. Often they suffer from the decline of traditional industries and are frequently located in the more central prosperous parts of the Community. In its Article 92(3)(c) method, the Commission has established a system which takes account of national regional problems and places them in a Community context. ...The better the position of a Member State relative to the Community situation, the wider must be the disparity of a region in order to justify the award of aid. ...the Commission does not in principle allow the award of operating aid in Article 92(3)(c) regions, and aid must be linked to initial investment and/or job creation.

88. E. C. Commission, Eighteenth Report on Competition Policy. Brussels, 1989, p. 147. For an application, see Commission Decision 88/318 of 2 March 1988 on Law No 64 of 1 March 1986 on aid to the Mezzogiorno OJ 1988 L 143/37.

89. E. C. Commission, Eighteenth Report on Competition Policy. Brussels, 1989, pp. 147-148, pp. 147-148.

C. Horizontal Policies

The new horizontal policies - environmental policy, the programme for small and medium-sized enterprises, and others - take as their starting-point the desirability of aid to accomplish certain goals. The presumption implied in the formal legal structure of Article 92 and established in past Commission practice may be reversed.

Article 92(3)(b) allows the Commission to exempt state aid related to important projects of common European interest. Projects which for example seek to protect the environment may meet this qualification:⁹⁰

...a project may be described as being of common European interest when it forms part of the European trans-national programmes supported jointly by the various governments acting together or when it is connected with concerted action taken by the various Member States to combat a common problem, for example the pollution of the environment.

What is problematical, however, is the effect for competition policy. The horizontal policies cannot easily be reconciled with a reliance on the market as a mechanism for resource allocation.

Environmental Policy

The first guidelines concerning environmental aid were produced in November 1974.⁹¹ The Commission endorsed the "polluter pays" principle, and indicated that firms should normally bear the cost of investments needed to comply with environmental laws. At the time, however, the Community was perceived as lagging behind in environmental protection. For this reason, the guidelines permitted

90. Joined Cases 62/87 and 72/87 Exécutif Régional Wallon and Glaverbel SA v. E. C. Commission Judgment of 8 March 1988, Report for the Hearing, p. 8.

91. E. C. Commission, Fourth Report on Competition Policy. Brussels, 1975, pp. 101-106.

state aid up to a specified ceiling for this purpose during a 6-year transitional period (1975-1980).⁹² Interpretation of these guidelines was relatively strict.⁹³

...the Commission also considered that, even confined to anti-pollution investments, the aid was incompatible with the common market, since firms should bear the costs of eliminating their own pollution, and should only be assisted in doing this if it could be shown that they were experiencing difficulties in making the necessary adaptations to their existing production plants.

The 1974 guidelines were supplemented in 1980.⁹⁴ At this time, the transitional period was extended through 1986. The guidelines were extended again in 1986, by which time the Commission was beginning to rethink the whole basis of its environmental policy.⁹⁵

However, developments in the years since 1974 have changed the context of environmental policy. The process has culminated in the environmental provisions of the Single European Act, which states that 'Action by the Community relating to the environment shall be based on the principles that preventive action should be taken, that environmental damage should as a priority be rectified at the source, and that the polluter shall pay. Environmental protection requirements shall be a component of the Community's other policies'... These developments call into question the concept of a purely transitional approach since it is now clear that improvement in the environment and the need to avoid distortions of competition caused by national measures in this field will remain a major task for an indefinite period.

92. See E. C. Commission, Sixth Report on Competition Policy. Brussels, April 1977, pp. 127-131 for instances in which the Commission approved and did not approve aid under these guidelines.

93. Commission Decision 77/260 of 22 March 1977 concerning aid planned by the Belgian Government towards the extension of capacity of an oil refinery at Antwerp OJ 1977 L 80/23.

