

COLLEGE OF EUROPE  
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THE REFINED ECONOMIC APPROACH  
IN THE STATE AID ACTION PLAN

*The balancing test*

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# AZ ÖSSZETETTEBB GAZDASÁGI SZEMLÉLET ALKALMAZÁSA AZ ÁLLAMI TÁMOGATÁSI AKCIÓTERVBEN – A MÉRLEGELÉSI TESZT

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## *Összefoglaló*

A jelen gazdasági helyzetben az állami támogatások ellenőrzése, mint a gazdasági válság kezelésének egyik eszköze, az érdeklődés középpontjába került. Az állami támogatások európai szintű felügyelete kevésbé ismert, ám mégis szerves része az uniós versenypolitikának; védi a torzításmentes versenyt a közös piacon, és segíti a különböző közös érdeket szolgáló célkitűzések megvalósulását. Az Állami Támogatási Akcióterv (továbbiakban: Akcióterv) keretén belül sor került a versenyjogi szabályozás modernizációjára, azzal a céllal, hogy a szabályok végrehajtásakor egy szigorúbb gazdasági elemzés kerüljön alkalmazásra, valamint a hatékonyság és a jogi kiszámíthatóság javítására törekedve. Ennek fontosságát támasztja alá, hogy Neelie Kroes versenypolitikai biztos mandátumának egyik fő feladata az állami támogatási szabályozás megreformálása volt, ezzel is támogatva a Lisszaboni Stratégia céljainak megvalósulását.

Az állami támogatási szabályok megfelelő és hatékony végrehajtása megköveteli a közgazdasági alapelvek mélyreható ismeretét. Ezzel összhangban a modernizációs folyamat központi elemét képezte egy

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1 Készült az állami támogatás 87. cikk (3) bekezdése szerinti összeegyeztethetőségének vizsgálatára vonatkozó közös elvekről bizottsági munkaanyag tervezetnek megjelenése előtt.

kifinomult közgazdasági szemléletmód bevezetése az Akcióterv keretei között. A reformok a szabályok olyan átformálását irányozták elő, amelyek segítik a „kevesebb és jobban célzott támogatás” célkitűzés megvalósulását, az állami támogatások pozitív és negatív hatásainak mérlegelésére kialakított módszertan alkalmazásával. Ennek a gyakorlati megvalósulása az úgy nevezett mérlegelési teszt, amely a következő kérdéseket tartalmazza:

- 1.) A támogatási intézkedés célja pontosan meghatározott közös érdekű célkitűzés-e?
- 2.) Megfelelő-e a támogatás kialakítása a pontosan meghatározott, közös érdekű cél eléréséhez, azaz a javasolt támogatás piaci hiányosság orvoslását, vagy egyéb célkitűzést szolgál-e?
  - Az adott szakpolitikai célkitűzés megvalósításához megfelelő eszköz-e támogatás?
  - Ösztönző hatású-e, azaz megváltoztatja-e a támogatás kedvezményezettjének magatartását?
  - A kezelni kívánt problémához képest arányos-e a támogatási intézkedés, azaz ugyanaz a magatartásváltozás elérhető-e kevesebb támogatással?
- 3.) Korlátozott-e a verseny torzulása és a kereskedelemre gyakorolt hatás, és így az összehatas pozitív-e?<sup>2</sup>

A jelen tanulmány ezen mérlegelési teszt szerepét elemezi az állami támogatások közösségi szintű ellenőrzésének rendszerében, analitikus áttekintés nyújtva annak alkalmazásáról a Bizottság végrehajtási gyakorlatában.

A tanulmány első része az állami támogatások fogalmkörét járja körül, megvitatva a nemzetek feletti ellenőrzési rendszer létjogosultságát, valamint az EKSZ által nyújtott jogi keretet. Ezen túlmenően bemutatja az állami támogatások indoklását szolgáló hatékonysági, illetve méltányossági célokat alátámasztó elméleteket. Ezt követően az Akcióterv fő elemeit tárgyalja a szerző, középpontba helyezve az összetett közgazdasági elemzést, mint a lisszaboni célok megvalósulásának egyik eszközt. A dolgozat továbbá bemutatja, a kifinomultabb hatás-alapú elemzés alkalmazását az összeegyeztethetőségi vizsgálatban, valamint betekin

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2 Az állami támogatás 87. cikk (3) bekezdése szerinti összeegyeztethetőségének vizsgálatára vonatkozó közös elvek című bizottsági munkaanyag-tervezet: [http://ec.europa.eu/competition/state\\_aid/reform/economic\\_assessment\\_hu.pdf](http://ec.europa.eu/competition/state_aid/reform/economic_assessment_hu.pdf)

tést nyújt ennek esetleges, EKSZ 87. cikkének (1) bekezdése alapján történő elemzésbe integrálásával kapcsolatos vitába.

A dolgozat magját a mérlegelési teszt elméleti és gyakorlati elemzése adja. Az általános bemutatás után a teszt egyes lépései kerülnek értékelésre a bizottsági gyakorlat alapján, olyan döntések elemzésén keresztül, amelyek elbírálása során a részletes vizsgálatot alkalmazták. Az esetek értékelésének célja a Bizottság döntő megállapításainak feltárása. Ezt a célt követve az elemzés alapját szolgáló bizottsági döntések különböző területekről kerültek kiválogatásra, úgymint a kutatásfejlesztés és innováció; a szélessávú internet fejlesztése és a szakképzés.

A mérlegelési teszttel mélyebben foglalkozó fejezet utolsó része bemutatja az akkor még tervezet formájában létező, a nagyberuházási projektekhez nyújtott regionális támogatások részletes vizsgálatáról szóló bizottsági útmutatást, amely magában foglalja a teljes mérlegelési tesztet, mint a legbonyolultabb ügyekben alkalmazandó módszert.

Az elemzés feltárja, hogy egy kifinomultabb gazdasági szemlélet bevezetése valóban rugalmasságot és hatékonyságot visz az állami támogatási szabályok végrehajtásába. Mindezek ellenére a hatásalapú szemléletmód teljes értékű alkalmazása az esetek többségben még mindig olyan akadályokba ütközik, mint a erőforráshiány vagy az információ korlátozott rendelkezésre állása. Ezen a helyzeten javíthatna, ha a bizottsági vizsgálat fókuszában a magas kockázatú versenytorzító hatással bíró esetek állnának. Ez a gondolatmenet számos kérdést vet fel. Kérdéseket, amelyek a közös piacon megjelenő versenytorzító hatás elemzéséből fakadnak, mivel ez az Unió szintű állami támogatási politika egyik fő pillére.

Ezzel kapcsolatban széles körű vita tárgya az összetettebb közgazdasági elemzés esetleges alkalmazása az állami támogatást meghatározó kritériumok vizsgálatakor, nevezetesen az utolsó két feltétellel összefüggésben, azaz a kereskedelemre gyakorolt hatás, illetve a versenytorzítás megállapításakor. A fent említett két feltétel tágra értelmezett a jelenlegi bizottsági gyakorlatban. A Bizottság különbséget tesz a két feltétel EKSZ 87. cikk (1) bekezdése szerinti jelentése, valamint azok összeegyeztethetőségi vizsgálat szerinti értelmezése között. A 87. cikk (1) bekezdése a versenytorzító hatás esetleges kockázatainak feltárására koncentrálna, mialatt a 87. cikk (3) bekezdése szerinti elemzés középpontjában a feltárt kockázat elemeinek meghatározása áll, illetve, ezen kockázati elemek mérlegelése a támogatás pozitív hatásaival szemben.

Egy következő, szorosan ide tartozó problémakör a mérlegelési teszt elemeinek sorrendje. Elviekben, ahogy az a különböző iránymutatásokban szerepel, illetve, ahogy a jelen esettanulmány is mutatja, a mérlegelési teszt egy teljes, három lépcsős értékelést tartalmaz a végső következtetés levonása érdekében. Az elemzett szabályok, gyakorlat és érvek alapján két kritikus pont látszik. Először is, a tesztet el lehet végezni szekvenciális módon: azoknál az állami támogatásoknál, amelyeknél nem igazolható, hogy a támogatás szükséges és megfelelő eszköz egy közös érdekű cél megvalósításához, nem kellene az intézkedés kereskedelemre és versenyre gyakorolt, negatív hatásait megvizsgálni. Ezzel egyrészt erőforrásokat lehetne megtakarítani mind a Bizottság, mind a tagállamok részéről, másfelől viszont ez a gyakorlat ellentétes lehet az állami támogatások nemzetek feletti ellenőrzésének fő indoklásával, mivel a versenyt, illetve a kereskedelmet torzító hatásokat nem vizsgálják. Egy esetleges orvoslát ezekre a nyitott kérdésekre az lehetne, hogy a mérlegelési teszt harmadik lépése, azaz a kereskedelemre, illetve a versenyre gyakorolt hatás vizsgálatára, a teszt legeslegelején kerülne sor, abból a célból, hogy már a mérlegelés elején ki lehessen szűrni azokat a támogatásokat, amelyeknek kereskedelemre gyakorolt hatása elhanyagolható, vagy amelynek kedvezményezettjei kis piaci részesedéssel rendelkező társaságok. Tulajdonképpen ezen az érvelésen alapul a csoportmentességi rendelet is, amelynek célja az alacsony összegű illetve intenzitású állami támogatások kiszűrése, azon a feltételezésen alapulva, hogy az ilyen támogatási intézkedéseknek nincs jelentős, versenyre gyakorolt hatása.

Végeredményben megállapítható, hogy az Állami Támogatási Akcióterv célkitűzései megvalósultak. A 2008-ban megjelent a tagállamok által nyújtott állami támogatásokról szóló éves jelentés (Scoreboard) szerint az állami támogatások szintje csökkent, és a tagállamok egyre inkább törekednek a támogatási intézkedések megfelelő tervezésére, ennek során pedig, a horizontális célokra összpontosítanak.

Az akcióterv céljainak megvalósulása elmozdulást jelent az állami támogatások európai szintű ellenőrzésének formai-alapú szemléletmódjától egy hatás-alapú elemzés felé, ahogy ez a jelen tanulmányban bemutatott bizottsági döntésekből is kitűnik. Azonban az alkalmazott közgazdasági elemzés még mindig finomításra szorul azzal a bizottsági

célkitűzéssel összhangban, amely a versenypolitika végrehajtása során mélyebb közgazdasági elemzés alkalmazására törekszik.

Valószínűleg még túl korai a reformprogram konkrét eredményeiről beszélni, különösképpen a jelenlegi helyzetben, amikor a figyelem, illetve az erőforrások középpontjában a gazdasági válság hatásaival való küzdelem áll. Az új összetételű Bizottság, új biztossal a versenypolitikai tárca élén, jelentős hatással lehet az európai versenypolitika, és így az állami támogatási rendszer prioritásaira is.



## STATUTORY DECLARATION

I hereby declare that this thesis has been written by myself without any external unauthorised help, that it has been neither presented to any institution for evaluation nor previously published in its entirety or in parts. Any parts, words or ideas, of the thesis, however limited, and including tables, graphs, maps etc., which are quoted from or based on other sources, have been acknowledged as such without exception.

