PUBLIC SUBSIDIES
A REPORT BY THE OFFICE OF FAIR TRADING

Contribution by the UNITED KINGDOM

Public subsidies

A report by the Office of Fair Trading

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EXECUTIVE SUMMARY

Overview

Each year the Government gives significant amounts of money in the form of subsidies to private business. Subsidies are an important policy tool for promoting business development, and addressing social issues and market failures. However, to date there has been little analytic work that considers the effects of such subsidies on competition. To address this question the OFT has undertaken economic research to highlight the situations in which subsidies are most likely to cause competition distortions. We have used the economic framework developed by this research to assess whether the current rules and guidance controlling subsidies effectively minimise the competition distortions that subsidies can cause.

We conclude that public subsidies have the potential to distort competition. While this is limited by the rules and guidance currently governing subsidy provision, there is still scope for distorting subsidies to be implemented. These could impose a cost to the economy and taxpayers that is not fully considered.

In this report we have highlighted the areas where we think improvements could be made to address this situation and made a number of broad recommendations directed at key areas. We now propose to carry out a second stage of research to examine how subsidies affect competition in practice, in order to develop more detailed recommendations.

Our research revealed that subsidies have considerable potential to distort competition because they alter not only the behaviour of the recipient firms, but also that of their competitors. The provision of subsidies may distort competition by:

- Causing firms to set output and pricing levels inefficiently,
- Keeping inefficient firms in the market, discouraging entry by efficient companies or encouraging entry by inefficient firms, and
- Distorting investment and research and development decisions.

Subsidies can be a very powerful policy tool that can be used to address market failures or achieve social objectives. It is for policymakers to decide whether, where and when to provide subsidies. However, it is important that the costs to the economy of distorting competition are fully recognised in assessing subsidies and that, where possible, these costs are minimised.

Rules and guidance exist, both at the European and at the national level, that limit the competition distortions that result from subsidies. Our assessment, however, is that
the current regime could go further to address the costs to competition associated with subsidies.

The European State Aid Rules ('European rules') are reviewed on an ongoing basis, and the UK Government has been pressing for the revised rules to have a more rigorous economic basis\(^1\). This position sits well with the analysis here, and we support these efforts.

There is also scope to improve national level guidance to ensure that suitable consideration is given to the potential costs to the economy due to competition distortions when subsidies are designed and provided. Consideration should be given to ways of improving appraisal and monitoring procedures to ensure that competition effects are included as one factor in the assessment of subsidies. The OFT proposes to use our second stage of work to provide advice to the government on how this could be achieved in practice.

The data currently collected on subsidies expenditure are collected for accounting and state aids monitoring purposes. The nature of these data makes it difficult to assess the likely scale of the problem in the UK. This is itself a problem, and consideration should be given as to how best to address it. Collecting and publishing better data on the amount given out in subsidies, the source, and the beneficiaries, would help improve the assessment of subsidy schemes and facilitate appropriate scrutiny of the use of taxpayers’ money.

**Subsidies in the UK**

At the simplest level, any intervention by government that provides assistance to a firm or group of firms is a subsidy. However, this is a very broad definition that would include government actions that would not be expected to affect competition, such as the provision of public education and general infrastructure. For the purposes of this report, we focus on interventions that assist some firms more than others.

A subsidy can take many forms, ranging from direct cash grants to tax breaks and loan guarantees. Many subsidies are state aids (SAs), and are subject to European rules, but there are also other types of subsidies that do not fulfil all of the criteria that define a SA and so fall outside the SA regime.

Public subsidies are provided by a range of bodies in the UK, including central government, devolved administrations, government agencies (particularly regional

\(^1\) The development of state aid policy is a reserved matter, i.e. policy is set UK wide by central government. The Department of Trade and Industry takes the lead in this area. Business support is a devolved matter so the devolved administrations develop their own policies and guidance in this area but may choose to use the same guidance as is used in other parts of the UK.
agencies) and local authorities. Subsidy schemes are often developed by one part of government and then administered by local bodies.

It is estimated that the UK spent over £6bn, or 0.59 per cent of GDP in 2003, on subsidies to private firms\(^2\). Although this is a significant figure, it is lower than many of our counterparts in Europe. There is no single definitive source of data about spending on subsidies to businesses in the UK. Because data are currently collected for accounting and state aids monitoring purposes, they do not present a clear view of the total amount of subsidy provided by the public sector to private business in the form of grants, low interest loans, benefits in kind and tax relief.

By collating and publishing more comprehensive data on the level and nature of subsidies, transparency over the use of public money could be improved. This would also make it easier to assess the impacts of subsidies on the economy generally and competition specifically. The OFT therefore recommends that central government and devolved administrations consider the case for collating and publishing more detailed data on the subsidies provided across the UK.

