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State Aid in the European Union: Where Law and Economics Meet

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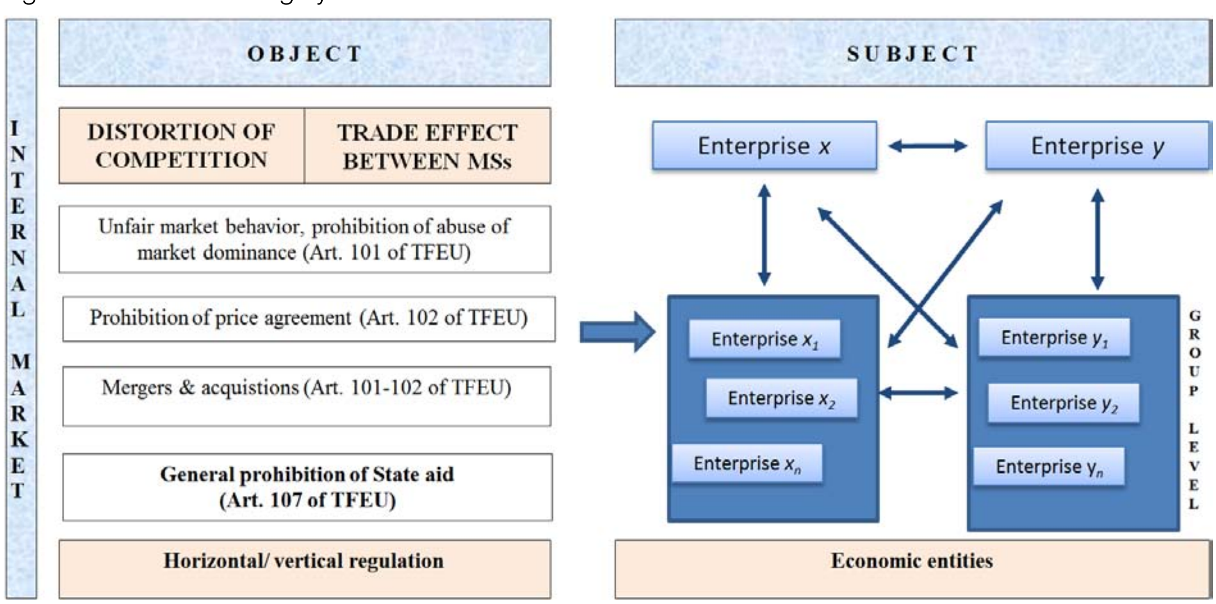
I. The Very Specific Nature of State Aid within the Meaning of the European Union Competition Law

The Competition Law of the European Union (hereinafter EU) is a specific area limited to the Member States (hereinafter MSs) and applicable to market players acting in the internal market of the EU – irrespective from their origins – and therefore it can be considered a unique legislation system all over the world. The Competition Policy is a Common Policy meaning that national sovereignty of a MS is limited. To understand how the competition policy works, it dates back entirely to the Treaty of Rome (1957) as primary source of law, establishing the European Economic Community which had already laid down the fundamentals and main provisions of rules on competition within the economic integration in order to ensure fair market terms across the MSs and to prevent them not to turn into protectionism by protecting their markets which could basically have undermined to create a common and afterwards, single and internal market, at the same time. While the main task of Competition Law in the EU (see Figure 1.) is basically to create and maintain fair market conditions focusing on the prohibition of price agreements (e.g. cartels), the abuse of dominance of market power and unfair market behavior, respectively. State aid is a special area of Competition Law. It has the task to control when a State intervenes in the economy either directly (e.g. through cash grants) or indirectly (e.g. through the tax system or by regulations) and therefore the internal market is distorted or threatens with it and the trade between MSs is affected, too, irrespectively from the form of grants and the ownership issues.



Source: Author's Compilation based on DG Competition, European Commission.

