

Refined Economic Approach in European State Aid Control—Will it Gain Momentum?

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A new guiding principle in the EC competition rules is the so-called “more economics based approach”. This refined economic approach is based on an effects analysis. The question is now whether this successful modernisation in antitrust and merger control will spill over to State aid. The Commission has already started implementing the refined economic approach to some areas of the State aid provisions. The balancing test in Article 87(3) EC Treaty is one example. However, the economic analysis in Article 87(1) EC Treaty analysis is still rudimentary. The authors think through the potential and consequences of a refined economic approach in Article 87(1) EC Treaty in accordance with the new interpretation of Article 81(1) EC Treaty. An appropriate economic procedure will be developed by applying the lessons learned from antitrust.

I. INTRODUCTION

The European Commission (Commission) is currently reforming its State aid rules and procedures. This reform is part of the overall process to modernise the competition rules. Under the title of “State Aid Action Plan”, the Commission announced that it aims to ensure that the EC Treaty’s (ECT) State aid rules are better suited to encourage Member States to contribute to the Lisbon Strategy. Since the adoption of the Plan, a number of new regulatory texts have been adopted (such as the new regional aid guidelines) and others are currently under revision. The review process should largely be completed by 2009.¹ With respect to this reform the European Commissioner for Competition Policy, Mrs. Neelie Kroes, announced: “It’s my flagship project as Competition Commissioner. And it’s the first ever comprehensive reform of State Aid policy in fifty years of Community law”.²

The Commission redesigns the State aid regime around two corresponding principles: efficiency and equity.³ Another important aim of the reform is to introduce a more refined economic approach.⁴ This refinement is already implemented in the other competition rules namely Article 81 ECT and the Merger Control provisions. The reform of Article 82 ECT is not finished yet but on the way. What is achieved in antitrust and mergers, the Commission now pursues in State aid. The development and

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¹ *Vademecum Community Rules on State Aid*, April 2007

² N. Kroes, *Two years into the SAAP—State of Play and Prospects*, Speech /07/316, [2007], European State Aid Law Institute Conference.

³ See e.g. N. Kroes, *The refined economic approach in State aid law: a policy perspective*, Speech/06/518, [2006] GCLC/College of Europe Conference, Brussels.

⁴ European Commission, *State Aid action plan: Less and better targeted State aid: a roadmap for State aid reform 2005–2009, Consultation document*, [2005].

enhancement of economic tools that the Commission uses to analyse State aid cases is at the top of the agenda.⁵ In the following, it will be assessed whether the lessons learned from the modernisation of the competition rules, in particular of Article 81 ECT, can be transferred to the State aid rules.

II. ECONOMICS IN THE EUROPEAN STATE AID RULES

The point of departure of EU State aid policy is laid down in Article 87(1) ECT. This article provides that State aid is, in principle, incompatible with the common market. Under Article 88 ECT, the Commission is given the task to control State aid. This article also requires Member States to inform the Commission in advance of any plan to grant State aid (“notification requirement”).

State aid rules cover only measures involving a *transfer of State resources*. Furthermore, the aid does not necessarily need to be granted by the State itself. It may also be granted by a private or public intermediate body appointed by the State. Financial transfers that constitute aid can take many forms: not just grants or interest rate rebates, but also loan guarantees, accelerated depreciation allowances, capital injections etc.

The aid should constitute *an economic advantage* that the undertaking would not have received in the normal course of business. Economic analysis establishes the extent to which an aid measure confers an economic advantage to the recipient of the aid. In many cases, it is easy to determine the size of the economic advantage, i.e. for direct subsidies granted to firms. In many other situations, however, it is much more difficult, in particular in the context where governments invest in companies or provide loans or guarantees.⁶

In addition, State aid must be *selective* and thus affect the balance between certain firms and their competitors. “Selectivity” is what differentiates State aid from so-called “general measures”.⁷

Another important aspect is the *effect on competition and trade*: With respect to a potential effect on competition and trade between Member States, a low intervention threshold was applied in the past. It was sufficient to show that the beneficiary is involved in an economic activity and that he operates in a market in which there is trade between Member States. Distortions of competition and effects on trade were assumed

⁵ <<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/518&format=HTML&aged=0&language=EN&guiLanguage=en>>.

