

State aid and distortion of competition

Paper for the state aid conference

By John Vickers¹

Chairman, Office of Fair Trading

14 July 2005

Introduction

My first encounter with today's subject was ten or so years ago when I belonged to an academic panel on state aid set up by the European Commission's competition directorate. It was not the happiest experience. The most interesting and important cases were then often outside the remit of the competition directorate. There seemed to be all sorts of potential cases for exception – one day we discussed SMEs in the morning and capital-intensive firms in the afternoon. (I began to feel sorry for moderately large labour-intensive firms.) On another occasion, an official pounced on the idea that more economic openness to the rest of the world would be desirable by asking what we should say if the Japanese then sold more cheap goods into the Community. My suggestion that we say "Thank you" did not prove welcome.

I mention this experience to illustrate how far Community state aid policy has come in recent years. Since the early 1990s the ratio of state aid to GDP has roughly halved. The proportion of aid that is 'horizontal', as distinct from sectoral, has risen steadily. Competition scrutiny of state aid by the Commission has substantially improved. But as the Commission's Action Plan indicates, the effectiveness of policy towards state aid can be sharpened further. Too much attention has sometimes been paid in the past to aid that is unlikely to do harm, while seriously distorting aid can be more effectively deterred and prevented. Greater transparency about state aid – and about the rules and processes that

¹ The views expressed in this paper are personal and not necessarily those of the OFT. I am very grateful to Lindsay Gardiner and the OFT public subsidies team for their help in preparing the paper, and also to John Fingleton, Amelia Fletcher, Daniel Gordon and Paul Seabright for comments and discussions on the topic.

apply to it – is needed. Moreover, the debate on subsidies to firms needs to go beyond the Commission's competition scrutiny of what member states do by way of state aid. More can be done at national level, including by competition authorities. And at Community level there is the most grotesque subsidy scheme of all – the Common Agricultural Policy.

How subsidies can distort competition

The Treaty has as a basic principle that state aid which distorts or threatens to distort competition will be incompatible with the common market.

The principal way in which subsidies can do harm by distorting competition is that if my firm or the goods that I produce get a subsidy and yours do not, then I will retain business, or take business from you, that you would serve more efficiently than me if competition had been undistorted. Inefficient though I may be, you do not get a fair opportunity to enter or grow in the marketplace. My incentives to become more efficient or innovative are dulled in the process, and so too are yours if you do not see a fair opportunity to compete. Inefficiency is perpetuated, dynamism, productivity and competitiveness are lost, the economy is poorer and the public are worse off.

That is not all. When governments are seen to be willing to play the subsidy game, it makes commercial sense for businesses to divert some effort and resources away from competing to deliver what actual people want to buy, towards competing for subsidies from the public administration. This distortion of competitive incentives away from satisfying consumers towards influencing public officials may well be interesting for the relevant bureaucrats, lucrative for the lobbying industry and popularity-inducing for politicians, but for the economy as a whole the subsidy-seeking game is costly without being at all productive. Unfortunately the costs – e.g. lost productivity – are often not visible. Yet it is an inescapable truth that every subsidy entails more tax, or less to spend on say health and education. There is no such thing as a free subsidy.

Indeed the public in the subsidising country may well be harmed – because of the higher taxes or poorer public services that finance the subsidy – though consumers elsewhere may even benefit (from cheaper imports), in the short run, despite the overall loss in productivity. This irony is however not hard to explain in view of the hidden nature of many of the costs of subsidy, and the lobbying strength of some established producer interests relative to the generally atomised consumer/taxpayer interest and to potential new or growing firms and those who would work in them.

From the distortion and weakening of competitive incentives, and encouragement of socially unproductive subsidy-seeking by vested interests, come two rationales for Community policing of state aid by member states. The first is to stop countries tilting the competitive playing field to favour their own producers at the expense of those in other countries and of overall efficiency and productivity – and hence of consumers in aggregate.