Figure 1: Typology of EU Competition Law

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As a general rule, any aid "*granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States*" (2012) normally be incompatible with the internal market and therefore prohibited. This provision is considered to be still unchanged, the legislation, however, especially the secondary and supplementary legal sources, legal acts have significantly been extended over time. The main elements of the notion of State aid (European Commission, 2016) are the following when assessing a state intervention measure as State aid:

1. *The Beneficiary Carries out an Economic Activity:* Any activity involving the supply of goods and services on a given market which presupposes the risk of service provided for it. Thus, the business is not merely a business with or without legal entity but any market player carrying out actually an economic activity in the internal market irrespective of its legal status.
2. *Imputability and State Resource:* The term "state" includes both an institution established or managed or partly financed either by the central budget or its subsystems. Thus, any direct or indirect aid measure granted by the ministries, institutions (aid grantors) and other authorities belonging to the central government and any local government body (municipality, county, etc.), constitutes State aid. Moreover, lack in state revenue such as tax allowances (partial or entire tax benefit and tax credit, too) also constitutes aid within the meaning of the EU Competition Law.
3. *Selectivity:* When undertakings in the same factual and legal situation are not automatically eligible for support, the aid measure constitutes State aid because of its selective nature. The selectivity can be sectoral (e.g. covering a particular market), geographic (e.g. limited to a particular region) or discriminatory by aiming at particular market players. If undertakings in the same factual and legal situation are automatically eligible for and benefit from subsidy from an aid scheme and fulfill all the required (general and specific) conditions, it qualifies for a general measure and therefore does not constitute State aid.
4. *Advantage at the Level of the Beneficiary:* Under the same market and financing conditions, the beneficiary will not be able to obtain advantage on the market compared to its competitors.
5. *Impact on Competition:* In competing markets, including those which have not yet been liberalized (that is closed by the state or will be opened gradually) but competition may arise, the aid measure is considered to distort or threaten to distort competition and therefore it qualifyes for State aid. If a particular market had been liberalized earlier but later closed in front of market players, it also distorts or threatens to distort competition.
6. *Effect on Trade between Mss:* In case when due to subsidy it is likely that customers, investments or services are attracted from other MSs or the establishment of companies are obstructed from other MSs in the area concerned and the free movement of goods and services in the internal market are breached.

When considering that an aid measure is qulaified as State aid based on the six criterion, State aid rules are to be applied. These criteria are conjunctive, meaning that all of them must be fulfilled for an aid measure to qualify as State aid and vice versa: if one of the constituent elements is not met, the aid measure does not constitute State aid. However, the European Commission (hereinafter EC) basically has the assumption that an aid measure distorts or threatens to distort competition and trade both from the supply and/or demand side.

Table 1: Forms of Aid and Block-exempted Aid Categories

<table>
<tr><td rowspan="6">Direct</td><td>Equity participation</td><td rowspan="11">Closure aid
Compensation of damages caused by natural disaster
Culture
Employment
Environmental protection incl. energy saving
Heritage conservation
Promotion of export and internationalisation
Regional development
Rescue & Restructure
Research and development incl. innovation
Sectoral development
SME incl. risk capital
Social support to individual consumers
Training</td></tr>
<tr><td>Cash grant</td></tr>
<tr><td>Guarantee</td></tr>
<tr><td>Recapitalisation</td></tr>
<tr><td>Impaired asset measures</td></tr>
<tr><td>Liquidity measures</td></tr>
<tr><td rowspan="5">Indirect</td><td>Soft loan</td></tr>
<tr><td>Tax deferral</td></tr>
<tr><td>Tax exemption</td></tr>
<tr><td>Tax benefit</td></tr>
<tr><td>Other (e.g. apport, real estate, land etc.)</td></tr>
</table>

Source: Author's Compilation based on Directorate-General for Competition, European Commission.

Article 107(2) and (3) of Treaty on the Functioning of the European Union (hereinafter TFEU, 2012) allows that under certain circumstances State aid can be granted if it is for an equitable and well-functioning economy and if it contributes to the economic development. The difference between Article 107(2) and (3) of TFEU is the applicability, while in the case of the former the aid is automatically compatible with the internal market (e.g. subsidies for restoring natural disasters, social aid, supporting individuals etc.), in the letter case the aid can only be considered compatible (e.g. to support employment, regional development, environmental protection and energy savings, culture, heritage etc.). In the case of compatibility with the internal market it has to be assessed whether it can be block-exempted – meaning that the aid can be granted under national competence – which depends on the type of aid (categories such as regional development or R&D&I) and its amount, of course. Above a certain threshold determined in the so-called block-exemption regulations (hereinafter GBER). Under the GBER aid can be granted either for horizontal or vertical objectives of common interest. In several circumstances State aid can only be approved individually (i.e. case by case) by the EC, more precisely by the Directorate-General for Competition, meaning that a MS has no control over it anymore.