⁶ Prominent examples include the assessment of whether a government acts like a “private investor” in providing (financial) support to a selected undertaking or a group of undertakings as well as the exemption rule under Article 86 ECT for the provision of services of general economic interest, the so-called “net additional cost test”. For the private investor test see Court of First Instance, Joined Cases T-228/99 and T-233/99, *WestLB v. Commission*, [2003] ECR II-435; and for the so-called “private creditor test” see Court of First Instance, Case T-36/99, *Lenzing v. Commission* [2004] ECR II-359. The net additional cost test is discussed in Commission, *Proposal on a Community Framework for State Aid in the Form of Public Service Compensation*, 2004. The Commission applied this approach in its RAI decision. See Commission Decision, *Rai*, OJ (L) 119/1, 23.4.2004.

⁷ Measures which are *de jure* not selective may *de facto* have a highly divergent economic impact on firms, sectors or regions. Economic analysis can help identifying the *de facto* impact of an aid measure on specific firms or industries.

to be present already when the measure was selective, that is when the market position of the aid beneficiary *vis-à-vis* its competitors was improved by the aid.⁸ These key provisions of European State aid law are laid down in Article 87(1) ECT, which reads as follows:

“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.”

According to this Article, aid measures that satisfy all the criteria outlined above are, in principle, incompatible with the common market. Articles 87(2) and 87(3) ECT specify in addition a number of cases in which State aid could be considered acceptable (the so-called “exemptions”). The existence of these exemptions justifies the vetting of planned State aid measures by the Commission, as foreseen in Article 88 ECT. This Article provides that Member States must notify to the Commission any plan to grant State aid before putting such plan into effect. It also gives the Commission the single power to decide whether the proposed aid measure qualifies for exemption or whether the “State concerned shall abolish or alter such aid”. Exemptions become only relevant when the State measure is found to be a State aid in accordance with Article 87(1) ECT. The intention of Article 87(3) ECT is to determine the pro-competitive benefits produced by that State aid and to assess whether these pro-competitive effects outweigh the anti-competitive effects.

There are currently three areas in State aid law where the refined economic approach is already implemented.⁹ In the following these areas are addressed first before continuing with a discussion of what the likely results would be if the refined economic approach would be introduced to Article 87(1) ECT as well.

A. BALANCING TEST

The first area is the application of the so-called balancing test in Article 87(3) ECT. The balancing test weighs the positive effects of e.g. risk capital measures or aid to research and innovation against potential crowding-out or other negative effects on competition and trade.¹⁰ The economic argument is that State aid may correct market failures and thereby restore competition again. In this analysis, several types of market failures are relevant which are discussed in a more detailed way below.¹¹

⁸ H. W. Friederiszick, L.H. Röller, V. Verouden, *European State Aid Control: An Economic Framework*, [2006], p. 5 f.

⁹ <<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/518&format=HTML&aged=0&language=EN&guiLanguage=en>>.

¹⁰ J. Fingleton, F. Ruane, V. Ryan, *Market definition and State aid control*, European Commission, DG Economic and Financial Affairs, European Reports and Studies, 1999, No. 3, pp. 65–76, p. 77. For example in case of environmental protection the possible instruments would include taxation, regulation, tradable emission licences and also State aid.

¹¹ See also R. Meiklejohn, *The economics of State aid*, European Commission, DG Economic and Financial Affairs, European Reports and Studies, 1999, No. 3, pp. 25–31, p. 25.

B. MARKET FAILURES

The assessment of market failures is another area where economic analysis is important. There are a number of market failures that prevent the market from functioning.

Externalities are the most frequently discussed type of market imperfection in the context of State aid policy.²² An externality exists whenever one individual's actions affect the well-being of another individual, whether for the better or for the worse, in ways that need not be paid for according to the existing definition of property rights in the society. Externalities of either the "positive" or the "negative" sort create a problem for the effective functioning of the market to maximize the total utility of the society. The "external" portions of the costs and benefits of producing a good will not be factored into its supply and demand functions because rational profit-maximizing buyers and sellers do not take into account costs and benefits they do not have to bear. Hence a portion of the costs or benefits will not be reflected in determining the market equilibrium prices and quantities of the good involved.²³ Accordingly, aggregate supply and demand for goods that entail positive externalities is too small. On the contrary, goods that entail negative externalities may encounter demand above the socially optimal level.²⁴

The term *public good* is used to describe goods that are characterised by non-rivalness and non-excludability.²⁵ Public goods cannot practically be withheld from one individual consumer without withholding them from all ("non-excludability") and for which the marginal cost of an additional person consuming them, once they have been produced, is zero ("non-rivalrous consumption"). Consequently private production of the good is unprofitable, and the good may not be provided at all by the free market.²⁶ National defence is an example of a public good.