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## ABSTRACT

State aid policy is one of the three main pillars of European competition policy. In line with the European Commission's "more economic approach", the rules have been modernized in order to achieve "less and better targeted aid" by an improved methodology of balancing positive and negative effects of state aids. Indeed, the central element of the reform program set by the State Aid Action Plan is to introduce a refined economic analysis, which was formulated in the so-called balancing test. This master thesis seeks to analyse the role of this test in the European state aid control giving an analytical overview on its implementation in the Commission's enforcement practise.

To this end, the first part presents the underlying legal and economic principles of state aid, and provides an overview on key elements the State Aid Action Plan brought about in line with the objectives of the reforms. On the basis of these principles, the second part conducts a case assessment evaluating the Commission's practice in the light of the more effects-based approach embodied in the application of the balancing test. The analysis reveals that indeed, the achievements of the modernization and the introduction of a refined economic analysis to state aid control represent a shift from the formalistic approach to a more effects-based assessment, which brings more flexibility and effectiveness into the enforcement of state aid rules. Nevertheless, the applied economic analysis needs to be "fine-tuned", especially with respect to the evaluation of effects on competition and trade between the Member States, which leaves some questions open.



# 1.

## INTRODUCTION

In the present economic situation, state aid policy became “hot topic” providing an instrument to tackle the global economic crisis. State aid control constitutes an important, maybe less known, part of the European competition policy; it protects competition in the common market and supports various objectives of common interest. Competition rules have been modernized to improve efficiency and legal predictability, and in order to apply more rigorous economic analysis in enforcing the rules. Further to this approach, the reform of state aid control has been one of the main priorities under the mandate of Commissioner Kroes in order to support the objectives of the Lisbon Strategy.

Appropriate and efficient enforcement of state aid rules requires a thorough understanding of the underlying economic principles. In line with this argument, the introduction of a “refined economic approach”, embedded in the State Aid Action Plan represents a central element of the modernisation process. The reforms aim at streamlining the rules in order to achieve “less and better targeted aid” by an improved methodology of balancing positive and negative effects of state aids. This master thesis seeks to analyse the role of this balancing test in the European state aid control giving an analytical overview on its implementation in the Commission’s enforcement practise.

To begin with, the first section of the thesis introduces the concept of state aid by discussing the main justifications behind a supranational state aid control, and by presenting the legal framework provided under the EC Treaty. The final part of this section covers the underlying theory regarding the two key rationales of state aid; efficiency and equity.

The second part elaborates on the main elements of the State Aid Action Plan focusing on the refined economic analysis, which represents an instrument to better focus and target state aid towards the Lisbon objectives. Furthermore, this section provides an overview on the application of a more effects-based approach in the compatibility

assessment and on its widely-debated potential introduction under Article 87(1).

The third section presents first the balancing test as the key instrument of assessing the compatibility of aid measures, and its integration into secondary legislation of state aid control. After a general introduction, the section evaluates the steps of the balancing test following the Commission's practice by examining various decisions in which in-depth assessment have been conducted. The analysis aims at revealing the decisive elements of the Commission findings. For this purpose, a number of the decisions have been selected from the following areas: R&D&I, risk capital, broadband development and training. The final part of this section presents the draft Guidance document on aid to large investment projects, which embodies the full balancing test as the method of assessment applied to the most problematic cases. In this context, the analysis seeks, through a few recent decisions, to detect the elements of the test in the current assessment practice, compared with the full balancing test.

Finally, on the basis of the conducted analysis the master thesis presents some concluding thoughts regarding the application of the balancing test in the light of the "more effects-based approach" of the reforms. Further, it discusses to what extent the objectives of the State Aid Action Plan have been achieved in respect of the introduction of a more rigorous economic analysis in the assessment methodology, and raises some open questions.

## 2.

### THE EUROPEAN STATE AID CONTROL

“State aid policy is one of the three main pillars of EU competition policy. State aid control stems from the need to maintain a level playing field for all companies active in the Single Market, irrespective of the Member State in which they are established. State aid control also contributes to avoiding contests between Member States where they try to outbid each other to attract investment. Preserving competitive markets is the best way for European citizens to get the products they want at competitive prices, and to foster innovation and growth.” (European Commission, 7 July 2008)<sup>1</sup>

#### **2.1 Rational for European state aid control**

The underlying principle behind the European state aid control is to ensure that competition between firms and trade between Member States is not distorted by the intervention of national governments. Hence, the focus of state aid control lies on the behaviour of Member States, which makes it different from the other fields of competition policy dealing with firms. The necessity of a supranational state aid control can be justified on the grounds that it safeguards the implementation of the internal market, and ensures the level playing field between undertakings. (Friederiszick, Röller, Verouden, 2006)

The strongest justification for a European state aid control is the potential existence of negative spillover effects of state aid on other Member States. Cross-border externalities occur when a country's behaviour affects other countries without compensation being paid or received. The focus of state aid control lies on negative cross-

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<sup>1</sup> MEMO/08/482, State aid: Commission adopts Regulation automatically approving aid for jobs and growth - Frequently Asked Questions, 7 July 2008

country externalities, i.e. negative effects on other European countries attributable to aid measures. The major problem arising here concerns the competition between national governments to attract investments in order to foster their own economic development. Firms' decisions to set up a new plant or expand the existing production facilities in a country often depend on the aid amount the national government is willing to grant, which may lead to race to the bottom, in which governments compete for investments resulting in large amount of aid and relocation of activities instead of creating new ones. (Spector, 2006)

The creation of the internal market is the core of the European Integration. The underlying principle behind the integration advocates for a more integrated market which promotes economic growth and competitiveness. Increasing competition is necessary for the well-functioning of the internal market. State aid can be detrimental to this process in number of ways such as protecting national incumbents and inefficient industries or supporting the presence of domestic firms in international markets. State aid control can solve this issue and stimulate competition as well as facilitate the implementation of a well-functioning internal market. Moreover, a supranational body may be better placed in order to prevent wasteful spending of national governments and it may be less affected by regulatory capture. (Friederiszick, Rölller, Verouden, 2006, p. 641)

In order to prevent the distortion of competition caused by the intervention of national governments and the negative effects of state subsidies on the internal market the EC Treaty provides a framework for an European state aid policy and empowers the Commission to enforce the established rules and to adopt secondary legislation to support the objectives laid down in the Treaty.

## **2.2 Legal framework of European state aid control**

In order to achieve the objectives of state aid control the EC Treaty provides a legal framework under the provision of Article 87. Paragraph 1 contains the definition of state aid establishing a general prohibition:

“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, insofar as it affects trade between Member States, be incompatible with the common market.”

Only state measures satisfying all the 5 cumulative criteria set by Article 87(1) constitute state aid and are subject to supranational state aid control. These criteria are as follows:

- the aid must be granted by the state or through State resources
- the aid must confer an advantage to the beneficiary
- favour certain undertakings, i.e. it is selective
- the aid must have an effect on trade between Member States
- and it must distort or threaten to distort competition<sup>2</sup>

Although state aid is in principle prohibited under Article 87(1), the Treaty provides certain exemptions, under which aid can be deemed compatible with the common market.

Measures falling under Article 87(2) are exempted automatically.

“The following shall be compatible with the common market:

- (a) aid having a social character, granted to individual consumers, provided that such aid 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 affected by the division of Germany, insofar as such aid is required in order to compensate for the economic disadvantages caused by that division.”

As regards measures falling under 87(3), in principle an *ex ante* notification is necessary. The Commission may authorise the measure after having assessed its compatibility with the common market.

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

- (a) aid to promote the economic development of areas where the

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2 If a measure is selective the last two criteria such as the effect on trade between Member State and the distortion of competition are assumed to be fulfilled in the Commission’s practice. This practice is arguable, but the economic assessment is rather limited in this respect. (Friederiszick, Röller, Verouden, 2006, p. 629)

standard of living is abnormally low or where there is serious underemployment;

(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) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;

(e) 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.”

Article 87(3) provides the Commission with certain discretion to assess and authorise state aids, which are compatible with the common market. Furthermore, this article is the legal basis of number of soft-law provisions such as frameworks, guidelines and also of the block exemption regulation. To mention some without completeness: regional guidelines, R&D&I framework, guidelines for rescue and restructuring aid and the new General Block Exemption Regulation. (Friederiszick, Röller, Verouden, 2006)

## **2.3 Efficiency and equity rationales for state aid**

State aid may be under some circumstances necessary for a well-functioning internal market. There are two main justifications for state aid in this respect: efficiency and equity.

### *2.3.1 Efficiency rationales*

The efficiency argument claims that state aid can be used as a remedy for market failures, which represents the economic rationale behind the provision of state aid.

In the model of perfect competition markets produce the Pareto-optimal output without any public intervention. However, markets often

fail to function properly in the reality and market processes do not lead to an economically efficient outcome. Therefore, in order to achieve the socially optimal allocation, public intervention is desirable to influence market forces. Certain types of market imperfections may be better solved by regulation; nevertheless the existence of market failure provides the fundamental justification for state aid as well.

The main market failures in the area of state aid are as follows<sup>3</sup>:

### *Externalities*

Externalities occur when the behaviour or activity of an undertaking affects other companies' activities and this spillover is not reflected in the market price. Externalities can be either positive or negative. The area of research and development is a good example to illustrate positive externalities. Research not leading directly to a new product or process cannot be protected by patents, moreover it is rather unavoidable that the acquired information diffuses during the research activity. These positive knowledge spillover effects benefit other companies who do not pay for it, thus the social returns arising from investing in more research exceed the private returns of the companies undertaking the R&D activity. At the same time firms do not take social returns into account; they consider only the profit they can make. As a result the market fails to produce the social optimum and private companies engage in too little research which entails that public intervention is beneficial to correct the market failure. (Neven, Verouden, 2008, p.106)

The same reasoning can be applied to aid granted to support training. In general, it is not profitable for a firm to provide general training to workers since they can leave the company and use their improved skills at another employer while the cost of the training is borne by the former company. Due to this free rider effect the companies will reduce their training budget, thus public support is desirable to provide the same level of training, which plays a key role in competitiveness. The classical example for negative externalities is pollution. In the case of pollution, the external costs of production are not borne by the firms; these costs are passed on to the society. There are different ways to handle this problem such as taxation, regulation and tradable emission permits. State

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3 The present subchapter focuses on certain types of market failures highlighted in the State Aid Action Plan.

intervention can change the incentives of market players and make them consider the cost of pollution as a side effect of their activity.

Public goods represent a special case of externalities, they are characterized by non-excludability and non-rivalry in consumption: nobody can be excluded from the consumption of such goods, and the consumption of a public good does not reduce its availability to others. Since nobody can be excluded from using the goods, consumers can take advantage of public goods without paying for them. Consequently, private production is unprofitable, and there is no incentive for the firms to provide public goods. Good examples for public goods are national defence, fireworks, lighthouses, public broadcasting and service of general economic interest. Given that the market does not exist in the provision of public goods, state aid may remedy this market imperfection without the risk of distortion of competition.<sup>4</sup>

### *Information asymmetries*

Information asymmetries occur when one party in a transaction has more or better information than the other party. Adverse selection is a good example to understand this particular market failure: if the buyers of a product have less information as the suppliers about a certain product, the supplier may reduce the quality of product, thus lower the costs, but sell it for the same price. As a result high quality products will be displaced by lower quality products. (Hildebrand, Schweinsberg, 2007, p.454).