Overall, in the public consciousness the concept of subsidy and State aid is still mixed nowadays, the lack of its unitary and consistent use is also confused and that is why should be considered a crucial issue among researchers. It can be assessed that State aid is State intervention but not vice versa: only a part of State sources qualify as State aid that are allocated to economic players during the redistribution. State aid therefore is a subset of State intervention according to the EU terminology, a narrow segment focusing on the interactions between the State and business sector with the exception of households (consumers and individuals). The rules basically determine the scope which under and the frames within that a MS can grant subsidies.

II. The Economic Perspectives of State Aid

a) *Macroeconomic Perspective*

Most of the main economic theories deal with the issue of State intervention and the efficiency of public spending and the possible impacts, respectively, from Adam Smith (1776) through Keynes (1936), Solow (1956) and Friedman (1962) to Krugman (1991; 1994); the opinions are basically heterogeneous. The basic question is whether the State is needed to intervene in the social and economic processes and if this is the case to what extent and by what means.

In the 20th century, there can be seen many examples that those developed countries with mixed (public- and private property-based, at the same time) economic models realised that the economy can not work efficiently without State intervention, i.e. merely under market terms, on the one hand because of the inequality of the distribution in goods, services and income, therefore redistribution is needed. On the other hand, if the market mechanisms do not function properly, the state has to intervene in the economy. In the 21th century the global challenges such as climate change, overpopulation, migration, limited availability of (natural) resources, the decrease of the number of areas under cultivation and parallel to that the likely increase in prices at the same time raise such questions which can not be solved on a purely market basis. Due to the fact that the market is basically interested in maximizing profits and/or minimizing costs. For example we can see the increasingly importance of innovation and R&D sector in the digitizing economies during the 21st century; its relevance was already recognized by Schumpeter (1912) and the State's role in stimulating it. Of course, competitiveness can not be without innovation in the 21st century: if a company does not produce more efficiently than its (innovative) market competitors, it will not remain competitive over time. Undoubtedly, but one of the characteristics of innovation is the partial or complete replacement of human labor force. If there is no work, there is no disposable income, there will be no demand, consumption etc. which is a barrier to economic growth. The State must also be able to handle such a situation. Otherwise, the basic frameworks and fundamentals of society can be cracked or even collapse in extreme cases, as Krugman (1994) or Huntington (2005) also points out. Contrary to this, Keynes had the vision in 1930 that the economic and social problems will be resolved within hundred years and prosperity will be general. As regards the past decades it can be seen for example that the views of Kornai (1980) on the role of the State on the public administration and the private sector in full contrast with Piketty (2014) on the role of capital in the 21st century as regards income inequality.

b) *Microeconomic Perspective*

The aim of the competing market players is to achieve the largest possible market share, the higher profit and the more secure market position in the market. If the advantage is obtained in compliance with the competition rules, i.e. not through an advantage that cannot be obtained on the market, it can be interpreted as meaning that an undertaking produces more efficiently, is more productive than its competitor(s), otherwise competition cannot be ruled out. Besides that the task of effective competition is to promote the raise of the living standard of the individuals and social welfare at the level of society as a whole in the long run,

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respectively. Nietsche and Heidhues (2006) distinguishes three levels of competition efficiency on welfare levels:

- *Allocative Efficiency:* If *MU=MC=P,* i.e. the marginal propensity of consumers is equal to the marginal cost of production, which is equal to the market price, the market allocation is efficient. Competition can promote allocative efficiency by reducing the abuse of market dominance (by using excessive prices, *P> MC*) by companies and / or by providing insufficient service and/or quality.
- *Productivity Efficiency:* If the company determines the output in the most cost-effective way in addition to the available technological level. Competition strengthens the selection of the most efficiently producing competitors in the market. If market mechanisms are in place, given fixed costs and fixed marginal costs, an increase in the number of enterprises above a certain level will no longer increase competition, will not lead to an improvement in productivity, because the benefits of economies of scale cannot be fully exploited by more enterprises. is present in the market.
- *Dynamic Efficiency:* Competition drives businesses to innovate for the benefit of consumers and society as a whole.