A market failure can also arise through differently distributed information. Information asymmetry models assume that at least one party to a transaction has relevant information whereas the other(s) do not. *Information asymmetry* occurs when one party to a transaction has more or better information than the other party. If the buyers are less informed than the suppliers of a good, this might be exploited by suppliers providing products with reduced quality and thus at lower costs which is not realized by buyers due to their information deficit. The consequence is a so-called adverse selection: worse products drive out qualitatively better products.²⁷

²² R. Meiklejohn, as note 11 above, at p. 28.

²³ <<http://www.auburn.edu/~johnspm/gloss/externality>>.

²⁴ M. Fritsch, T. Wein, H.-J. Ewers, *Marktversagen und Wirtschaftspolitik*, [1996], p. 81.

²⁵ Paul A. Samuelson, *The Pure Theory of Public Expenditure*, Review of Economics and Statistics Vol. 36, No. 4, pp. 387-389.

²⁶ R. Musgrave, P. Musgrave, L. Kullmer, *Die öffentlichen Finanzen in Theorie und Praxis*, No. 1, [1990], p. 55-56.

²⁷ G. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, The Quarterly Journal of Economics, [1970], No. 84, pp. 488-500.

Markets may also not function efficiently when there is a *coordination problem* between market actors. This aspect plays a key role in standards setting. Another aspect is *market power*. Notably, market power leads to prices that are too high from society's point of view, thereby not achieving efficiency.²⁸

The aims of State intervention and implementation of State aid are to correct market failures because it would be more efficient and welfare-enhancing than market solutions. In the case of an identified market failure the government can calculate the net benefit caused by the intervention. Its objective is to grant aid where that net benefit is positive: the benefits outweigh the costs. Because of these economic considerations a thorough economic analysis is necessary to disclose the real intention and the justification for a State measure.

The third area for the use of the refined economic approach is the *justification for the conditions for compatibility*. In so doing, a distinction is made between a lighter and a more detailed assessment, depending on the risks of distortion of competition and trade. There are a limited number of cases where a detailed assessment is required.

III. REFINED ECONOMIC APPROACH IN ARTICLE 87(1) EC TREATY

As illustrated above, the application of the more economics based approach in State aid is currently focused on Article 87(3) ECT. However, a comparison with the other competition law provisions reveals similarities between the early approach under Article 81 ECT and the current policy under the State aid provision.²⁹

The current Community supervision of State aid is based on a system of *ex ante* authorisation. Under this system, Member States are required to inform ("ex ante notification") the Commission of any plan to grant or alter State aid and they are not allowed to put such aid into effect before it has been authorised by the Commission ("Standstill-principle"). Under the ECT, the Commission is given the competence to determine whether or not the notified aid measure constitutes State aid in the sense of Article 87(1) ECT and if it does, whether or not it qualifies for exemption under Article 87(2) or (3) ECT. Member States can not grant any State aid unless it has been notified and authorised by the Commission. Any aid, which is granted in absence of Commission approval, is automatically classified as "unlawful aid". Thus, the Commission has extensive powers with respect to State aid.

A. MODERNISATION OF ARTICLE 81(1) EC TREATY

The same approach was used when applying Article 81 ECT in the old times. Article 81(1) ECT prohibits all agreements which may affect trade between Member

²⁸ H.W. Friederiszick, L.-H. Röller, V. Verouden, as note 8 above, at p. 15.

²⁹ C. Ahlborn, C. Berg, *Can State Aid Control Learn from Antitrust? The Need for a Greater Role for Competition Analysis under the State Aid Rules*; A. Biondi, P. Eeckhout, J. Flynn, *The Law of State Aid in the European Union*, Oxford: University Press, [2003], pp. 41–65, p. 41 f.