Information asymmetries arising on financial markets may justify public intervention. Financial markets are often reluctant to invest in new activities and in activities with long pay-back periods. In this case the state may intervene by providing financial means to high risk investments or to projects with high sunk costs. Small and medium-sized enterprises are the worst affected by the problem of information asymmetries. Access to capital is more difficult to SME's than to large companies due to the smaller guarantee they are able to provide and to the restricted information available about their long term prospects. Therefore the state shall use different instruments to offer incentives to

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4 However, discrimination by the authorities in the course of contracting the providers of public goods may raise competition concerns on the market of inputs. (Meiklejohn, 1999)

the financial sector in order to increase funding to small and medium sized companies. (Neven, Verouden, 2008, p.109)

### *Coordination Problems*

Coordination problem between different actors may impede efficient market functioning. Lack of information on future events and outcomes leads to incomplete contracts between parties and inefficient levels of investment. Moreover, designing and enforcing the contracts is also costly and expenses increase by the number of contractual parties. Standard-setting represents a good example in this context. (Neven, Verouden, 2008, p. 110)

### *Market power*

Market power leads to higher prices, thus public intervention to reduce market power can be considered an appropriate tool to increase economic efficiency and foster competition. State aid may facilitate new entry into the market and thereby may stimulate competition, which increases also the benefits of consumers resulting from lower prices. However, state aid may lead to increased market power when companies, who are not recipients of the measure, have to leave the market or where state aid is used to set up entry barriers. (Friederiszick, Röller, Verouden, 2006)

Beside the above mentioned market failures Meiklejohn (1999, p.30-31) lists a number of other market imperfection which may justify state aid. These are institutional rigidity; imperfect factor mobility which is closely related to the problem of externalities of agglomeration; frictional problems related to sectors or firms in need of restructuring and effects of subsidies granted by other countries. However, one may argue that these imperfections are borderline cases, and they rather belong to the equity rationale of granting state support.<sup>5</sup>

### *2.3.2 Equity rationales*

Economic theory of market failure is concerned with efficiency and does not include other Community objectives like redistribution or equity arguments. However, in the field of state aid one cannot leave out equity

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<sup>5</sup> See „The economics of State aid” by R. Meiklejohn, *European Economy*, 1999. for more details.

objectives such as redistribution, regional cohesion, or employment and industrial policy aspects. Indeed, for instance redistribution is one of the most important purposes of granting subsidies in order to establish a socially acceptable outcome of market process. The Treaty itself provides ground for authorisation of state aid on the basis of social and regional policy.<sup>6</sup> (Friederiszick, Röller, Verouden, 2006, p. 634).

Regional policy represents an important common objective aiming at reducing regional disparities, and promoting regional, economic and social cohesion. Regional aid can be a justified instrument to achieve these policy objectives by supporting investments and economic activities, as well as job creation in disadvantaged regions.<sup>7</sup> Aid may pursue social cohesion objectives by promoting employment of disadvantaged and disabled workers. Equity objectives can provide grounds also for state aid as a tool of structural policy. Rescue and restructuring aid aims at avoiding excessive unemployment, and thereby maintaining social cohesion. In addition, it may facilitate the transition to better functioning markets by alleviating adjustment problems caused by structural changes.

However, state aid is not always the best instrument to tackle redistribution or other non-economic issues due to its side effects on efficiency which may lead to a trade-off between efficiency and equity objectives. For instance in the field of R&D, granting aid to large scale research project with the aim of correcting market failures may lead to supporting already well-developed research centres in advanced regions instead of regions in need of assistance. Regional aid may involve inefficiencies, since the shift of investment from one region to another one creates positive effects in the aided region but it decreases development in the other region. In the case of structural policy, state aid may hinder the necessary adjustment process, which results in efficiency losses.

Economic analysis can help in identifying the potential trade-offs and to assess whether State aid is the most appropriate instrument to meet public policy goals, for instance to reduce regional disparities. (Friederiszick, Röller, Verouden, 2006, p. 635)

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6 Article 87(2) and 87(3)(a) and (c).

7 Commission Guidelines on national regional aid for 2007-2013, OJ C 54, 04/03/2006.

### 3.

## ROADMAP FOR STATE AID REFORMS: THE MAIN ASPECTS OF THE STATE AID ACTION PLAN

### 3.1 The State Aid Action Plan

The European Commission launched its State Aid Action Plan in June 2005.<sup>8</sup> The Action Plan contains a reform programme of the European state aid control during the period of 2005-2009. This subchapter will examine the Consultation Document highlighting the most important elements of the process.

The reform plans aim at streamlining the secondary state aid rules in line with the objectives laid down in the Lisbon Strategy<sup>9</sup>. Prior to the Commission's announcement the European Council urged the Member States to reduce the amount of state aid and to ensure that the granted subsidies target the correction of market failures focusing on social and economic cohesion, and sustainable development in line with priorities of the New Lisbon Strategy.<sup>10</sup> (Merola et al., 2006, p.43)

The first part of the document explains the rationale for state aid policy and presents the new challenges triggering an action plan of modernization: state aid plays an important role in the new Lisbon Action Programme; state aid policy facilitates the functioning of the internal market by protecting competition and it is closely related to the most important objectives of common policies (regional and social

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8 State aid action plan - Less and better targeted state aid : a roadmap for state aid reform 2005-2009 (Consultation document), COM(2005) 107, 7 June 2005 ("SAAP" hereafter).

9 The Lisbon Strategy is an action plan launched on March 2000 with the aim of making the European Union „the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010”, available at [http://ec.europa.eu/growthandjobs/index\\_en.htm](http://ec.europa.eu/growthandjobs/index_en.htm)

10 Communication to the European Spring Council, „Working together for growth and jobs – A new restart for the Lisbon Strategy”, COM (2005)24, Brussels 2 February 2005.

cohesion, employment, research and development, environmental protection, etc.). These elements together with the enlargement in 2004 required the adaptation of state aid policy as well. Furthermore, the Commission wishes to reduce the administrative burden on Member States, to improve legal certainty and transparency, as well as to focus on the most distortive cases.

The fundamental objective of the SAAP is to face these new challenges by implementing a reform agenda which is based on the following key components:<sup>11</sup>

- less and better targeted aid granted by the individual states
- application of a more refined economic approach as a tool to achieve the objective of less and better targeted aid. To this end the Commission reinforces the application of the balancing test as the way of compatibility assessment under Article 87(3)<sup>12</sup>
- introduction of more effective procedures, better enforcement, higher predictability and enhanced transparency
- encouraging a shared responsibility and cooperation between the Commission and Member States.

The Consultation document provides for recommendations and modifications concerning key policies such as research and development, improvement of business climate, human capital, services of general economic interest, regional policy, transport, energy and information technology. Whereas the last part deals with the modernisation of practices and procedures of state aid and sets up an agenda reviewing the existing Commission documents.

### **3.2 Refined economic approach**

One of the most important objectives of the state aid reform is the application of a more refined economic approach to the Community's state aid rules. The idea originates from the modernization of the antitrust rules, where the effects-based analysis has been already implemented<sup>13</sup>.

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11 SAAP, *supra* note 8, point 18.

12 See Chapter 4 of this paper (p. 16) for more details on the application of the balancing test.

13 Mainly in Article 81 and in the Merger Regulation, furthermore recently also in

According to the Commission introducing more economic analysis helps to find the right balance between the benefits and costs of state aid and thereby guides the Member State in designing less and better target aid.

This chapter presents the main arguments related to the introduction of more economic analysis in the European state aid policy, more specifically its possible application to Article 87(1) and its current role in the compatibility assessment under Article 87(3).

The wording of the Treaty together with the Commission's practice indicates that the place of the economic analysis is the compatibility assessment under Article 87(3), whereas the application of Article 87(1) remains more form-based. Even the State Aid Action Plan does not give any view on a potential role of economic analysis regarding the definition of state aid. Nevertheless, one can argue that an effects-based approach could play a role in assessing the criteria set by Article 87(1).

Further to this argument Article 87(1) may imply three areas where economics could contribute to the assessment. First, in evaluating whether and to what extent the aid confers an advantage to the recipient. In this context the Commission has been already applying the Market Economy Investor Principle as a method of assessment<sup>14</sup>. The MEIP test is used mainly in cases where the state invests in firms or provides loans or guarantees. The support granted by the government constitutes state aid only if the rate of return received by the state is lower than what a private investor would have been accepted under the same circumstances. This is the only field of assessment under Article 87(1) where economic analysis has a significant role in the current practice. The second area where economic analysis would have a great importance is the criterion of selectivity. The notion of "favouring certain undertakings" renders state aid different from the so-called general measures, which apply without distinction to all firms in all economic sectors across the board.<sup>15</sup>

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Article 82 by the adoption of the new Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings.

14 It is essentially a hypothetical test asking the question whether a private investor would have provided such a fund or support to the beneficiary under normal market conditions.

15 *Vademecum Community law on State aid*, European Commission, Directorate General for Competition, 30 September 2008, p. 6.

However, seemingly not selective measures may have diverse economic effect on regions, sectors and companies. Economic analysis could play a role in this context to identify the consequences and a real impact of aid on the market. (Friederiszick, Röller, Verouden, 2006, p. 628)

The most significant field to which a more refined economic approach could be applicable is the evaluation of the effects of state aid on trade and competition. In practice, as outlined earlier, both criteria are assumed to be fulfilled when the measure is selective. Consequently there is a rather limited room for economic analysis in this respect. This practice was confirmed by the Commission in its *Vademecum on Community rules on State Aid* stating that “It is sufficient if it can be shown that the beneficiary is involved in an economic activity and that it operates in a market in which there is trade between Member States”.<sup>16</sup> (Hildebrand, Schweinberg, 2007) A more detailed analysis of the effects of state aid on competition is carried out in the course of the compatibility assessment under Article 87(3) as the third phase of the balancing test. However, in numerous cases the Commission will not arrive to the examination of the negative effects of aid on competition because the proposed measure does not pass the first two steps of the test. This raises legal concerns, given that the Commission has the right to forbid aid measure only if competition is distorted on the internal market. (Monopolies Commission, 2008, p. 65)

As underlined earlier, the key role of economic analysis is set under Article 87(3) by the Treaty and the Commission’s practice. Under this provision state aid can be deemed compatible with the common market after the compatibility assessment undertaken by the Commission. The SAAP on the basis of previous experience formulated the existing compatibility assessment into the so-called balancing test reinforcing the application of economic analysis in the Commission’s practice.