When examining the proportionality of the market failure and the aid, Garcia and Neven (2005) argued that a higher amount of aid may be justified if it is proportionate to the size of the market failure to be addressed. This finding is nuanced by Buehler et al. (2007) stating that the aid intensity should be proportionate to the market failure:

- In addition to having a less incentive effect on the recipient firm, the low aid intensity also has a welfare-reducing effect due to the marginal cost of public money because it does not address the existing market failure. However, low intensity may also indicate that there is no market failure.
- In the event of a serious market failure, high intensity will not have a greater distortive effect on competition because, in the absence of aid, there is little or no competition.

However, the situation is more complex and it is not the level of aid intensity that is decisive, but the rate of return of the beneficiary. Compared to a similar investment by a non-aided beneficiary, the higher rate of return of the aided company has a much more distortive effect on the competitor(s). The aid intensity must therefore be negatively correlated with the rate of return on the investment planned by the beneficiary. In addition to the socially desirable maximum welfare, the aid intensities are as follows:

$$\left(\frac{s-r}{m}\right) \geq i \geq h-r \qquad (1)$$

where *s* is the social rate of return on the investment, *i* is the aid intensity, *r* is the financial rate of return on the investment, *m* is the marginal cost of the aid *(m>1)* and *h* is the rate of return expected by the beneficiary. The government 's goal should be to minimize taxpayers' money when transferring it to businesses, so it should aim to be $i \cong h - r$.

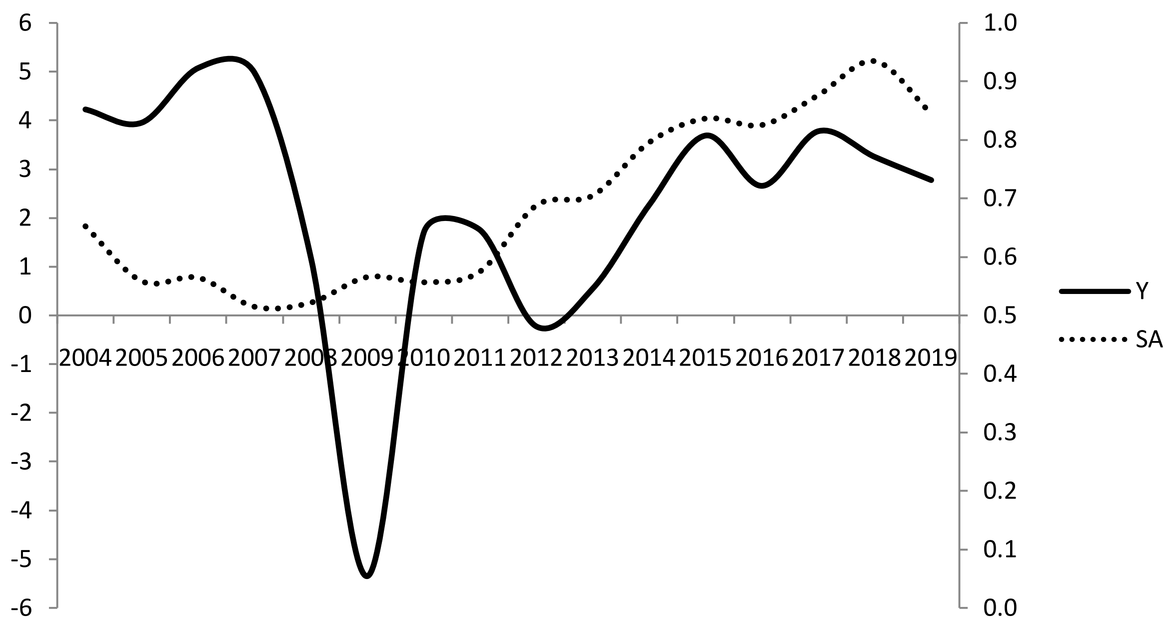
This approach is basically a balance sheet approach meaning that it does not address the potential effects, the utilization of the aid, despite the same methodology, the individual cost and revenue items are not the same when calculating the social and financial return on investment, so comparability is questionable. It could be applied to return on investment, since in the event of a market failure, the rate of return on the beneficiary's equity should be negative in the case of aid and the rate of financial return on investment without aid should be negative. In the case of a service provider, the interpretation of marginal cost may also raise questions. The formula also does not take into account the cost savings resulting from the aid: if the number of employees increases as a result of state aid – assuming that the number of unemployed decreases in parallel – the state's expenditure on the unemployed (annuities or retraining programs) decreases, while the earnings of the employee entering or returning to the labor market increase and part of the earned income is realized in consumption. The purchasing power also increases compared to the initial situation by consuming more and/or at a higher level and/or decides to postpone consumption, i.e. savings. The consumption indirectly increases budget revenues through taxes and contributions, and in the economy it promotes the process of reproduction, economic growth. Thus, for the current budget, the support can be effective in the results approach if the discounted expected budget revenues and cost savings exceed the discounted support as an expense mértékét *(ΣNPV revenues/ ΣNPV grants> 1)*.