The second rationale is that Community policing might help bolster member state resistance to subsidy-seeking vested interests. However, one wonders why home-made resistance cannot be enhanced, and the strength of Commission-derived discipline is not altogether straightforward when one considers that the Commission's remedy against unlawful state aid that has already been paid is that it be refunded to the subsidising member state. Besides the fact that most such refunds go uncollected, this is a rather odd incentive system because distorting competition and getting the money back might be even better for the subsidiser than not being caught. There might be stronger discipline if at least some of the unlawful aid went into the Community purse, as with antitrust fines.

None of the above is to say that all subsidies to firms are bad. There are various circumstances in which unassisted market forces will lead to undersupply of important activities or services, and in some of those circumstances appropriately designed subsidy schemes might well make good sense. Because subsidies can be good, a blanket ban – "*per se*" prohibition in antitrust language – would be wrong. Instead, as elsewhere in competition policy, criteria for intervention against competition-distorting subsidies need to be developed, and on wider policy grounds principles of good subsidy design need to be developed.

Priorities for Commission action against state aid

Two principles to guide where the Commission should (and should not) intervene against state aid flow from the points above. The first is whether the aid is likely to have a significant anti-competitive effect in the market. It is more likely to do so if the aid is in favour of a recipient with a substantial market presence. The second, having regard to the lobbying power of vested interests, is whether the recipient is a long-established incumbent operator.

If such principles had been established in the past, there might have been no need for intervention against the financial arrangements between Ryanair and Charleroi airport. For historical "national champion" reasons, airline and airport markets are often still both characterised by entrenched incumbents with market power and close links to each other and to governments. Low-cost entrants such as Ryanair have brought, and continue to bring, strong pro-competitive challenges into this historically uncompetitive arena, typically bypassing

dominant airports by making deals with airports like Charleroi. Large benefits have resulted for travellers, incumbent airlines have been spurred to make their own offerings more attractive to consumers, and single market goals have been advanced. That the state aid process led to intervention in such a case at least raises questions about policy priorities.

Going forward, it would seem important, as with competition policy more generally, to undertake some basic market analysis when considering the application of the state aid rules. Is the aid significant relative to the market? Does it favour those with market power? Are there few players in the market? Is the aid selective? The more positive the answers to such questions, the more liable to distort competition the aid would seem to be, and the more necessary Commission action against them. We hope that the Commission's Action Plan will develop a robust economic approach along these lines to target its efforts against competition-distorting aid.

Testing and designing subsidies

Defenders of subsidies – whether or not they are competition-distorting – often seek to justify them under the banner of “market failure”. Though well-established, this is an unfortunate phrase. It can easily suggest that where markets have “failed”, non-market solutions are called for. In fact it simply means that market forces alone may not be expected to yield the best outcome. Often the best solution then is not to displace market forces but to work with them. Moreover, the presence of “market failure”, while a necessary condition for public intervention such as subsidy, is very far from being a sufficient condition and hence an adequate justification for it.

Within member states, subsidy schemes should therefore be tested by routinely asking the commonsense question whether they are the best way to promote the public interest goals they are meant to advance. Thus, besides the requirements of EC state aid law, it would seem desirable on policy grounds, at national as well as Community level, to show not only that a subsidy is not competition-distorting, but also that it is indispensable and proportionate to its aims. For example, a subsidy scheme aimed at job-creation would not be good policy if other measures (such as the removal of job-inhibiting regulations) could better achieve the aim, or if the same aim could be achieved at less cost, or more fully for the same cost. (Of course cost should include indirect costs – e.g. from competition-distortion – as well as direct financial cost.)

Tests of indispensability and proportionality are familiar from other parts of EC law. For example, one of the tests in the Article 81(3) prohibition of anti-competitive agreements is that there must be no restrictions on competition that

are not indispensable to the attainment of benefits from the agreement. In other areas of European law, such as free movement for persons and freedom of establishment, the case law indicates that regulatory restrictions must be applied in a non-discriminatory manner; be justified by imperative requirements in the general interest; be suitable for securing the attainment of the objective which they pursue; and not go beyond what is necessary in order to attain it.² The cause of better regulation would be well served if such tests as these became a routine part of the assessment of regulation at national, not just Community, level. The same applies to the appraisal of subsidies.