An open debate revolves about the definition of the desirable welfare standard in the compatibility assessment. As discussed, state aid can be authorised if it fulfils one of the conditions laid down in Article 87 corresponding to the common interests. The question and the debate concern the relevant measure for assessing whether aid is in line with the common interest. In other fields of competition policy the Commission’s assessment is focused on consumer welfare. Hence, one could ask the

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16 *Ibid.*, p. 7.

question whether the same approach should be followed also in state aid control. Friederiszick, Röller, Verouden (2006, p. 647) argue for an approach in which the focus lies on the surplus of consumers and taxpayers being less powerful agents than firms. According to their view considering the interest of consumers and taxpayers and leaving out firms from the welfare criterion compensates the inequality. Heidhues and Nitsche (2006, p. 26) advocate for a total welfare approach which measures the sum of producer and consumer surplus, as well as all general costs of granting state aid such as taxation, costs owing to political failure and administering the aid, as well as the reduction of competitors' profit.

The SAAP does not reveal any concrete guidance concerning the type of benchmark model to be used in the assessment. However, in the R&D&I Framework the Commission briefly refers to this issue stating that in the European state aid policy the total welfare model should be applied as opposed to the antitrust rules in which consumer welfare is decisive factor.<sup>17</sup> (Monopolies Commission Germany, 2008)

### **3.3 The implementation of the SAAP**

The timeline set for the implementation of the SAAP has come to an end. Significant number of the objectives and plans have been implemented since the start of the reform process and numerous steps have been taken to improve the role of economic analysis in state aid policy in order to help the Commission and the Member States to better balance the positive and negative effects of aid in line with the “less, and better targeted aid” objective. To mention the most important achievements: the upper limit of de-minimis aid was raised to EUR 200.000, numerous guidelines have been adopted in relation to service of general economic interest, regional aid, environmental protection, risk capital and framework on research, development and innovation integrating the principles of the action plan. Corresponding to the objectives of the reforms, the General

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17 “In economics, the term “efficiency” (or economic efficiency) refers to the extent to which total welfare is optimised in a particular market or in the economy at large.” Community Framework for State aid for Research and Development and Innovation, OJ 2006 C323/1, footnote 3.

Block Exemption<sup>18</sup> was introduced in 2008 to reduce the number of aids subject to ex ante notification and to give guidance to the Member State how the right type of aid is designed. The GBER allows for automatic approval of 26 categories of aid measures extending the scope of block exemptions for environmental protection, risk capital, and research and development aid for large companies.<sup>19</sup>(Kroes, 2008)

As pointed out above, aid measures exceeding the threshold set by the block exemption regulation have to be notified to the Commission who will in principle use the balancing test to check the compatibility of the aid. The Commission recently prepared Guidance papers on the criteria that will be applied in the course of the in-depth assessments with regard to training aid, aid to disadvantaged and disabled workers and regional aid to large investment projects. These Consultation documents are still under discussion. Last, but not least one of the main objectives of the SAAP is to improve and to simplify procedures. To that end the Commission is working on a so called Simplification package, which contains three major elements (Kroes, 2008):

Best Practices Code, which aims at the modernisation of procedures and implies commitment from both the Commission and the Member States.

Simplified procedure, adopted on 29 April 2009, to accelerate the time line approval of cases where the notification is complete or where precedents exist.

Enforcement Notice<sup>20</sup> adopted in February 2009 with the purpose of reinforcing the cooperation between national courts and the Commission. In the notice the Commission stresses the important role of national courts in the enforcement of state aid rules and provides them with practical and user-friendly support in individual cases.

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18 Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General block exemption Regulation), OJ L214, (“GBER” hereafter).

19 Before the adoption of GBER the following categories fell under block exemption: aid for SME’s, aid for research and development by SME’s, employment, training and regional development.

20 Commission notice on the enforcement of State aid law by national courts, Official Journal C085, 09/04/2009.

## 4. BALANCING TEST: AN OVERVIEW AND CASE ANALYSIS

### 4.1 The balancing test

As discussed earlier, Article 87(3) provides for certain conditions for exemption of state aid from the general prohibition on the grounds of common interests which may involve both efficiency and equity aspects. The Commission introduced the balancing test as a tool of assessment involving more refined economic analysis. Before going through the three steps of the test in more detail it should be noted that the balancing test is integrated into the rules as well, thus the different guidelines have a similar structure. The aim of these guidelines is to help Member States in designing aid measures in line with the relevant state aid rules. The test has been integrated in the R&D&I Framework, in the Guidelines on risk capital for SME's<sup>21</sup> and in the Guidelines on environmental aid<sup>22</sup>. Currently, a number of other guidance documents are under public consultation in which the Commission has elaborated the balancing test and the criteria applied in the course of the compatibility assessment with regard to state aid measures subject to notification.

The balancing test measures the positive and the negative effects of state aid. If the positive effects outweigh the negative impact of a measure, aid can be authorised by the Commission on the grounds that it is compatible with the internal market. The different steps of the test are as follows:

Stage 1: Is the aid measure aimed at a well-defined objective of common interest (e.g. growth, employment, cohesion, environment)?

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21 Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises, OJ C 194, 18/08/2006. (Risk Capital Guidelines hereafter).

22 Community Guidelines on State aid for environmental protection, OJ C82, 1/4/2008.

Stage 2: Is the aid well designed to deliver the objective of common interest; i.e. does the proposed aid address the market failure or other objective?

- (i) Is state aid an appropriate policy instrument?
- (ii) Is there an incentive effect; i.e. does the aid change the behaviour of firms?
- (iii) Is the aid measure proportional; i.e. could the same change in behaviour be obtained with less aid?

Stage 3: Are the distortions of competition and effect on trade limited, so that the overall balance is positive?<sup>23</sup>

This part of the paper aims at introducing briefly the different stages of the test before proceeding to the analysis of individual cases in which the Commission has applied the balancing test to examine the compatibility of the measure. The test can be regarded as a sort of cost-benefit analysis: The first two stages deal with the benefits of the aid measure, whereas the costs are assessed under the third stage including the balancing of the positive and negative effects.

*Stage 1: Is the aid measure aimed at a well-defined objective of common interest (e.g. growth, employment, cohesion, environment)?*

In order for the aid to be authorised it has to target common objectives. These objectives are laid down in Article 87(2) and 87(3) focusing on efficiency and equity. The analysis at this stage concerns the question whether the aid contributes to a greater wealth of the economy or to a better redistribution of wealth. Efficiency can be demonstrated by correcting market failures, whereas equity justification is found to be verified if the aid aims at social or regional cohesion. Furthermore, the potential trade-offs between efficiency and equity objectives have to be taken into account. (Hildebrand, Schweinberg, 2007).

Proving that aid acts as a remedy for market failures or targets equity objective is an essential condition, but not sufficient for an aid measure to be authorised. As underlined in the SAAP “State aid should be the appropriate policy instrument and should be designed so that it effectively solves the market failure by creating an incentive effect and

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23 Community Framework on Research and Development and Innovation, OJ C 323, 30/12/2006 (R&D&I Framework hereafter).

being proportionate.”<sup>24</sup> This leads us to the second step of the test which can be divided into three key issues as follows.

*Stage 2: Is the aid well designed to deliver the objective of common interest; i.e. does the proposed aid address the market failure or other objective?*

*Is state aid an appropriate policy instrument?*

In most cases state aid is the “second best” option to achieve efficiency, therefore it has to be verified whether other less-distortive policy instruments, for instance regulation, are not available to attain the same policy objective.

*Is there an incentive effect; i.e. does the aid change the behaviour of firms?*

Another indispensable condition for aid to be approved is to verify the incentive effect of the aid. In other words, the aid measure should induce a change in the behaviour of the recipient. The analysis of the incentive effect is regarded as one of the key areas of the refined economic approach. If there is no incentive effect, the firm’s behaviour is not influenced by the government’s intervention. Accordingly, it cannot correct the targeted market failure and consumers are not better off either since the aid represents only a shift of money from the taxpayers to the beneficiary. In legal terms, an aid without incentive effect cannot contribute to the objectives of common interest which are laid down under Article 87(3). (Evans, Nyssens, 2007) In order to verify the existence of incentive effect the Commission undertakes a counterfactual analysis to see whether the recipient would have undertaken the same extra activity even in the absence of state aid.

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

The third question, assessing whether a measure is well designed refers to the efficiency of state aid: aid measure is regarded as proportional only if the same result could not be achieved by less aid; in other words, the amount and the intensity of the aid have to be limited to the extra

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<sup>24</sup> SAAP, *supra* note 8, p.7.

activity of the firm induced by the aid.

The last stage of the test concerns the assessment of the negative effects of state aid, and the actual balancing of the benefits determined by the first steps against the costs of aid.

*Stage 3: Are the distortions of competition and effect on trade limited, so that the overall balance is positive?*

Even if an aid measure is considered as an appropriate and well designed policy instrument, it may have negative impact on competition and trade between Member States. Under this stage the Commission first evaluates the negative effects on trade and the potential risk of distortion of competition. The R&D&I Framework mentions different types of distortion of competition with regard to state aid among which the first three concern competition between firms, whereas the last type relates to the effects of aid on competition between Member States.

- a) State aid may distort competition by granting aid to inefficient production. Supporting inefficient firms or sectors and thereby keeping them on the market, has a negative impact on productive efficiency and on total welfare.
- b) State aid may increase the risk of crowding out effect and distort dynamic incentives of firms: by the help of state aid a firm can increase its presence on the market, which makes rivals adjust to the new situation and reduce their investment plans.
- c) State aid can be used by the recipient to increase market power and engage in exclusionary practices.
- d) Member States can directly influence trade and international allocation of goods by supporting domestic industries and the inflow of foreign investments. State aid may have effects on trade of goods and services in the territory of the EU regardless of the location choices or aid might induce relocation of economic activities across Member States leading to an inefficient production structure in the EU. (Friederiszick, Röller, Verouden, 2006, p. 653-654).

Having identified all the negative effects, the Commission will weigh them against the positive effects of the aid measure. If the overall balance is positive the aid can be authorized pursuant to Article 87(3).

By the introduction of the SAAP the methodology of assessment shifted from a form-based approach to a more effects-based analysis. However, it does not entail a full economic assessment in all cases. If an aid measure falls outside of the application of the de-minimis or the General Block Exemption regulation it has to be notified to the Commission, who will assess the compatibility of the aid with the common market. The guidelines and frameworks issued by the Commission explain the principles of the economic analysis applied to individual cases and provide for three different levels of assessment: the first two levels imply a faster procedure in which certain legal assumptions are applied, although the second level requires the detailed verification of the incentive effect, and a more detailed procedure involving in-depth economic analysis, i.e. the full balancing test for large projects. (Nicolaidis, Kekelekis, Kleis, 2008)

## **4.2 Application of the balancing test in practice: case analysis**

The aim of this chapter is to analyse how the Commission has applied the balancing test in practice and what are the main conclusions to be drawn from the methodology concerned. The analysis follows the steps of the balancing test looking at different cases, thereby revealing the key factors. The cases at hand are chosen from the field of aid to research, development and innovation; broadband development; risk capital to SME's and training aid.<sup>25</sup> As stressed earlier, not all the aid measures are subjected to the full balancing test. The conditions of the test are presumed to be satisfied if the aid measure falls within the thresholds<sup>26</sup> set by the relevant framework, guidelines or the General Block Exemption Regulation. If aid exceeds the thresholds a detailed assessment is conducted on a case by case basis and the extent of the analysis depends on the potential distortion of competition and the nature of the case in question.<sup>27</sup> For instance in the case of training aid the detailed assessment focuses essentially on the verification of necessity and incentive effect of the aid, the Commission did not apply the full

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25 See a detailed list of Commission decisions with references in ANNEX II.