$$\sum_{i=1}^{n}\frac{A_i}{(1+r)^i} < \sum_{i=1}^{n}\frac{C_i+VAT_i+IT_i+CT_i+DI_i-S_i}{(1+r)^i}$$

where *A* is the amount of aid granted in year *i, C* is the amount of employer and employee contributions, *VAT* is the amount of value added tax and excise duties, *IT* is the amount of personal income tax, *CT* is the amount of corporate tax, *DI* is the increase in the amount of disposable income spent minus consumption fixed costs, minus the amount of income intended to be saved and *S* the expenditures saved on the state unemployment benefit, i.e. cost savings and the discount rate. At the same time, it does not manage the external effects of the aid and does not take into account the transaction costs, ie the additional costs of the aid. it also does not take into account the potential (market foreclosure) distortive effect on competitors.

III. Empirical Results of State Aid

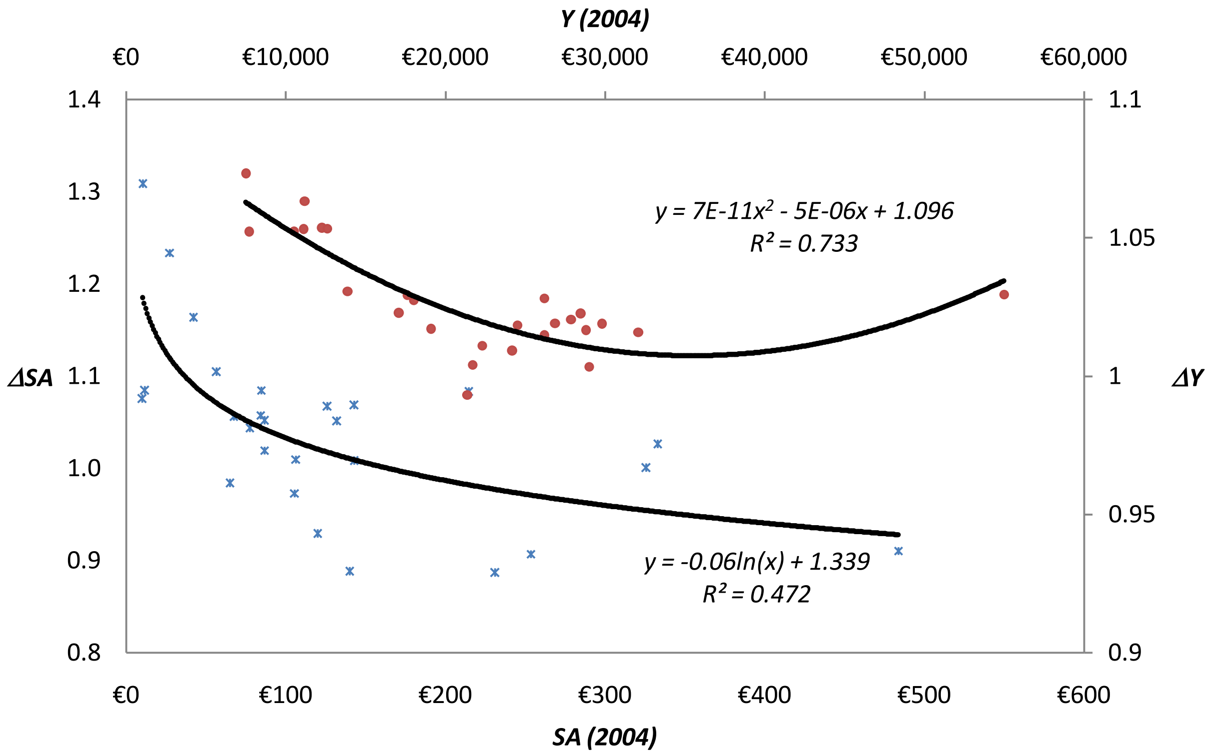
There is no MS where no State aid is granted. Between 2004 and 2019 the total spending was 0.7% of GDP on average. On the basis of data provided by the MSs, DG COMP publishes an annual report (namely Scoreboard) on subsidies according to their category, form (direct/indirect) and purpose (horizontal, sectoral) on the basis of 704/2004 Regulation. The aid amounts are collected at current price and with the exception of the euro area are converted into constant prices by the inflation rate of the given reference year in the given MS. According to the latest statistics in 2019 the overall spending by MSs for State aid was EUR 134.6 billion, including Croatia and the United Kingdom as well. The importance of GBER is growing with a relative share of 76% out of all aid measures, representing over 97% of the new implemented ones. MSs spent on average around 46% of the total spending on GBER measures, an increase of more than 10% compared to 2013 when the so-called new GBER – fitted to the seven-year programming period between 2014 and 2020 – was introduced. In terms of the absolute amounts, the difference is more spectacular with a value of around 500 times higher from EUR 104 million (Cyprus, 0.47% of GDP) to EUR 53 billion (Germany, 1.54% of GDP), overall EUR 95.5 billion in 2019. It is Malta, Latvia and Hungary where the highest the GDP proportionate State aid spending can be observed on average with the values of 1.8%, 1.57% and 1.48%, respectively.