94. E. C. Commission, Tenth Report on Competition Policy. Brussels, 1981, pp. 157-158.

95. E. C. Commission, Sixteenth Report on Competition Policy. Brussels, 1987, p. 176.

Under present guidelines, environmental aid qualifies for an Article 92(3)(b) exemption as an important project of common European interest if⁹⁶

- (i) the aid is intended to facilitate the implementation of new environmental standards;
- (ii) the net grant equivalent of the aid does not exceed 15% of the value of the aided investment;
- (iii) only firms have installations in operation for at least two years before the entry into force of the environmental standards in question;
- (iv) the eligible firm bears the entire cost of normal replacement investment and operating costs.

These guidelines suggest that market failure no longer has the decisive significance one attributed to it as a condition for the acceptability of state aid. It is notable that the guidelines are broadly interpreted. Listings of instances of state aid to which the Commission does not object (published in the annex of the annual Report on Competition Policy) indicate that the Commission permits numerous instances of aid aimed at protecting the environment.

Research & Development

While the main concern of sectoral policy has been the management of structural excess capacity, a subsidiary purpose has been to promote technological competitiveness. By coordinating investment in innovation, the Commission seeks in effect to minimize a kind of "technological excess capacity."⁹⁷

96. Ibid.

97. E. C. Commission, Eighth Report on Competition Policy. Brussels, 1979, p. 126; footnotes omitted.

For other industries the Commission's action has been much more limited, and has been confined to those, such as computers, certain areas of electronics and aerospace, in which, because of the strength of competition from producers in third countries, the Community industry has proved unable to take full advantage of a rapid growth in demand. In these cases the Commission has laid particular stress on the need to avoid a duplication of efforts and has accordingly argued for collaboration between Member States on some projects and more generally for a coordination of national measures. It has in general been favourably disposed to aids which are granted within a coordinated framework of this kind and particularly to those for research and development.

Underlying this policy is an evident belief in market failure, as regards technological advance.⁹⁸ State aid is seen as a device for improving on the performance of the unaided market.

Because the market is seen as generating a less-than-optimal level of investment in research and development, there is a general presumption in favor aid for research and development.⁹⁹

...the Commission has traditionally taken a favourable view ...when it has come to scrutinize individual schemes under Article 92 ... This ...is justified by ...the aims of such aid, the often considerable financing requirements for R&D, the risks attached and, given the distance from the market place of such projects, the reduced likelihood of distortions of competition or trade between Member States.

Aid for research and development to promote an important project of common European interest may be exempted under Article 92(3)(b). The Commission has approved aid granted by the Netherlands for the development of a common standard for high-definition colour television on this basis.¹⁰⁰

98. See the remarks on state to the electronic data processing industry in E. C. Commission, Second Report on Competition Policy, p. 93, where it is clear that the market for financial capital is seen as the source of market failure.

99. Community Framework for State Aids for Research and Development OJ 1986 C 83/2.

100. E. C. Commission, Eighteenth Report on Competition Policy. Brussels, 1989, p. 151.

The Commission enjoys the discretion to decide whether or not a particular project is important and of common European interest. This involves not only an evaluation of the innovative nature of the project, but also a consideration of market factors.¹⁰¹

The mere fact that the investments envisaged enabled new technology to be used does not make the project one of common European interest; that certainly cannot be the case when... the products have to be sold on a saturated market.

Where the activity being aided does not involve an important project of common European interest, an exemption may be made based on Article 92(3)(c). For this to be possible, the Commission must determine that the aid does not adversely affect trading conditions to an extent contrary to the common interest.