Where a subsidy is justified, moreover, its efficient design and application will often take advantage of competition rather than distort it. For example, if policy intervention is required to secure delivery of some public good or service that would otherwise go unsupplied or undersupplied, then competitive tendering to secure its supply will often be better than subsidising whoever has supplied it in the past.

National assessment of subsidies

Given the state aid rules in the Treaty, it is natural that debate on subsidies tends to focus on Commission scrutiny of member states' actions. But scrutiny begins at home and the role of finance ministries and other national authorities needs more emphasis. In particular, as with advocacy of pro-competitive deregulation, there is an important role for national competition authorities.

Government interactions with markets – as supplier, regulator, buyer and subsidiser – are a current theme of OFT work. Our work on subsidies is in two phases. First, we commissioned a report on *Public Subsidies*³ that sets out an analytical framework for assessing the competition impact of subsidies. The report goes on to identify ways to improve aspects of the current system of subsidy control, in particular by:

- developing a stronger economic basis for the application of the EC rules (as discussed above)
- supplementing national policy guidance to ensure that competition considerations are incorporated in subsidy design
- better monitoring procedures by subsidy providers to assess competition impacts and to ensure effectiveness and value for money, and
- greater transparency about what subsidies are provided and to whom.

² See the judgment of the ECJ in Case C-55/94, *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995].

³ *Public Subsidies* (paper OFT 750) was published on 24 November 2004 and is available via www.oft.gov.uk/business/markets+studies/subsidies.htm.

The second phase of our work, which is now under way, is examining through case studies how subsidies can distort competition in practice, and is developing more detailed recommendations that are proportionate to the scale of the problem. Though the primary domestic discipline on subsidies must be the finance ministry, our work together with experience elsewhere (notably in Denmark) suggests that national competition authorities have a useful complementary role to play.

We hope that this work will help inform assessment of public subsidies not only in the UK. In the future there may also be a role for national competition authorities in assisting with the application of the EC state aid rules.

The biggest subsidy of all

Of course by far the biggest subsidy scheme of all is operated by the European Union itself. The Common Agricultural Policy absorbs almost half the EU budget and is further bolstered by costly protectionism. It is not hard to see how the CAP, like the Corn Laws in nineteenth century Britain, is an agreeable system for agricultural landowners, especially large ones. But for the European public as consumers and taxpayers, for the budget deficits of EU member states, for the productivity and competitiveness of the European economy, and not least for developing country farmers, the system is grotesque.

The Corn Law tariffs lasted from 1815 to 1846, when, despite the parliamentary power of the landed interest, they were repealed following popular agitation for free trade. The CAP has altered over time, usually in response to wider international pressure, but it has so far resisted radical reform for considerably longer than the entire life of the Corn Laws.

Conclusions

Subsidies cause economic harm when, but not only when, they distort competition. More generally, subsidies can distort incentives and are liable to capture by vested interests. So although subsidies can be an important policy tool, they need tight discipline. One source of discipline comes from the EC rules on state aids, which with a stronger economic basis can be better targeted and made more robust. Better national discipline is needed too. Competition scrutiny of subsidies can be made more systematic. Good subsidy design generally works with competition, not against it. "Market failure" is not a blanket justification for subsidy – tests of indispensability and proportionality should apply. And greater transparency is needed to allow better assessment of how effectively subsidy policies achieve their stated goals, and to help expose who is getting what, how and why.

European Commission competition scrutiny of national subsidies under the state aid rules is of great importance for European competitiveness, and the Commission's plans to enhance the focus, effectiveness and transparency of state aid processes and policy are welcome. But complementary to Commission scrutiny of national subsidies, there can and should be more rigorous scrutiny nationally. As to the biggest subsidy of all, Europe must radically reform itself.