States and which have as their object or effect the prevention, restriction or distortion of competition. As an exception to this rule, Article 81(3) ECT provides that the prohibition contained in Article 81(1) ECT may be declared inapplicable under certain circumstances. In 1962, Regulation No. 17 laid down a system of supervision requiring restrictive practices affecting trade between Member States to be notified to the Commission in order for them to qualify for an exemption. The Commission thus had the exclusive power or monopoly to authorize restrictive practices meeting the conditions of Article 81(3) ECT. In establishing a “competition culture” in Europe, this system of centralized authorization was useful.³⁰ However, as a practical result of this centralized authorization system the analysis of the two elements (1) “may affect trade between Member States” and (2) “which have as their object or effect the prevention, restriction or distortion of competition” was neglected in the past. The Commission was in a hurry when applying Article 81(1) ECT in order to resort to its sole jurisdiction with respect to Article 81(3) ECT. Any deepened analysis in Article 81(1) ECT, which was not under the monopoly of the Commission, would have jeopardized this power.

The reform of Article 81(1) ECT by means of Regulation No. 1/2003³¹ initiated an exception system in Europe. Any administrative or judicial authority called on to apply the provisions prohibiting agreements which restrict competition could simultaneously apply the provisions laying down the conditions for exemptions contained in Article 81(3) ECT. Thus, the Commission returned its monopoly powers and Article 81 ECT became in its entirety a directly applicable provision which individuals could invoke in court or before any authority empowered to deal with such matters. This new framework means that restrictive practices no longer have to be notified in order to be validated. The guiding principle of this new exemption regime is that companies can assess by themselves whether their agreements infringe the provisions laid down in the competition rules.³² The direct effect of the legal exception system established by Regulation No 1/2003 increased the responsibility of companies, given that they are no longer subject to a prior-notification requirement.

On the other hand, the new regime changed the interpretation of the two elements (1) “may affect trade between Member States” and (2) “which have as their object or effect the prevention, restriction or distortion of competition” in Article 81(1) ECT as well. By applying the so-called “more economics based approach”, the economic assessment in Article 81 ECT became much more detailed. The assessment

³⁰ The Commission’s exemption monopoly has led companies to notify large numbers of restrictive practices not only in order to obtain legal certainty but also in order to block private action before national courts and national competition authorities. This has undermined efforts to promote a rigorous and decentralized application of the competition rules. It was thus essential to adapt the system to the economic and social changes which have occurred since 1962 so as to relieve companies of unnecessary bureaucracy and to allow the Commission to become more active in the pursuit of serious competition infringements and to increase enforcement of the competition rules by the national authorities and courts.

³¹ Council Regulation (EC) No. 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty.

³² <<http://europa.eu/scadplus/leg/en/lvb/l26059.htm>>.

whether an agreement between undertakings, which is capable of affecting trade between Member States, has an anti-competitive object or actual or potential anti-competitive effects is broadened. The second step, which is relevant only when an agreement is found to be restrictive of competition, is to determine the pro-competitive benefits produced by that agreement and to assess whether these pro-competitive effects outweigh the anti-competitive effects. The balancing of anti-competitive and pro-competitive effects is conducted exclusively within the framework laid down by Article 81(3) ECT. The same is true with the State aid provisions under Article 87(3) ECT.

The modernization means that agreements between undertakings are only caught by the prohibition rule of Article 81(1) ECT when they are likely to have an appreciable adverse impact on the parameters of competition on the market, such as price, output, product quality, product variety and innovation. Agreements can have this effect by appreciably reducing rivalry between the parties to the agreement or between them and third parties. For the purpose of assessing whether an agreement or its individual parts may restrict competition it needs to be considered how and to what extent the agreement affects or is likely to affect competition on the market. The following two questions provide a useful framework for making this assessment. (1) Does the agreement restrict actual or potential competition that would have existed without the agreement? (2) Does the agreement restrict actual or potential competition that would have existed in the absence of the contractual restraint(s)?³³

Today, the analysis under Article 81(1) ECT is a full economic assessment on a case-by-case basis. In order to facilitate application, the Commission introduced market share caps—agreements below a certain market share threshold are not assumed to restrict competition—as well as a hardcore list. The objective of the market share caps is to grant companies which lack market power, and most do, a safe harbour within which it is no longer necessary for them to assess the validity of their agreements in the light of the competition rules.³⁴ To conclude, Regulation No. 1/2003 with the shift to the authorisation system as well as the introduction of the more economics based approach changed the application of Article 81(1) ECT. The question is whether the Commission will apply this policy change to the State aid rules, in particular to Article 87(1) ECT, as well? There is a general consensus that when it comes to assessing the impact of State aid on competition and trade, the Commission can build on experience gained in the field of antitrust and merger control, where antitrust economics have developed sophisticated analytical tools over time. An increased use of these techniques in the State aid field is likely. The issue is how substantial the differences between antitrust and merger control on the one hand, and the State aids discipline on the other,

³³ Communication from the Commission, *Notice Guidelines on the application of Article 81(3) of the Treaty*, (2004/C 101/08).