A series of Commission decisions makes clear that aid which would otherwise run fail to qualify for one of the Article 92 exemptions cannot be saved by characterizing it as R&D aid. Commission practice is carefully to scrutinize individual aid packages, to assure itself that the aided activity is genuinely innovative in character. Modest technical improvements and routine refittings of equipment will not

101. Joined Cases 62/87 and 72/87 Exécutif Régional Wallon and Claverbel SA v. E. C. Commission Judgment of 8 March 1988, Judgment of 8 March 1988, p. 8.

qualify, even if they embody some technological progress.¹⁰²

Small- and Medium-Sized Enterprise

Aid for small and medium-sized enterprise was initially seen as a means of assisting such firms to overcome their peculiar difficulties:¹⁰³

- (1) limited access to markets for financial capital;
- (2) small size not justified by economic need;
- (3) greater difficulty adapting to technological, industrial, and commercial developments;
- (4) acquiring information needed to extend operations to the Community scale and beyond.

The Commission has consistently maintained a positive attitude toward SMEs, because of the role they are seen as playing in a market economy.¹⁰⁴

As in previous years, one of the Commission's main concerns in the competition policy area was its concern to strengthen and preserve small and medium-sized enterprises...as an essential element in a healthy and competitive environment. ...such businesses form one of the basic foundations of the European economy because of the contribution they make to the competitive structure of the market, their flexibility and their dynamism.

102. See Commission Decision 87/16 of 23 April 1986 on a proposal by the Italian Government to grant aid to a firm in the chemical industry (producing industrial auxiliaries, intermediates and pesticides) OJ 1987 L 12/27; Commission Decision 87/194 of 12 November 1986 on a FIM loan to a mineral-water and glass-water manufacturer OJ 1987 L 77/43; Commission Decision 87/303 of 14 January 1987 on an FIM (Industrial Modernization Fund) loan to a brewery OJ 1987 L 152/27; and Commission Decision 89/254 of 15 November 1988 relating to aid which the Belgian Government has granted to a petrochemicals company at Ottignies/Louvain-la-Neuve (SA Belgian Shell) OJ 1989 L 106/34. For a positive decision, see Commission Decision 89/305 of 21 December 1988 concerning aid from the French Government to an undertaking in the motor vehicle sector - Peugeot SA OJ 1989 L 123/53.

103. E. C. Commission, Sixth Report on Competition Policy. Brussels, 1977, p. 132.

104. E. C. Commission, Seventeenth Report on Competition Policy. Brussels, 1988, p. 29. See also COM(86) 445 final, 20 September 1986 - action programme for SMEs.

The Commission allows more generous levels of aid for research and development if the aid is directed toward SMEs.¹⁰⁵

...the Commission considers that, as a general rule, the level of aid for basic industrial research should not be more than 50 % of the gross costs of the project or programme. As the activity being aided gets nearer to the market place, i.e. covers the areas of applied research and development, the Commission in its examination and evaluation of national proposals will look in principle for progressively lower levels of aid.

Special allowance can also be made for aids directed genuinely at smaller and medium-sized enterprises in this case for example, aids may be acceptable at levels 10 percentage points higher than in other cases.

However, an otherwise unacceptable aid package is unlikely to be saved by characterizing it as targeting small and medium-sized firms. In one case involving a proposed program of aid for southern Italy,¹⁰⁶

The Italian authorities argue that the industrial base of the region [between Rome and Naples] consists mainly of small to medium-sized firms in mature industries which are vulnerable to foreign competition, especially from Spain and Portugal. Without such aid for the services sector, the process of replacing obsolete activities and introducing technological innovation and new industry would come to a halt.

The Commission rejected this argument, partly because market forces seemed capable of preserving a place for small and medium-sized firms.¹⁰⁷

...the economy of the Centre-North also has this structure. There, decentralization and a swing away from vertical integration have produced a new pattern of industry based on smaller units.

105. Community framework for state aids for research and development OJ 1986 C 83/2 p. 4.

106. Commission Decision 88/318 of 2 March 1988 on Law No 64 of 1 March 1986 on aid to the Mezzogiorno OJ 1988 L 143/37 at 41.