When do subsidies affect competition?

Competition is the process of rivalry between firms that helps markets to function effectively, by rewarding efficient firms that direct resources to the use most valued by consumers. If firms are not rewarded for making the right decisions, or are rewarded for making the wrong decisions, then resources are used inefficiently. This gives rise to a cost to the economy.

The OFT commissioned the economics consultancy Frontier Economics to examine how public subsidies could adversely affect competition in principle. Frontier Economics concluded that almost all subsidies have some impact on competition. The extent of this impact depends on two sets of factors: the characteristics of the subsidy and the characteristics of the market(s) in which the recipients operate.

The main characteristics of a subsidy that affect the size of the competition distortion are:

- the absolute size of the subsidy as well as its size relative to the costs of the activity being subsidised,
- the level of selectivity of the subsidy, i.e. whether it is provided to one, some or all firms in a market,
- whether the subsidy affects the recipient’s costs directly, and

\(^2\) Estimate based on Public Expenditure figures gathered by HM Treasury.
whether the subsidy is provided on a recurring basis.

In terms of market characteristics, distortions are most likely to be significant if:

- the market is concentrated, i.e. if there are relatively few firms operating in the market affected by the subsidy,
- there is a high level of product differentiation,
- the firms in the market are of markedly different sizes,
- there are barriers to entry, or
- firms in the market compete on research and development.

**How do existing rules address the risk of subsidies distorting competition?**

**THE EUROPEAN STATE AIDS REGIME**

The European rules and guidelines on SA ('the European rules'), enforced by the European Commission ('the Commission'), are the main constraint on subsidies. They have a significant effect in limiting distorting subsidies, but there are still gaps that may allow distortions to occur. The Directorate General of Economic and Financial Affairs has recently launched a study into the impact of state aids on competition, which demonstrates that there is currently interest within the Commission in examining this area.

The Treaty of Rome starts from the premise that SAs distort competition, and places a ban on them. However, it makes exceptions for SAs that target a number of social and economic objectives that are considered to be compatible with the Common Market. For example, it permits SAs that put right the damage caused by natural disasters.

The Treaty also states that aid may be allowed for certain economic objectives, for example to promote certain economic or cultural activities or to promote growth in particular regions. There are block exemptions for certain types of aid, for example aid to small and medium-sized enterprises. Aid meeting the conditions laid out in the block exemption regulations is not subjected to any further analysis on whether it might distort competition. For other types of SA, e.g. to promote R&D or address regional

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4 Article 87 (2) EC

5 Article 87 (3) EC
imbalances, there are published guidelines that set out the criteria the aid should meet. The Commission may also assess compatibility with the Common Market directly where no regulations or guidelines apply.

The European rules address a number of the factors we have identified as being a source of competition distortion. For example, they set more conditions on subsidies that are more likely to affect firms’ costs directly, and therefore their behaviour in the market.

However, there are other factors that are not fully recognised. The market characteristics and position of recipients in that market have been identified in our analysis as important factors in determining the existence and size of the competition distortion. The European rules do not, for example, address the effects that similar subsidies can have on different types of firm, nor do they in all cases require policymakers to look at the characteristics of the markets affected by subsidy. This means that distorting subsidies could be allowed by the SA regime.

The European rules are reviewed on an ongoing basis, and are currently being revised in pursuit of the European Commission’s stated aim of ‘less and better state aid’, as set out in a speech by the former Commissioner of DG Competition, Mario Monti, earlier this year⁶. The European state aid rules should be improved to take better account of the potential for competition distortions to arise. We support the current review insofar as this results in guidelines that have a more rigorous economic basis.

We urge the UK Government to continue to engage in the European debate to make the case for changes to the rules to further reduce the potential for subsidies to distort competition.

GOVERNMENT ACTION IN THE UK

The gaps that we have identified in the SA regime could potentially be addressed by action at the national level, though action at the EC level would usually be the best course for addressing subsidies where products are traded in international markets. However, current rules and guidance fall short of this and could let through distorting subsidies without adequate recognition of the costs of competition distortions.

In the UK, subsidies are provided by the central government, devolved administrations, government agencies and local authorities. Most bodies develop their subsidies independently using the guidance for policy appraisal issued by HM Treasury, known as the 'Green Book', or the Scottish Public Finance Manual, which follow the same

approach to appraisal. This guidance sets out the criteria and methods to be used to assess the proposed subsidies, including the costs and benefits that should be considered. Public bodies also apply their own sets of guidance, where such exist.

In general, the available guidance does not adequately cover the adverse competition effects subsidies can generate. Thus, where there are gaps in the European rules that allow distorting subsidies to be implemented without appropriate consideration of their competition costs, these are not generally addressed in a systematic manner at the national level.