³⁴ <http://ec.europa.eu/comm/competition/annual_reports/1998/en/_027_034.pdf>.

is which may not allow the Commission to directly transpose the economic techniques developed in antitrust or merger control into State aids analysis.³⁵

In principle, the two Articles, Article 81(1) and Article 87(1) ECT, share the same substantive structure: both provide a general prohibition. Both prohibitions are subject to a number of exemptions which are based on efficiency or public policy considerations. Articles 81 and 87 ECT use similar jurisdictional conditions (an effect on trade between Member States) and substantive tests (i.e. a distortion or restriction of competition). Although the wording is different, the overall similarities are quite high.³⁶ In the following a likely modernisation of Article 87(1) ECT is discussed.

B. MODERNISATION OF ARTICLE 87(1) EC TREATY

In principle, Article 87(1) ECT acts as a screening device by identifying whether a measure is considered as State aid or not and whether or not it qualifies for exemption under Article 87(2) or (3) ECT. Member States can not grant any State aid unless it has been notified and authorised by the Commission. Thus, the Commission has the monopoly to authorise State aid measures under the provision of Article 87(3) ECT. As with Article 81(1) ECT, the Commission and the EC Courts have interpreted the concept of State aid in a wide way in the past.³⁷

Under this approach, the assessment of the criteria “distortion of competition” and “effect on trade” under Article 87(1) ECT was rather rudimentary. The Commission typically met its burden of proof already by documenting the beneficiary and pointing out the advantage over the competitors.³⁸ Guiding principles were (a) “that any aid granted to a particular competitor runs the risk of seriously distorting the conditions of competition”³⁹ and (b) that the aid might have an “effect on trade between Member States”.⁴⁰ The analysis of the two elements was passed as soon as a State aid granted a selective economic advantage to an undertaking.⁴¹ To confirm that trade takes place between Member States it was sufficient that one of the undertakings receiving aid was trading inside or outside the Community.⁴² A relatively small amount of aid or a relatively small size of the undertaking implied already the possibility of an effect on

³⁵ L. Evans, Deputy Director General for State aid, DG COMP, European Commission, *Delivering the State aid reform*, Interview, Concurrences No. 4–2006, <http://ec.europa.eu/comm/competition/speeches/text/sp2006_025_en.pdf>.

³⁶ C. Ahlborn, C. Berg, as note 29 above, A. Biondi, P. Eeckhout, J. Flynn, as note 29 above, at p. 42 f.

³⁷ P. Heidhues, R. Nitsche, *Study on methods to analyse the impact of State aid on competition*, Economic Paper No. 244 of the European Commission, [2006], Brussels, p. 2.

³⁸ European Court of Justice, Case T-204/97, *EPAC v. Commission*, [2000] ECR II-2267, para. 87.

³⁹ European Court of Justice, Joined cases C-278/92, C-279/92 and C-280/92, *Commission v. Spain*, [1994] ECR I-4103, para. 41.

⁴⁰ There have only been a very few cases where the effect on competition and trade was analysed in detail. See European Commission, Case 258/00, *Germany Freizeitbad Dorsten*, [2001]; and European Commission, Joined Cases N 560/01 and NN 17/02 [2002].

⁴¹ A measure can be selective in terms of favouring certain companies, the production of specific products or the development of a specific region.