107. Ibid.

Employment

Programmes of state aid that have the effect of increasing employment will often be found acceptable, particularly if they also involve the promotion of research and development or small and medium-sized firms. Thus in 1986 the Commission approved portions of a Belgian regional aid program.¹⁰⁸

The provisions not contested by the Commission were a partial relief from corporation tax for six years for companies which before 31 December 1987 reduce their weekly working hours by at least 8% and correspondingly increase their workforce, and a partial relief from corporation tax for 10 years for 'innovative' companies employing less than 100 people engaged in the exploitation of new high technologies.

The Commission raised no objection to these parts of the Act, because they were in line with stated Commission policy to encourage employment by reducing working hours and to promote small and medium-sized enterprises, particularly in high-technology sectors.

However, claims are carefully scrutinised. Aid will not be exempted merely because it may indirectly protect employment and the pay levels of employees. In a decision where this issue was raised, the Commission stated¹⁰⁹

The Belgian authorities also pointed out in their comments that the investment would not only maintain the jobs of 336 persons, but would also lead over the next few years to the recruitment of several hundred workers in the district bordering on the Turnhout area, which qualifies for regional assistance and where the rate of unemployment is particularly high. However, this knock-on effect is by no means assured and at this juncture the effect of the aid on the employment situation in the Turnhout area cannot be assessed.

108. E. C. Commission, Sixteenth Report on Competition Policy. Brussels, 1987, p. 138.

109. Commission Decision 81/984 of 23 November 1981 on a Belgian Government proposal to aid certain investments in a refinery at Antwerp OJ 1981 L 361/24 at 25.

VII. Trends in Commission Practice

A. Early Presumption in Favor of the Market Mechanism

Community policy has been to give preference to the unaided market if possible, as a way of organizing trade. For example, in Re aids to the textile industry: Italy v. E. C. Commission Italy attempted to turn the effect of the reduction in social charges on competition into an affirmative defense. Social charges on Italian textile firms, it argued, were higher than those on competitors in other member States. The reduction in social charges simply eliminated this disadvantage and could not, therefore, be considered a distortion of trade. The general issue raised by this argument is the appropriate reference point for deciding whether or not there is a distortion of competition. Here the Court was clear that distortions of competition were to be assessed with reference to the pre-aid situation.¹¹⁰

...in the application of Article 92(1) the point of departure must necessarily be the competitive position existing within the common market before the adoption of the measure in issue.

Similarly, in Firma Steinike und Weinlig v. Bundesamt für Ernährung und Forstwirtschaft¹¹¹ the FRG sought to defend an aid program for German agriculture, food industries, and forestry on the ground that similar programs were carried on in other member States. The

110. Case 173/73 (1974) ECR 709 at 720 (1974) 2 CMLR 593 at 607.

111. Case 78/76 (1977) ECR 595 (1977) 2 CMLR 688.

Court's response was:¹¹²

Any breach by a member-State of an obligation under the Treaty in connection with the prohibition laid down in Article 92 cannot be justified by the fact that other member-States are also failing to fulfill this obligation. The effects of more than one distortion of competition on trade between member-States do not cancel one another out but accumulate and the damaging consequences to the Common Market are increased.

If there is only one distortion to competition, economic theory teaches that removing the distortion will improve welfare. If there is more than one distortion to competition, the theory of the second best teaches that removing only one of them need not improve welfare.¹¹³ The Court in Firma Steinike and Weinlig goes beyond economic theory and affirms a policy reliance in the undistorted competitive process

112. Case 78/76 (1977) ECR 595 at 598 (1977) 2 CMLR 688 at 723. For a similar approach when applying Article 46 of the Treaty to countervailing duties, see Case 337/82 St Nikolaus Brennerer und Likorfabrik v. Hauptzollamt Krefeld (1984) ECR 1051 (1985) 3 CMLR 83.