Therefore, the OFT recommends that consideration should be given to ways of supplementing policy appraisal guidance to ensure that competition considerations are included as one of the factors to be taken into account when designing a subsidy. The supplementary appraisal guidance could involve a 'competition filter', as is the case already in the Regulatory Impact Assessment process. The filter could set certain thresholds below which no further competition analysis is required. This would have the advantage of focusing resources on the subsidies that have the biggest potential to cause competition distortions.

The competition impact associated with a scheme or a particular subsidy may sometimes only be identified once the subsidy has been given. This could be picked up through regular monitoring of existing subsidies. However, current monitoring arrangements focus on how effective the scheme has been in achieving its main objectives and whether it has proved to be 'value for money' and, as with appraisal, the relevant monitoring guidance makes no mention of the need to consider the competition effects of the schemes.

The OFT therefore recommends that, once appraisal guidance has been supplemented, all subsidy providers should ensure that monitoring procedures assess the impact of the subsidy on competition as well as its effectiveness and value for money.

Next steps

This report sets out our findings that, despite the rules and guidance controlling them, subsidies can still in principle distort competition. We now need to carry out empirical research in order to test our findings in practice, and identify the changes to the current rules and guidance that might help reduce competition distortions. Therefore, we propose to undertake a second stage of research that examines how subsidies can affect competition in practice, and develops the broad recommendations contained in

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7 A subsidy scheme is a fund of money that is disbursed in a number of payments to different firms according the set criteria. A subsidy payment is an individual payment to a firm.
this report in a detailed and proportionate manner. We seek the support of central government and devolved administrations in this work.

Empirical work would test the extent to which our theoretical findings are borne out in practice. We intend that the empirical work will take the form of case studies into a diverse range of subsidies, including examples of best practice. Depending on suitable candidates being available we would examine subsidies of different magnitude and selectivity to firms with different levels of market power. This would enable us to understand the extent to which the characteristics identified through our research affect markets in practice. We would welcome views from subsidy providers and other stakeholders on suitable examples for study.

In this report we have made broad recommendations, targeting the areas in which we think the rules and guidance could be improved. We would aim to use the results of our case studies to assist with the development of more specific recommendations as to how competition distortions arising from subsidies can be appraised and addressed. Most importantly, recommendations can be made that are proportionate to the scale of the problem.
## CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Introduction</td>
<td>10</td>
</tr>
<tr>
<td>2 Subsidies in the UK</td>
<td>3</td>
</tr>
<tr>
<td>3 The effect of subsidies on competition</td>
<td>14</td>
</tr>
<tr>
<td>4 European state aid rules</td>
<td>31</td>
</tr>
<tr>
<td>5 Control of subsidies in the UK</td>
<td>46</td>
</tr>
<tr>
<td>6 Further work</td>
<td>63</td>
</tr>
</tbody>
</table>

### Annexe

- A List of consulted parties
- B European state aid rules
- C Frontier Economics: a report on the competition effects of subsidies
1 INTRODUCTION

1.1 This study set out to determine whether public subsidies could, in principle, be distorting competition in the UK. It applies economic research to the current rules and guidance controlling subsidies to assess whether these minimise effectively the risk of competition distortions arising from subsidies. We have found that, although the existing rules and guidance governing subsidy provision limited the distortion, there is still scope for highly distorting subsidies to be implemented. In this report we highlight a number of areas in which we think changes could be made to improve subsidy provision. We propose to undertake a second stage of research that uses case studies to examine how subsidies can affect competition in practice, and develops the broad recommendations in this report in a detailed and proportionate manner.

1.2 Any intervention by government that provides assistance to a firm or group of firms could constitute a subsidy. For the purposes of our report we have focussed on government interventions that assist some firms more than others, because these would be expected to have an impact on competition in the market in which they are deployed. As the UK spent over £6bn on subsidies to private firms in 2002, there is a clear possibility that subsidies could be having a significant effect on competition in various markets in the UK.

1.3 With support from Frontier Economics, we investigated how public subsidies affect markets and the circumstances in which subsidies are most likely to have significant adverse impacts on competition.

1.4 We examined the existing rules and guidelines for subsidies, both those at European level and those set by UK bodies, to assess whether these limit the use of subsidies of the sort that are most likely to cause competition distortions.

1.5 We make broad recommendations aimed at improving the existing rules in order to reduce the competition distortions that subsidies can create. We propose to undertake further work to gather detailed supporting evidence from case studies and develop these recommendations.