⁴² European Court of Justice, Case T-204/97, *EPAC v. Commission*, [2000], para. 88 ff.

trade between the Member States.⁴³ Thus, the Commission hurried with a certain automatism through the two provisions “distortions of competition” and “effect on trade”. No detailed examination whether the conditions of Article 87(1) ECT were really met was required. The Commission rather confined itself to a purely qualitative argumentation.⁴⁴

This approach was accepted by the Court of First Instance (CFI) in the past. The Court held that: “(...) the Commission is not required to carry out an economic analysis of the actual situation on the relevant market, of the market share of the undertakings in receipt of the aid, of the position of competing undertakings and of trade flows of the services in question between Member States, provided that it has explained how the aid in question distorted competition and affected trade between Member States.”⁴⁵ The Commission confirmed this approach in April 2007 in its *Vademecum on Community Rules on State Aid*. The Commission still advocates for a wide approach. According to the Commission, in the assessment of State aid it is sufficient that it can be shown that the beneficiary is involved in an economic activity and that he operates in a market in which there is trade between Member States. This brief description of the criteria defining State aid confirms that the scope of Community State aid rules is still wide (but not open-ended).⁴⁶ However, recent case law of the CFI suggests that a change is about to happen.

C. RECENT CASE LAW

The CFI calls for the application of a refined economic analysis in Article 87(1) ECT. By introducing a shift from a form-based to a more effects based analysis, the CFI requires a comprehensive analysis of the two terms “distortion of competition” and “effect on trade”. The insufficient examination of the two criteria “distortion of competition” and “effect on trade” had already been criticised in previous judgments.⁴⁷ In *AITEC v. Commission*, the CFI clarified further that the effect of a State aid on competition and on the intra-Community trade needs to be measured.⁴⁸ However, the real break through is the *Le Levant v. Commission* case. In this case, the CFI complained that that the decision did not contain an indication to what degree and in which market the aid distorted or might have distorted competition.⁴⁹

The applicants criticized that the contested decision did not identify the market on which competition was allegedly distorted. The complaint was that the contested

⁴³ *Ibid.*, para. 42.

⁴⁴ L. Hancher, T. Ottervanger, P. Slot, *E.C. State Aids*, [1999], para. 2–050.

⁴⁵ Court of First Instance, Case T-55/99, *CETM v. Commission*, [2000] ECR II-3207.

⁴⁶ *Vademecum Community Rules on State Aid*, April 2007. <http://ec.europa.eu/comm/competition/state_aid/studies_reports/vademecum_on_rules_2007_en.pdf>.

⁴⁷ Court of First Instance, Joined cases T-447/93, T-448/93 and T-449/93, *Associazione Italiana et al. v. Commission*, [1996] ECR II-1631, para. 142.

⁴⁸ European Court of Justice, Case T-447/93, *Associazione Italiana Tecnico Economica del Cemento v. Commission*, [1996], para. 138–143.

⁴⁹ Court of First Instance, Case T-34/02, *Le Levant v. Commission*, [2006], paras 123 f.

decision did not clarify whether the relevant market is the cruise services market or the market for products relating to cruise vessels, or what the geographical dimensions of such a market might be: global, regional or local to Saint-Pierre-et-Miquelon. Likewise, the contested decision did not identify the distortion of competition at issue. The CFI confirmed the applicants' plea and declared that a classification as aid, in the sense of State aid incompatible with the common market, requires that all the conditions set out in Article 87(1) ECT are fulfilled.⁵⁰ It follows from Article 87(1) ECT that those conditions are as follows: (1) There must be an intervention by the State or through State resources. (2) The intervention must be likely to affect trade between Member States. (3) It must confer an advantage on the recipient by favouring certain undertakings or the production of certain goods. And (4), it must distort or threaten to distort competition. The contested decision did not examine how all the four conditions laid down in Article 87(1) ECT for a finding of incompatibility with the common market were met. Regarding the condition relating to distortion or threat of distortion of competition, it was clear—as acknowledged by the Commission at the hearing—that there was nothing in the contested decision explaining how and on what market competition is affected or likely to be affected by the aid. The CFI continued by saying that “this absence of analysis is all the more striking”. Consequently, the contested decision did not explain how the aid in question meets three of the four conditions laid down in Article 87(1) ECT for a finding that that aid is incompatible with the common market.