113. Monopoly reduces welfare because it results in an output restriction and a shift of resources to the production of products that are, from a social point of view, less desirable. If output is restricted in only one market, and the restriction is eliminated, net welfare must rise, because output rises in a market where output is more valuable and falls in a market where output is less valuable, from a social point of view. If there are output restrictions in several markets, however, elimination of output restriction in one market may draw resources from some other market in which output is restricted. It may well be that output in the market from which resources are withdrawn is worth more, from a social point of view, than output in the market in which output restriction is eliminated. In this case, the effect of a partial elimination of output restriction will be to reduce overall welfare. See Lipsey, R. G. and Lancaster, Kelvin "The General Theory of the Second Best," Review of Economic Studies Volume 24, Number 63, October 1956, pp. 11-32.

as a device for obtaining satisfactory performance in the common market.¹¹⁴

Consistent with this precept, when confronted with counterbalancing state aids, the Commission's response has been to try to eliminate all of them.¹¹⁵ Where elimination has not been possible, the Commission has sought to equalize the level of subsidy.¹¹⁶

B. An Emerging Presumption in Favor of Certain Types of Aid?

On the other hand, the so-called "accompanying" or "flanking" policies, including regional policy, environmental policy, social policy, and the promotion of economic and social cohesion, were given a boost by the Single European Act. This boost may be reflected in recent trends in Commission practice.

New horizontal policies, such as environmental policy and the programme for small- and medium-sized enterprises, take as their starting-point the desirability of aid to accomplish certain goals. The presumption implied in the formal structure of Article 92 and

114. This is consistent with an early characterization of the relation between state aid and the formation of the common market:

...there is no real common market in an industry straddling several countries if one of those countries subsidizes its own industry.

(Opinion of Advocate General Lagrange, Case 30/59 De Gezamenlijke Steenkolenmijnen in Limburg v. ECSC High Authority (1961) ECR I at 41.)

115. See Commission Decision 79/496 of 2 May 1979 on the United Kingdom scheme of assistance in the form of interest relief grants in favour of the offshore supplies industry (offshore supplies relief grant, OSIRG) OJ 1979 L 127/50 at 50.

116. Commission Decision 88/437 of 20 January 1988 concerning aids planned by the French Government in favour of a shipbuilding contract for which there is competition between yards in several Member States OJ 1988 L 211/24.

established by past Commission practice may be reversed. Restriction of the grant of aid promoting the aims of horizontal practices may be permissible only where unjustified distortion of competition can be established.

State aid is increasingly seen as a vehicle for making the completion of the internal market politically acceptable.¹¹⁷

The problem also has to be seen in the context of wider policies which 1992 will bring about. The most important of these is that of coherence of the economies of the Member States and particularly the development of the more peripheral and poorer regions of the Community. The Commission has recognized this by bringing into play the derogation of Article 92(3)(a) EEC which allows high levels of State aid to be given in these regions...

There appears to be an increased willingness to use state aid as a device to resolve political problems. Suitably controlled, state aid can bolster political consensus in favor of economic union, by ensuring that the benefits produced by such a union are distributed in a way that is perceived as fair.

VIII. Conclusion

By its implementation of Treaty provisions regarding state aid, the Commission reveals a belief that markets work well in the long run but can benefit from selective prodding in the short- and medium-run. The benefits of economic union are seen as flowing from the unrestricted play of market forces, but the Commission will accept distortions of competition to speed the rate at which markets move toward long-run, competitive, equilibrium.

State aid, even operating aid, may be permitted in severely depressed areas, to promote employment and development. State aid may be permitted to speed the reorganization of industries with structural

117. Ibid.

excess capacity. State aid may be permitted to promote genuinely innovative projects of common interest. However, aid which simply keeps unhealthy concerns alive or postpones their inevitable day of reckoning slows the market adjustment process, and is not permitted.

The Commission also recognizes political imperatives. Hence the Commission is increasingly prepared to accept the grant of aid merely because, for example, it facilitates the raising of environmental standards or encourages small and medium-sized enterprise.

The challenge faced by the Commission, in 1992 and beyond, is to continue to balance the disparate economic and political goals of the Community.



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