26 See ANNEX I.

27 R&D&I Framework, *supra* note 24, point 7.1.

balancing test in this area. However, in the draft guidance paper<sup>28</sup> the Commission elaborated the test also in relation to training aid subject to notification. The aim of the present analysis is to examine the detailed assessment applied only to a small number of cases; more precisely the full balancing test in the areas of R&D&I, risk capital and broadband development, and a less detailed scrutiny regarding training aid cases. The analysis does not present the cases in detail but seeks to focus on the decisive elements which led the Commission to the conclusion.

#### *4.2.1 State aid in line with the common interest*

The starting point of the balancing test is to verify the existence of objective of common interest that is targeted by the aid measure.

In the case of R&D&I the common interest refers to economic efficiency, equity objectives are not addressed by the related framework<sup>29</sup> The Commission considers knowledge spillovers, imperfect information and coordination failure as possible market failures specific to this area. However, according to the R&D&I Framework, it is not enough to claim the existence of these imperfections, the Member States has to verify whether state aid addresses a general market failure concerning R&D&I in the Community, or it concerns a specific market failure.<sup>30</sup>

The cases at hand reveal that the existence of market failure was approved on several grounds. The Commission established that the sector, in which the projects were carried out, was characterized by the presence of one specific market failure, by asymmetry of information<sup>31</sup>. However, this fact does not apply the automatic assumption that every single project in the sector faces a market failure, hence it has to be verified that the market imperfection is specific to the individual project. In two of cases concerned the Commission concluded that the nature of the project implied very long term returns and high technological and

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28 Public consultation on “Criteria for the compatibility analysis of training State aid cases subject to individual notification, 2009.

29 Although, regional discrepancies can add to the gravity of the market failure. (R&D&I Framework, *supra* note 24, point 7.3.1).

30 R&D&I Framework, *supra* note 24, point 7.3.1.

31 The cases concern research projects in the jet-engine sector.

commercial risks resulting in unavailability of private funding and risk sharing partners. Furthermore, the Commission accepted the argument that a company in development was not able to finance new projects from revenues deriving from older projects as opposed to firms with successful previous projects. However, in the case of Volvo Aero<sup>32</sup> the Commission had doubts about the existence of the market failure. The state support was granted at a late stage of the project, therefore it was presumed that the beneficiary had access to private funding through its parent company.

As regards aid for risk capital to SME's according to the Commission there is no general market failure in the Community. However, it accepts the presence of market gaps related to investments at certain stages of the enterprises' development. The guidelines indicate that "These gaps result from an imperfect matching of supply and demand of risk capital and can generally be described as an equity gap."<sup>33</sup> In other words, due to the difficulty to obtain reliable information, the market provides less risk capital than the optimal level and enterprises even with growth prospect and successful business plan do not attain funding. Thus, the main market failure which concerns the access to capital by companies at the early stage of development is imperfect or asymmetric information, which may manifest in transaction and agency costs and exacerbating risk aversion towards investing in SME's.

In this respect, the cases in question reveal that no further evidence was required concerning the presence of market failure in the course of the detailed assessment, since the aid measures did not exceed the threshold set by point 5.2. of the guidelines.<sup>34</sup> Hence, the Commission accepted a general reasoning behind the objective of the aid measures,

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32 Commission Decision C33/2008 (ex N 732/2007), *Volvo Aereo*, para. 36.

33 Equity in this context means ownership interest in a company, represented by the shares issued to investors, Risk Capital Guidelines point 1.3.2 and 2.2.

34 Measures „providing for tranches above EUR 1,5 million per target SME over each period of twelve months, follow-on investments or financing of the expansion state for medium-sized enterprises in non-assisted areas as well as for measures specifically involving an investment vehicle". Risk capital guidelines, *supra* note 20, 5.2.1.

namely that it targeted “to alleviate an alleged market failure at the level of early stage investments”<sup>35</sup>

The assessment of the present cases concerning aid to broadband development are based directly on Article 87(3)(c) of the EC Treaty<sup>36</sup> because they do not fall under the scope of any existing guidelines or frameworks, thus the full balancing test was carried out when examining the compatibility of the measures. The first step of the balancing test was easily proven on several grounds in the decisions. The area of broadband contains a number of objectives of common interest; both equity and efficiency considerations can be identified given that broadband development contributes to the Commission’s “broadband for all” action plan<sup>37</sup> by improving access to broadband to citizens and businesses in underserved regions of the Member States, thereby state aid promotes regional economic development. As regards the efficiency aspects, broadband can be associated with a number of positive externalities among which network externalities are the most significant. Due to the high fixed cost of network deployment, broadband networks tend to be more profitable in densely populated areas, where demand is higher and more concentrated. Accordingly, private network operators are reluctant to provide broadband services or invest in broadband infrastructure, thus the lack of broadband coverage in rural areas requires public intervention. On these grounds the Commission found it verified that the aid measures in question granted for the provision of widespread and affordable broadband pursued cohesion and economic development objectives, and satisfied the first stage of the balancing test. In addition, in the case of Metropolitan Area Networks<sup>38</sup> the Commission considered market power as a market failure in the sector due to the first-mover advantage of the telecom incumbent on the broadband market. Since this issue was only partly remedied by regulation, aid may be beneficial to increase competition.

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35 Commission Decision N 263/2007, *Saxon Early Stage Fund*, para.8.

36 “aid to facilitate the development of certain economic activities or of certain economic areas”.

37 „i2010 - A European Information Society for growth and employment” COM(2005)229, 01/06/2005.

38 Commission Decision N 285/2005, *Metropolitan Area Networks*, para. 62.

As to training aid cases, the Commission did not analyse in further detail the existence of a common objective targeted by the aid measures in the course of the compatibility assessment.

#### *4.2.2 Well designed aid*

##### a) Aid is an appropriate instrument

As regards the cases in the area of R&D&I, the main argument supporting the appropriateness of aid appears to be the high level of risk and the high amount of funding required to the implementation of the projects. Due to these factors state aid was viewed as the most suitable instrument to limit the risks. The form of provision is also important in this context: for instance a reimbursable advance is considered to be less distortive than a direct grant.

As regards the risk capital cases the Commission considered the aid measures appropriate because on the one hand it was proven that introducing other instruments<sup>39</sup> was not successful, and on the other hand the risk capital funds would be a co-investment with private investors by which the Member States sought to encourage private investments in parallel with public finance.

As to broadband development the cases at hand reveal that state aid is part of the policy instruments which are used to improve broadband coverage in Member States, especially in rural and remote areas. Other supporting instruments, for instance ex ante regulation is essential but not sufficient to bring more private investments for providing broadband connection in the underserved areas because provision requires access infrastructure in the first place, which is costly and unprofitable. Accordingly, public funding was the most appropriate instrument to improve broadband coverage by building up the necessary infrastructure.

The appropriateness of the aid measures were not examined during the assessment in the training aid cases.

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<sup>39</sup> For instance structural measure to attract early stage investments.

b) The aid provides incentives to the recipient

Verifying the incentive effect in the area of R&D&I requires clearly defined proof. According to the R&D&I Framework, demonstration of the incentive effect is the most important condition in the assessment of state aid to R&D&I.<sup>40</sup> The analysis of the incentive effect may be carried out on three levels. If the criteria provided by the framework are met an automatic assumption applies; for all other measures notification is required to demonstrate the existence of the incentive effect. The framework provides several indicators to verify that aid induces a change in the behaviour of the beneficiary and thereby increases the R&D activity of the firm. If at least one of these conditions can be proven the Commission in principle accepts the existence of incentive effects.<sup>41</sup>

When the Commission undertakes a detailed assessment it will require the Member State to verify precisely the incentive effect supporting by detailed documents and reports.<sup>42</sup> The aid measures at hand were found to be well-specified because they supported a launch of a new project. According to the counterfactual analysis in aid to Rolls-Royce the recipient when drawing up the business plan assumed that the aid would be approved by the Commission. Since the company did not have any alternative scenario in the absence of the aid, it was proven that the project would not have taken place or would have been revised to a great extent without aid.<sup>43</sup> In two of decisions the Commission noted that the projects bore high start-up investment costs resulting in low or negative level of cash-flows. In addition to the preceding elements, the national authorities demonstrated the high level of risk involved in the projects such as technical risk (arising from the novelty of the product; feasibility test can be run only at late stage), market risk (the project would open up a new market segment) and commercial risk (relating to pricing policy). The Commission noted that foreign exchange risks were not significant in verifying the incentive effect and it also raised doubts about the necessity and the incentive effect whenever official the

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40 R&D&I Framework, *supra* note 24, point 7.3.3.

41 R&D&I Framework, *supra* note 24, point 6.

42 R&D&I Framework, *supra* note 24, point 7.3.3.

43 Commission Decision N 195/2007, *Rolls-Royce*, para. 113.

government decision on providing aid would be taken at a late stage of the project.<sup>44</sup>

State aid for risk capital has to increase the availability of risk capital for SME's. If the measure complies with the criteria laid down in the Risk Capital Guidelines, the Commission considers the incentive effect to be verified. In most cases it follows from the nature of the measure. The Commission's assessment reveals that even if private investors do not participate initially in the risk capital fund management, the fund would not be able to take investment decisions without the corresponding decision of the private investors on co-financing an SME. As a result, private investors have an influence on the fund's investment decisions, which ensures commercial management. Furthermore, potential private investors would be represented in the investment committee as well, which supports profit-driven investment decisions independently from the SME's.

In the cases concerning broadband development the selection procedure ensured the incentive effect of the recipient, who was selected through open tendering. Tender participants had to submit an investment plan including the amount of aid which was necessary to implement the investment on the basis of expected total investment, operating costs and revenues.

As regards training aid measures, the cases at hand can be viewed as instances when the Commission had doubts about the existence of the incentive effects, therefore a detailed scrutiny was conducted in order to check the compatibility of the aid. Training aid can be deemed to be compatible with the common market "only when it is not directly required for the operational activities of the beneficiary"<sup>45</sup>. If a training programme had been carried out even without aid it can not be considered as contribution to economic development pursuant to Article 87(3)(c) and as a remedy for market imperfections, namely underinvestment in training of workers. This is a strict interpretation of the rules<sup>46</sup> which first appeared in the Commission decision on training

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44 *Volvo Aereo*, *supra* note 33, para. 70.