In another more recent case, *Republic Italy v. Commission*, the fact that the undertaking operated in the common market and took part in trading was considered by the CFI not to be sufficient to determine a “distortion of competition” or “an effect on trade”. Rather, the CFI explicitly called for an analysis of the potential effects of funding in this case.⁵¹ The two more recent cases, *Le Levant v. Commission* and *Republic Italy v. Commission*, confirm and support the trend towards a more detailed and effects based examination of all the four criteria laid down in Article 87(1) ECT. It follows from these cases that the Commission needs to apply a refined economic approach in Article 87(1) ECT as well. Thus, in accordance with the effect based approach in antitrust and merger control the Commission needs to assess in a systematic way the economic effects of the two terms “distortion of competition” and “effect on trade”. If the Commission is not successful in proving the effects, a State aid in terms of Article 87(1) ECT might be denied.

⁵⁰ European Court of Justice, Case C-142/87, *Belgium v. Commission* (“Tubemeuse”), [1990] ECR I-959, para. 25; European Court of Justice, Case C-482/99, *France v. Commission*, [2002] ECR I-4397, para. 68; and European Court of Justice, Case C-280/00, *Altmark Trans and Regierungspräsidium Magdeburg*, [2003] ECR I-7747, para. 74.

⁵¹ Court of First Instance, Joined cases T-304/04 and T-316/04, *Republic Italy v. Commission*, [2006], para. 69.

IV. APPLICATION OF THE REFINED ECONOMIC ANALYSIS IN ARTICLE 87(1) EC TREATY

In accordance with the effects based approach in Article 81(1) ECT, the effects on competition and trade need to be examined in Article 87(1) ECT as well.

A. ASSESSMENT OF DISTORTIONS OF COMPETITION

Any analysis should start with a basic evaluation of the market facts. First, the relevant product and geographic markets should be defined and the market position of the undertakings should be assigned. The idea is that an aid for an undertaking with a high market share may lead to a substantial effect on competition. On the other hand, aid provided to undertakings with low market shares is not capable at all to distort competition. This principle would allow in accordance with Article 81(1) ECT the creation of "safe harbours". If the market share of the aid recipient is e.g. below 30 percent, it is not necessary to notify the State aid to the Commission. By means of self assessment, the State can measure itself whether the State aid granted is in coherence with the Treaty provisions. Another key element in the analysis is the assessment of the market failure. There are always reasons when markets do not work properly. The issue is to find out whether the State aid addresses the market failure identified accordingly and whether the State measure is appropriate to heal the market failure without distorting competition. The issue to address is the counterfactual. The following two questions may provide a useful framework for making this assessment. (1) Does the State aid restrict actual or potential competition that would have existed without the State aid? (2) Does the State aid restrict actual or potential competition that would have existed in the absence of the market failure? The result of such an analysis is a statement based on economic evidence whether a State measure causes distortions of competition in terms of Article 87(1) ECT. Any assessment of a distortion of competition would apply the criteria outlined below:

- Definition of the relevant product and geographic market;
- Identification of the market position and market circumstances;
- Identification of the market failure and the corresponding State aid;
- Measurement of the impact of the State aid on the market failure;
- Identification of distortions of competition.

B. ASSESSMENT OF EFFECTS ON TRADE

Pursuant to Article 87(1) ECT, State aid is not compatible with the common market as long as it affects trade between Member States. The criterion "effect on trade" provides a basis to define the relationship between European State Aid Control and the national law of the Member States. According to case law, the Commission has to set out the circumstances, in which the aid is threatening to

affect trade.⁵² However, in accordance with an effect based approach it would be necessary to prove substantially that trade is actually or potentially affected by a State measure.

V. CONCLUDING REMARKS

Economic analysis is playing an increasing role in State aid provisions. The refined economic approach is already implemented in Article 87(3) ECT. If a State measure distorts competition and affects trade, it is classified as a State aid in the sense of Article 87(1) ECT. A refined economic analysis under Article 87(1) ECT would shift the burden of proof. Member States could self assess whether the State aid is in accordance with Article 87(1) ECT or not. This shift of power to the Member States would induce a sharing of responsibility between the Commission and the Member States. The Commission trusted the undertakings that they will observe their responsibilities in Article 81(1) ECT, so why not trust the Member States? It is evident that the application of the refined economic approach to Article 87(1) ECT may cause a revolution but would be, on the other hand, coherent with the overall modernisation of the competition rules.

⁵² The European Court of Justice ruled in Case *Leeuwardener Papierwarenfabriek* that the European Commission had not sufficiently set out the affects on trade. See European Court of Justice, Case 296 and 318/82, *Netherlands v. Leeuwardener Papierwarenfabriek*, [1985], para. 24.