Source: Author's Calculation based on State Aid Scoreboard, Eurostat

Figure 2: GDP growth rate (Y, axis y1) and State aid expenditure in percentage of GDP (SA, axis y2) between 2004 and 2019 in the EU

While the total State aid spending scattered with a range between 0.51% and 0.93% as a whole in the EU; among the MSs there can be observed relatively higher disparities with values scattering from 0.04% to 4.35% between 2004 and 2019 (Figure 2.). So much the worse in the case of GDP growth rates: as a whole in the EU it fluctuated between -5.4% and 5.1%, disparities at country level are more significant, it varyed between -14.8% and 25.5%. State aid can be considered to be relatively independent from GDP growth rate. It can be assessed that the level of subsidies seem to be inflexible to the macroeconomic performance. Due to the crisis it has not shown significant increase as regards spending on subsidies but afterwards it has raised parralel to the growth rate. Nevertheless, the impact of the financial crisis has remarkably spilled over the MSs but affected them in different ways.



Source: Author's Calculation based on State Aid Scoreboard, Eurostat

Figure 3: State aid per capita (SA, axis x1, blue dots), GDP per capita (Y, axis x2, red dots) and their annual average change (ΔSA, axis y1 and ΔY, axis y2) between 2004 and 2019 in the EU

As it can be seen (Figure 3) the State aid expenditure per capita varyed between 10 and 485 euros in 2004 whereas the income level between 7,500 and 55,000 euros across the MSs, there can observed that the annual average change in State aid expenditure fluctuated between 0.88% and 1.31% and the increase was relatively higher than the growth in income level (ranged between 0.98% and 1.07%) between 2004 and 2019. It can be assessed that those MSs with a relatively lower State aid expenditure per capita could grow better than those with a relatively higher share. Not as the same in the case of income level: it can not be clearly stated that the poorer MSs could better increase their income level than the richer ones.

IV. Conclusions

In this article my main intention was on the one hand to reflect on the issue of regulatory system of subsidies in the European Union by giving an overview about the very specific legal nature and environment of State aid. On the other hand dealing with the issue of State intervention both in macro- and microeconomic way I pointed out that there can not be observed significant relationship between the GDP growth rate and State aid expenditure in the EU in the long run. Rather, Member Sates with relatively low share of per capita spending have increased it between 2004 and 2018. Nevertheless, as a whole it can be assessed that the expenditure on State aid has grown faster than the increase in income level.

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