45 Commission Decision 2008/878/EC, OJ L313, 22/11/2008, *DHL*, para. 50.

46 There is no requirement to prove the incentive effect of state aid under Regulation 68/2001, which was the regulation applicable to this case.

aid to Ford Genk and to GM Belgium.<sup>47</sup> Indeed, the Commission, in the course of the assessment of the present cases, referred to the above mentioned decisions as grounds for interpretation of the Regulation 68/2001 on training aid.<sup>48</sup>

In the DHL case the Commission concluded that the major part of the training would have been undertaken in any event, even without state aid. There were two main arguments underlying the decision in question. Firstly, the Commission found that the training was indispensable to start the operation of the new facilities. DHL did not prove that it was able to hire sufficient number of skilled workers. Subcontracting did not appear to be a possible option for DHL either; moreover employees were not willing to move to the new location. Secondly, the Commission noted that significant part of the training was obligatory under national and European legislation.<sup>49</sup> The necessity of aid was verified only regarding training to operation managements given that the training programme was not found to be indispensable to the operation of the centre and it was regarded as general measure which provided transferable skills and thereby enhanced employability of the workers.<sup>50</sup> The existence of an incentive effect was questioned in the other decisions as well, however after a detailed assessment the national authorities proved that the aid measures led to additional training activities. As pointed out earlier, the detailed assessment of training aid measures has focused on the verification of the incentive effect of the aid. However the draft commission document on the criteria for assessment of large training aid measures<sup>51</sup> will introduce the full balancing test into this area as well.

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47 Commission Decision 2006/938/EC, OJ L366, 21/12/2006 and Commission Decision 2007/612/EC, OJ L243, 18/09/2007.

48 Commission Regulation No 68/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to training aid, OJ L10, 13/01/2001, it is replaced by the General Block Exemption Regulation as from 8 August 2008.

49 *DHL*, *supra* note 46, para. 63.

50 *DHL*, *supra* note 46, para. 87-88.

51 Criteria for assessment, *supra* note 29.

### c) Proportionality of the aid

Proportionality refers to the condition that aid should be limited to the minimum necessary.

Aid to R&D&I projects can be regarded as proportionate according to the cases at hand if the aid intensity is below the relevant maximum aid intensity set by the R&D&I Framework, if the costs accruing after licensing the first prototype of the product cannot be financed by the measure, and if the measure is designed in such a way that benefit would not be conferred to the beneficiary in the event of the success of the project. The last element can be ensured by granting aid in the form of repayable advances, which would be reimbursed in a proportional manner from the recipient. However, if the reimbursable amount is calculated in foreign currency, and hence the foreign exchange risk is entirely born by the government, the measure may raise concerns regarding its proportionality.<sup>52</sup>

The assessment of proportionality with regard to risk capital measures examined whether the investors and the management were not overcompensated. The cases illustrate that the Commission regarded positively the fact that the management of the fund was selected through an EU-wide open tender, and that the same procedure was anticipated for involving private investment in the fund. Furthermore, ensuring market rates concerning the remuneration of the management was also considered in favour of proportionality.

In the broadband decisions the Commission has established a number of elements, which indicate the proportionality of an aid measure. Proportionality can be confirmed by market research, which identifies the target areas requiring public assistance and thereby reduces the amount of state aid and the threat of distortion on competition in respect of existing providers. Open tender as selection procedure is deemed to be positive in this regard, since it limits the potential advantage conferred to the selected operators. Furthermore, the selected operator is obliged to provide wholesale access to other operators in order to stimulate competition on the retail level. The Commission noted that the projects sought to minimise the negative effects of the measures on existing infrastructure providers and operations by allowing the tender

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<sup>52</sup> *Volvo Aereo*, *supra* note 33, para. 91.

participants to purchase or rent infrastructure from another operator, which may avoid duplication and improves economic efficiency. The projects were technologically neutral, the retail prices offered by the operator were in line with the average prices in the area concerned and the contracts had limited duration (3-5 years). Moreover, if the recipient profit had been higher than it was anticipated in the initial plans, the proportional part of the aid would have to be returned.

As regards training aid, a measure is considered proportional if it respects relevant rules on eligible costs and aid intensities provided by the block exemption regulation.

#### *4.2.3 Negative effects of the aid and the overall balance*

The assessment regarding negative effects of R&D&I aid consists of four main issues as already mentioned: distortion of dynamic incentives and crowding out effect; support to inefficient production; maintaining market power and the negative impact on trade between Member States. The cases at hand did not raise any significant concerns of distortion of competition based on the Commission findings. Due to the particular characteristics of the market<sup>53</sup> such as small number of large market players, strong buyer power, bidding markets and limited market share, the Commission did not find any serious concerns of distortions of dynamic incentives to invest. Moreover, there was no major risk of creating market power or maintaining inefficient market structure owing to the nature of the selection procedure (open tender), the particular situation of the market and because the projects aimed at a specific experimental development, thereby stimulating competition on the market.<sup>54</sup> Having balanced the negative and positive effects in the present cases, the Commission reached a positive conclusion given that the identified positive effects outweighed the limited negative effects of the aid.<sup>55</sup>

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53 The cases concern the aero engine sector.

54 Commission Decision N 195/2007, para.138-148; Commission Decision 2009/179/EC, para. 183-187.

55 Commission Decision 2009/179/EC, OJ L66, 11/03/09, para. 206-211, N 195/2007, para. 148.

Risk capital measures chosen for the present assessment had moderate negative effects on competition according to the Commission's assessment, given that the objective of the measures was to overcome the market failure existing in relation to financing early stage development of SME's, namely the lack of private investments. Moreover, the risk capital fund would facilitate private investment into SME's and increase the possibility for SME's to obtain funding from other private sources. Since the measures aimed at investing in newly created enterprises, of which business plans demonstrated positive prospect of future profitability, the Commission found it verified that there is no significant risk of distortion of competition.<sup>56</sup> Concluding the assessments the Commission identified a great number of positive effects induced by the measures which offset the limited negative impact on competition.

Regarding measures to support broadband development the Commission reached the conclusion that the measures had a positive impact on competition, and negative cross-border effects for other Member States were not found. Consequently, the overall balance was considered to be positive taking into account the objective and the characteristics of the projects, as well as the way they were designed by the national authorities.

With regard to training aid cases, as pointed out earlier, the Commission did not evaluate the negative effects of the aid in the course of the compatibility assessment.

#### *4.2.4 Evaluation*

Summarizing what has been outlined earlier, the main elements can be pointed out as follows.

As far as the assessment of R&D&I projects is concerned the ground for justification is the presence of market failure, equity consideration does not play a significant role in this area. The main emphasis was put on the analysis of the incentive effect. The Commission first checked whether the project involved a significant increase in scope, size and budget before moving on to the detailed assessment to examine whether

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<sup>56</sup> Commission decision N 479/2006, para.92; Commission Decision N 263/2007, para.146; Commission Decision C 33/2007, para. 112.

the increase was induced by the state aid itself. The official date of granting the aid is regarded as a decisive factor in this respect: it raises concerns if the formal decision on the provision is taken at such a point in time, when the project is well advanced.

As for aid to risk capital the rules were designed in such a way that in practice, compliance with the requirements of the guidelines ensured the incentive effect and limited negative risk of distortion of competition. In other words, aid to risk capital can be granted only in the absence of private investment sources, thus distortion of competition through crowding-out effect does not apply. Moreover incentive effect can be indirectly confirmed by the fact that the measure supports private investments by requiring minimal participation of private investors in the risk capital measure.

The Commission's assessment in the field of broadband development reveals that the projects at hand are assessed directly under Article 87(3)(c) given that there is no applicable secondary legislation in this area. The main conditions for compatibility are the necessity and the proportionality of the aid measure. The risk of distortion of competition, hence the degree of the detailed assessment increases in proportion to the density of population in the area where the project takes place. In this context, it should be noted that in general, public support to broadband development constitutes state aid with potential risk of competition, however aid in underserved areas can actually stimulate competition as the decisions at hand reveal.<sup>57</sup>

As regards training aid the Commission seems to follow a more rigorous interpretation of the rules, especially in the motor vehicle sector, by undertaking a detailed assessment in order to verify the incentive effect of the aid. The full balancing test is to be introduced in this area as well by the draft guidance document explaining the methodology of assessment in relation to measures subject to notification.

Finally, the decisions examined in the present analysis reveal that the test is not an accounting exercise in the sense that it does not quantify the positive and the negative effects of aid to determine the balance "in

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<sup>57</sup> See more details on the role of competition policy concerning broadband development: Broadband roll-out and competition policy – what role for public funding?, Speech of Neelie Kroes, European Commissioner for Competition Policy, „Bridging the broadband gap” Conference, Brussels, 15 May 2007.

numbers”. It is rather an assessment to identify cases in which aid can be detrimental to the common market by distorting competition.

### **4.3 Compatibility assessment of large investment projects**

The present section of the paper discusses the methodology the Commission follows when assessing the compatibility of aid to large investment projects in line with the rules laid down in the Guidelines on national Regional Aid for 2007-2013.<sup>58</sup> It implies that the chapter did not attempt to elaborate the guidelines to a great extent, but focuses on the elements of the balancing test which could be potentially detected from the Commission’s practice to date and in the draft guidance paper introduced by the Commission earlier this year. Recent decisions<sup>59</sup> will help to shed light on the Commission practice in this context.

On the basis of Article 87(3)(a) and (c), and corresponding to the RAG, State aid may be deemed to be compatible with the common market, if it is granted to promote the economic development of certain disadvantaged areas. One of the instruments of these national regional aid measures is aid to large investment projects targeting specific regions in order to remedy regional handicaps. The relevant rules and the levels of assessment are integrated in the RAG, which defines large investment projects as “an initial investment with an eligible expenditure above EUR 50 million” in present value.<sup>60</sup> The Commission established special rules in relation to large projects, since they are less affected by regional discrepancies and they have more impact on competition. In order to limit the distortion of competition, the RAG applies an automatic progressive scaling-down to the aid intensities in these cases. Furthermore there is a notification obligation if the aid amount exceeds the maximum aid level which could be granted to an investment with EUR 100 million eligible costs. The scope of the assessment is to analyse whether the aid measure is in line with the rules set by the guidelines, with special regard to two criteria, which ensure the limited

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58 Commission Guidelines on national Regional Aid for 2007-2013, OJ C54, 4.3.2006, (“RAG” hereafter).

59 See details on the Commission decisions in ANNEX II.

60 RAG; *supra* note 59; para. 60.

negative impact on trade and competition. If the Commission finds that the recipient has a market share above 25%, or the production capacity created by the project exceeds 5% of an underperforming or declining market, the Commission will carry out a detail assessment which corresponds to the full balancing test.<sup>61</sup> The draft commission document<sup>62</sup> provides guidance about this in-depth assessment which applies only to very few cases, hence the Commission does not intend to conduct the full balancing test in most of the cases when assessing compatibility of regional aid to large projects. It should be underlined that the RAG already embodies a refined economic analysis as opposed to the preceding rules, which prohibited any aid falling outside the above mentioned critical thresholds without any further assessment.

This section of the paper analyses the different steps of the balancing test elaborated in the Guidance in line with the Commission's practice based on the decisions at hand. The cases, chosen for the present analysis concern large investment projects in the motor vehicles and electronic equipment sector, in the New Member States. In three cases the Commission decided to open a formal investigation involving a detailed assessment of the compatibility of the measure. Of these, in the case of IBIDEN Hungary<sup>63</sup>, the Commission concluded that the notified part of the aid is incompatible with the common market; the aid measure to Dell Products Poland<sup>64</sup> is yet under scrutiny; whereas the Commission reached a positive decision concerning aid to BVG Medien Poland<sup>65</sup> after the detailed assessment.

To begin with the draft Guidance, as far as the positive effects of the aid is concerned, the Member State in question has to demonstrate that the aid measure aims at an equity objective of common interest<sup>66</sup> and that the supported project contributes to economic development of the region concerned. The document lists a number of indicative criteria which

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61 RAG; *supra* note 59; para. 67-68.

62 Draft Guidance on the in-depth assessment of regional aid to large investment projects, ("Guidance" hereafter)

63 Commission Decision 2008/830/EC, IBIDEN Hungary, OJ L295, 04/11/2008

64 Commission Decision C 46/2008 (ex N 775/2007), Dell Products Poland

65 Commission Decision C11/2008 (ex 9082006), *BVG Medien Poland*

66 See more about the equity objective of regional aid in RAG; *supra* note 59., para. 2-3.

can be used to verify the contribution of the aid to region's development, such as the number of direct or indirect jobs created, training activities pursued by the beneficiary, clustering effect, knowledge spillovers, etc.<sup>67</sup> The next step of the balancing test, as demonstrated earlier, concerns the analysis whether the aid measure is well designed, in order to achieve the above mentioned objective. The Member State has to prove that state aid is the most appropriate instrument, after having considered other policy instruments to support investment and job creation (for instance infrastructure development, education and training).

The most important element of this compatibility assessment is the verification of the incentive effect of the aid which is undertaken at form-based level checking the compliance with the general rules of the RAG in this respect, and at more effects-based level. As regards the latter the Commission established two scenarios, in which incentive effect of the aid can be proven.

- (1) the aid gives an incentive to the recipient to undertake an investment in the assisted region which would not be profitable otherwise at any location,
- (2) the aid gives an incentive to locate the investment project in an assisted region by giving compensation for the costs related to regional disadvantages.

An important element of the verification, in addition to providing evidence about the project itself, is the counterfactual scenario to demonstrate the recipient's behaviour in the absence of aid.<sup>68</sup>

The RAG provides for safeguards such as aid ceilings and the progressive "scaling-down" rule to ensure that state aid is proportionate to the gravity of regional handicaps. However, an in-depth assessment requires a more detailed analysis in this regard, involving submitting evidence on rates of return on investments.

Negative effects of aid are analysed in a general manner under the RAG<sup>69</sup> focusing on the potential risk of distortion of competition established by those criteria of the RAG which triggers the in-depth analysis. Accordingly, a number of important indicators of negative effects such as relevant market, market share and potential overcapacity

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67 Guidance; *supra* note 53; point 2.1.

68 Guidance; *supra* note 53, point 2.3

69 RAG; *supra* note 59, para. 68

are already identified in the course of the initial assessment. However, the full balancing test requires the refinement of these elements in order to verify whether the beneficiary has market power and whether aid leads to a creation or maintenance of inefficient market structures, which may be detrimental to competitors, and thereby the measure distorts competition. The third indicator<sup>70</sup> the Commission takes into account is the potential negative effects of state aid on trade and location. The Commission needs to assess whether without aid, the project would have gone to another region which would be in higher need of the investment to stimulate the region's development. In addition, if aid leads only to a relocation of existing activities without any investment in extra activity, any disadvantage related to the relocation and born by the region in which the economic activity was originally located has to be considered amongst the negative effects of the measure. Having identified all the positive and negative effects, the Commission will establish the overall balance taking into account the impact of aid on cohesion in the European Union.<sup>71</sup>

A potential contradiction can be pointed out as regards the sequence of the balancing test. Point 24 of the Guidance explicitly states that "aid will not be approved in cases where it appears that the same investment would take place in the region also without aid." This could lead to the interpretation that if the Member State fails to prove the incentive effect, the Commission does not have to carry out the remaining steps of the balancing test, namely the analysis of the negative effects, saving time and resources. Furthermore, it can be also justified on the grounds that the potential risk of distortion of competition has been already identified before the opening of the formal investigation. On the other hand, according to point 50 of the Guidance "No single element is determinant, nor can any set of elements be regarded as sufficient on its own to ensure compatibility", which might question the above mentioned decisive nature of the incentive effect.

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70 According to the Commission these are the three main indicators associated with the negative impact of regional aid to large investment projects, but this is a non-exhaustive list, other indicators can be taken into account during the case by case assessment.

71 Guidance; *supra* note 53; point 3 and 4.

As to the decisions at hand, it can be highlighted that the Commission has not applied the full balancing test in any of the cases yet. However, it should be noted that two of the cases in which the Commission opened a formal investigation procedure were assessed under the old regional aid rules, which did not provide for any detailed assessment in the meaning of the balancing test.<sup>72</sup> The decision on aid to Dell Products Poland already foresees a detailed assessment on the positive and negative effects of the aid, if the relevant thresholds are not found to be respected. Nevertheless, some of the steps of the test can be identified, even if in a less detailed manner, in the Commission's practice concerning large investment projects. The objective of the measure, that is the contribution to regional development has to be explained briefly without providing further substantial evidence. There is no need to demonstrate that state aid is the most appropriate instrument vis-à-vis other general measures and proportionality is considered verified if the relevant aid ceilings are respected. The assessment of the incentive effect of the aid reveals a remarkable difference in the extent to which it requires a detailed analysis. In the current assessment practice it is sufficient to show that the application for the aid by the recipient and the confirmation of eligibility by the aid granting authorities have taken place before the start of the project. Whereas, the Guidance represents a shift from a form-based approach to a more sophisticated, economic analysis as regards the verification of the incentive effect in the detailed assessment. The core element of the analysis in the Commission's practice concerns the two criteria under point 68 of the RAG as thresholds for a detailed scrutiny in procedural terms and as indicators of a possible threat on distortion of competition in economic terms. Accordingly, this step of the assessment can be associated with the last step of the balancing test, the evaluation of the negative effects. In this regard, the decisions at hand reveal that the key issue of the analysis is the delineation of the relevant market. This particular element of the assessment has always been elaborated to a greater extent as opposed to other steps of the evaluation; however the negative decision on aid for IBIDEN Hungary sets a precedent in terms

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72 Aid to IBIDEN Hungary and aid to BVG Medien Beteiligungs were assessed under the provision of Guidelines on national regional aid 1998 (OJ C 74,10.3.1998) and the Multilateral Framework on regional aid for large investment projects (OJ C70,19.3.2002).

of the detailed information and evidence the Commission takes into accounts in order to define the relevant market. The decision can be also viewed as an attempt to demonstrate the Commission's more stringent approach towards aid to big market players with higher risk of distortion of competition. Furthermore, the applied economic reasoning can be regarded as a step towards the objective of the SAAP proposing more refined economic analysis in the state aid control. One may argue a further elaborated guidance on the Commission's practice in delineating the relevant market; however it seems problematic to provide general guidelines due to the specificity of individual cases.

There are some concluding points to stress concerning the existing practice in relation to the Guidance. First of all, the draft document introduces more flexibility to the assessment of the positive effects on cohesion and the negative impact on trade and competition, numerous aspects of community interests may be taken into account. The approach of the document by applying the full balancing test to problematic cases is in line with the objective of the State Aid Action plan, which attempts to introduce a more effects-based approach, and to achieve less and better targeted aid, as well as more transparency. Nevertheless, there are some critical remarks to point out at this point. From the point of view of the Member States and also of the Commission the detailed scrutiny involves significant costs and resources. However, since the in-depth analysis applies only to a minimal number of cases, this critical argument does not seem to carry much weight. The last part of the Guidance establishing the balancing of the positive and negative effects of aid states that the Commission may approve, condition or prohibit the aid. In footnote the document mentions that "When aid is granted on the basis of an existing regional aid scheme, it is however to be noticed that the Member State retains the possibility to grant such aid up to the level which corresponds the maximum allowable amount that an investment with eligible expenditure of € 100 million can receive under the applicable rules."<sup>73</sup> The same approach was followed in the *IBIDEN* Hungary decision in which the Commission prohibited only the aid amount exceeding the notification threshold.<sup>74</sup> On the one hand, this practice can be justified given that aid falling below the

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73 Guidance; *supranote* 53; point 4, footnote 20.

74 Commission Decision 2008/830/EC, OJ L295, 04/11/2008, para. 107.

notifications threshold would be exempted from notification under the block exemption regulation in the first place, hence granted without any further scrutiny. On the other hand, it raises questions related to legal certainty and the consistency of the rules since this approach entails that aid can be (partially) granted even if it is incompatible with the common market, because it lacks incentive effect or raises competition concerns.

The verification of incentive effect raises some important questions as well. As underlined earlier, apart from the in-depth assessment in very few cases, the control of the incentive effect of state aid remains a form-based exercise and ultimately in the hands of Member States, which does not support the main objective of the European state aid control, namely avoiding subsidy-race between governments. Another issue to consider in this respect is that costs of investment may be lower in a disadvantaged region, hence aid may lead to windfall gains in these cases, given that the beneficiary faces lower labour and land costs than in a prosperous region. A good example to illustrate this argument concerns large investment projects in new Member States in Central and Eastern Europe.

In practice, there have been relatively few cases notified to the Commission, even less when the Commission opened a formal investigation procedure. The underlying reason appears to be the fact that aid granting authorities and beneficiaries try to avoid the uncertainty and the lengthy process of scrutiny in which Member States have to prove that the project does not threaten to distort competition. As a result most of the aid measures fall just below the notification thresholds and this tendency indirectly supports the Commission's policy objective of less aid to large projects.



## 5.

### CONCLUSION

Under the shadow of the global financial crisis the State Aid Action Plan has come to the end. In November 2008 Commissioner Kroes concluded that the main objectives of the reforms have been successfully accomplished. State aid policy has been streamlined in line with the key objectives of the refined Lisbon Strategy, and in order to guide Member States in designing state aid measures, which are compatible with the common market.

The cornerstones of the modernization have been to achieve less and better targeted aid and to refine the economic analysis applied in state aid policy. To date the more effects-based approach has been elaborated in the balancing test helping to identify and better balance the positive and negative effects of aid.

In this context, the first section of the present paper has discussed the underlying legal and economic principles of the state aid reform, as well as the key elements the consultation process brought about. On the basis of these principles the next section has presented a case assessment evaluating the Commission's practice in the light of the more effect-based approach embodied in the application of the balancing test. The analysis reveals that indeed, introducing a refined economic analysis to state aid control brings more flexibility and effectiveness into the enforcement of state aid rules. Nevertheless, the implementation of a more effects-based approach appears yet to be obstructed by shortage of resources and restricted information at many times, which could be improved to an even greater extent by placing the focus of the Commission scrutiny on cases with significant risk of impeding the well-functioning of the common market. This leads us to some questions which are still left open; questions deriving from the analysis of distortion of competition on the internal market as one of the underlying principles of the European state aid control.

In this regard, it is widely debated that a potential application of a refined economic analysis to the definition of state aid especially to

the last two criteria, namely the “effect on trade” and “distortion of competition” would be desirable to screen out aid measures which do not have negative effects on other Member States. In contrast to this argument, the above mentioned criteria are interpreted widely in the current practice: the Commission makes a distinction between the notion of the two criteria under Article 87(1) and those under the compatibility assessment, in so far as Article 87(1) concentrates more on determining the existence of potential risks on competition and effects on Member States, whereas the analysis under Article 87(3) aims at identifying the elements of the demonstrated risk and balance them against the positive effects of aid.

Another related issue concerns the sequencing of balancing test. In principle, as laid down in the guidelines and as follows from the cases subject to the present analysis, the balancing test would entail a full assessment of the three stages to establish the overall balance. On the basis of the assessed rules, practice and arguments two critical points seem to emerge in this respect. Firstly, in practice the test could be carried out in a sequential way: aid failing to be verified as a necessary and appropriate tool to target a common objective does not undergo the analysis of negative effects on trade and competition. On the one hand, it saves resources both on the side of the Commission and the Member States; however, on the other hand this practice may be conflicting with the main justification for supranational state aid control, given that the distorting effects on competition and on trade are not evaluated. Secondly, a possible remedy for these open issues could be to place the third step of the test to the very beginning to screen out aid granted to firms with small market share and with no cross-border effects on trade. As a matter of fact, this approach is one of the principles underpinning the block exemption regulation which aims at filtering out aid with low amount or low aid intensity based on the presumption that such aid has no significant impact on competition.

Overall, the objectives of the State Aid Action Plan are considered to be achieved, according to the latest Scoreboard issued in 2008 the level of state aid has decreased and Member States tend to grant better targeted aid focusing mainly on horizontal objectives. The accomplishment of the SAAP represents a shift from the form-based approach of the European state aid control to a more effects-based assessment as the decisions at hand reveal as well, however the applied economic analysis needs to be

“fine-tuned” in light of the Commission’s objective of introducing more economic reasoning in the enforcement of competition policy. One may raise the question: what are the next steps? Probably it is too early yet to see the concrete results of the reform process, especially in the present economic situation in which the focus and most of the resources are concentrated on tackling the economic crisis. Moreover, the mandate of the current Barroso Commission is coming to the end, which may have an impact on the priorities of the European competition policy, thus on the state aid regime as well.



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C 46/2008 (ex N 775/2007), Aid to Dell Products Poland Sp. z.o.o., decision to initiate the formal investigation procedure, 10/12/2008

## ANNEX I

### **Detailed assessment is applied to measures where the aid exceeds the following thresholds:**

In the case of R&D&I aid:

- Project aid and feasibility studies (per undertaking, per project/ feasibility study):
  - projects in fundamental research: EUR 20 million;
  - projects in industrial research: EUR 10 million;
  - all other projects: EUR 7.5 million;
- Process or organisational innovation in services activities (per project / per undertaking): EUR 5 million;
- Innovation clusters (per cluster): EUR 5 million.

In the case of risk capital to SMS's:

- Investment: EUR 1.5 million per SME per year;
- Providing finance for the expansion stage for medium-sized enterprises in non-assisted areas;
- Follow-on investments into companies that already received aid to fund subsequent financing rounds beyond EUR 1.5 million and the companies' early-growth financing;
- Participation by private investors below 50% in non-assisted areas or below 30% in assisted areas;
- Seed capital to small enterprises with (i) less or no private participation by private investors, and/or (ii) predominance of debt investment instruments as opposed to equity and quasi-equity;
- Measures specifically involving an investment vehicle;
- Costs linked to the first screening of companies in view of the conclusion of the investments, up to the due diligence phase ('scouting costs').

In the case of training aid:

- Any individual training aid, whether granted ad hoc or on the basis of a scheme, will be subject to this guidance when its grant equivalent exceeds EUR 2 million per training project. Pursuant to Article 6.1(g) of the General Block Exemption Regulation, OJ L 214, 9.8.2008, p. 3–47.
- For ad-hoc training aid to a large firm below the threshold of € 2mio, the Commission will apply the principles as outlined in the document, though in a less detailed manner.

In the case of large investment projects (on the basis of the RAG):

- Where the total amount of aid from all sources exceeds 75 % of the maximum amount of aid an investment with eligible expenditure of EUR 100 million could receive, and where
  - (a) the aid beneficiary accounts for more than 25 % of the sales of the product concerned on the relevant market (before and after the investment), or
  - (b) the production capacity created by the project is more than 5 % of the market, unless the average annual growth rate of the apparent consumption over the last five years is above the average annual growth rate of the European Economic Area's GDP.

Source: Nicolaides, Kekkelekis, Kleis (2008, p. 54)

## ANNEX II

### **Main facts of the cases selected for the purpose of the present paper**

#### **Research, Development and Innovation**

- N 195/2007, Rolls-Royce Deutschland – BR725 project, 11/03/2008
- The notified aid was going to be granted to Rolls-Royce Deutschland Ltd.&Co KG, in the form of a repayable advance for the experimental development of a new business-jet engine. The beneficiary of the aid is Rolls-Royce Deutschland Ltd.&Co KG, who was going to carry out the aided R&D-project's essential parts. The Commission decided that the notified aid was compatible with common market given that the aid's positive effects outweighed its negative ones.
- Commission Decision of 21 October 2008 on the State aid C 9/07 (ex N 608/06) which Spain intends to grant to Industria de Turbo Propulsores OJ L66, 11/03/09
- The Spanish authorities wished to grant aid to ITP for its participation in the Trent 1000 engine, which was being developed by another company for the Boeing B 787 aircraft. The aid beneficiary, Industria de Turbo Propulsores, is a Spanish aero engine company located in Spain. The Commission decided to open proceedings because of lack of information and it had several doubts on the compatibility of the aid. The Commission raised no objection after the detailed scrutiny.
- C33/2008 (ex N 732/2007) Volvo Aero – Genx, Sweden, decision to open a formal investigation procedure, OJ C253, 04/10/2008

The notified aid was granted in the form of a repayable advance to Volvo Aero Corporation, a large enterprise active in the aeronautic sector. The R&D project aimed at developing a number of components for the jet engine GENx by Volvo Aero. The Commission decided to open proceedings as the measure raised a number of doubts about the

compatibility of the aid, such as existence of market failure, the necessity and incentive effects of the aid, as well as its proportionality.

### **Risk capital to SME's**

- N 479/2006, Risk Capital Scheme “Sustainable Energy – Province of North-Holland”, The Netherlands, 20/12/2006
- C 33/2007 (N 729/2006 and N 339/2006), IBG Risk capital fund Sachsen-Anhalt, Germany , OJ C246, 20/10/2007 (positive decision has not published yet in the OJ)
- N 263/2007, Saxon Early Stage Fund (Technology Founder Fund Saxony), Germany, 31/01/2008

The primary objective of the aid measures was to provide risk capital to SMEs, for the alleviation of the market failure that exists for the start-up of innovative undertakings by establishing an investment fund. The Commission in the IBG Risk Capital Fund case decided to open a formal investigation procedure concerning IBG Fund silent participations, in which it reached the conclusion that this particular part of measure did not constitute state aid within the meaning of Article 87(1), and closed the case with an overall positive decision. As to the other measures the Commission concluded that they were compatible with the common market.

### **Broadband**

- N 284 / 2005 , Regional Broadband Programme: Metropolitan Area Networks, Ireland, 08/03/2006
- N 157/2006, South Yorkshire Digital Region Broadband Project, United Kingdom, 22/11/2006
- N 14 / 2008 ,Broadband in Scotland - Extending broadband reach, United Kingdom, 30/04/2008
- N 115 / 2008, Broadband in rural areas of Germany, 02/07/2008

The objective of the notified measures were to support investments necessary to ensure access to broadband services in rural or underserved areas, where there were currently no or insufficient broadband services available. The Commission came to the conclusion regarding all the measures at hand that the aid was compatible with the common market.

## **Training aid**

- C 35/2007 (ex N 256/2007) Training aid to Volvo Cars Gent, Belgium, 11/03/2008 (positive decision has not published yet in the OJ)
- Commission Decision of 2 July 2008 on State aid C 18/07 (ex N 874/06) which Germany is planning to implement for DHL, OJ L313, 22/11/2008
- C 23/2007 (ex N 118/2007) Training aid for Vauxhall Motors Ltd, United Kingdom, 16/04/2008, (positive decision has not published yet in the OJ)

All the three cases concern training aid in the motor vehicle sector. The Commission decided to open proceeding on the basis of doubts concerning the incentive effect of the aid measure, in other words the Commission doubted whether the aid was necessary for the training project. The Commission found that the incentive effect was verified (at least partly), thus the aid was compatible with the common market. In the case of Volvo the aid was authorized after that Belgium had reduced the amount of aid and the eligible costs taking into account only those training activities which would have not been carried out without aid. As to training aid to DHL the Commission concluded that a significant part of the aid was not necessary for implementing the training programme and did not induce additional training activities, thus only a smaller part of the original aid amount was endorsed.

## **Large investment projects**

- N 767/07, Ford Craiova, 30/04/2008

The Romanian authorities wished to provide ad hoc regional aid to Ford Motor Company Inc for two investment projects, of which one concerned the manufacturing of vehicles and the second involved the manufacturing of engines. The Commission found that that the notified aid was in line with the RAG, hence it is compatible with Article 87(3)(a).

- Commission Decision of 30 April 2008 on State aid C 21/07 (ex N 578/06) which Hungary is planning to implement in favour of IBIDEN Hungary Gyártó Kft., OJ L295, 04/11/2008

The Hungarian authorities intended to grant regional investment aid to IBIDEN Hungary Gyártó Kft. to establish a new manufacturing plant for the production of ceramic substrates for Diesel Particulate Filters. The Commission decided to open a formal investigation procedure on the grounds of concerns regarding the delineating of the relevant market and the market share of the recipient. After the detailed assessment the Commission prohibited the aid amount subject to notification because it the beneficiaries market share exceeded the 25% threshold on the relevant market.

- C 46/2008 (ex N 775/2007), Aid to Dell Products Poland Sp. z.o.o., decision to initiate the formal investigation procedure, 10/12/2008

The Polish authorities decided to provide aid to Dell Poland for setting up of a new plant to produce personal computers (PCs), including notebooks and desktops, and servers in Łódź thereby promoting regional development. The Commission initiated proceedings because it had doubts about the conformity of the aid measure with the criteria set by point 68 of the RAG. Therefore the measure is subject to detailed scrutiny, during which the Commission will apply the balancing test to assess the compatibility of the measure.

- C 11/2008 (ex N 908/2006), MSF 2002 – Aid to BVG Medien Beteiligungs GmbH, Poland, 10/12/2008, (positive decision has not published yet in the OJ)

The measure was granted by the Polish authorities to establish a new plant for the printing of magazines, catalogues and inserts with rotogravure technology in order to boost regional development. The Commission decided to open a formal investigation to assess the relevant geographic market and the capacity created by the project in more detail. After the in-depth analysis the Commission authorized the aid measure, which was found to be in line with the state aid rules.