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Estimate based on Public Expenditure Survey figures gathered by HM Treasury, covering subsidies provided by government departments and agencies in England, Northern Ireland, Scotland and Wales. Data on subsidies are discussed in detail in Chapter 2 of this report.
1.6 This investigation, by the Markets and Policy Initiatives (MPI) division of the Office of Fair Trading (OFT), is part of a wider theme of considering the effects of Government interventions on the operations of markets. Other reports on this theme include an OFT study into public procurement published in September 2004. See http://www.oft.gov.uk/Business/Market+studies/procurement.htm
2 SUBSIDIES IN THE UK

This report looks at the impact of public subsidies on competition. We have focussed on government interventions that assist some firms more than others, although any intervention by government that provides assistance to a firm or group of firms could constitute a subsidy.

We recognise that subsidies are an important policy tool, and may have benefits in certain circumstances, for example by addressing market failures, or encouraging economic growth and employment. However, they also generate a cost by causing competition distortions. This creates a cost both to the taxpayer, and to the economy.

In the UK, subsidies are provided by a wide range of public bodies. There is no single, definitive source of data about spending on subsidies to businesses in the UK. It is estimated that the UK spends over £6bn per year on subsidies to private firms. Because data are currently collected for accounting and state aids monitoring purposes they do not present a clear view of how much money is provided by the public sector to private business in the form of grants, low interest loans, benefits in kind and tax relief.

By collating and publishing more comprehensive data on the level and nature of subsidies, transparency over the use of public money could be improved. This would also make it easier to assess the impacts of subsidies on the economy generally and competition specifically. The OFT therefore recommends that central government and devolved administrations consider the case for collating and publishing more detailed data on the subsidies provided across the UK.

Introduction

2.1 There is no generally accepted definition of a public subsidy. In this chapter we describe the range of government interventions that could be considered to be subsidies and set out the subsidies we focus on. We then give a broad description of the provision of subsidies in the UK and recommend that improvements are made to data collection on subsidies. The order of the chapter is as follows:

- What is a subsidy?
What is a subsidy?

2.2 In the broadest sense, any intervention by government that provides assistance to a firm or group of firms would constitute a subsidy. For the purposes of our report we have focused on government interventions that assist some firms more than others, as these might be expected to affect competition. This means that that the intervention must either be available only to a selection of firms, or must affect recipients’ competitiveness in different ways. This focus excludes certain government actions, such as the provision of public education, general infrastructure and health care which we would not expect to affect competition at all, as discussed in more detail in chapter 3.10.

2.3 The following forms of subsidies fall within our focus:

- **Cash grants** – direct payments to producers
- **Credit** – government guarantees or low interest government loans
- **Tax** – reduction of specific tax liability, such as tax credits
- **Equity** – public sector equity participation, such as where the public sector buys significant amounts of a new share issue
- **In-kind subsidies** – government provision of goods and services at below-market prices, such as free advice
- **Cross subsidy** – public bodies using government funds to support their activities in commercial markets, and

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10 Regulations that alter the costs incurred by businesses could also be considered to be subsidies. We do not examine these in this report as the OFT regularly undertakes studies into the competition effects of specific regulations.
• **Procurement** – government purchases of goods and services at above-market price.

2.4 Throughout this report, we use the terms 'payments', 'subsidies' and 'interventions' interchangeably to refer to public subsidies.

**Scope of this report**

2.5 This report examines how subsidies can affect competition in principle, and the extent to which existing rules work to minimise adverse competition effects. The report does not examine the justification for subsidies; that is, it does not examine the basic case for the subsidy.

2.6 Subsidies can have a range of purposes. They can be used to address market failures and encourage economic growth and employment, or as a means of redistributing money from one sector of the economy to another. As the rationale underlying the decision to provide subsidies to firms is a policy judgement for government, we do not consider this aspect here. Instead, we consider the potential for subsidies to have an adverse effect on competition, and whether this is recognised sufficiently in their design and implementation.

2.7 Our analysis considers the general effects of subsidies on markets rather than assessing effects on specific sectors. A number of sectors have particular rules and policy issues. For example, many subsidies to agriculture are administered under the Common Agricultural Policy (CAP). Similarly, there are specific rules and policy issues for broadcasting, transport, defence and health. We have not examined the rules and practices in these sectors. However, our analysis of the principles of how subsidies affect competition will equally apply to these sectors.

2.8 A large number of the subsidies provided in the UK are subject to European rules because they are considered to have potential to affect trade between Member States. These subsidies, called 'state aids', are considered within the scope of our study.
Who provides subsidies in the UK?

2.9 Subsidies are distributed by bodies at all levels of government in the UK, including central government, regional agencies responsible for economic development, and third parties contracted to run subsidy schemes\(^{11}\). Most support to industry is a devolved matter, so arrangements differ slightly between Scotland, England, Northern Ireland and Wales\(^{12}\). Figure 2.1 shows the arrangements for disbursing subsidies down to regional level in England, and Figure 2.2 shows the situation in the devolved administrations of Scotland, Wales and Northern Ireland. The various approaches to subsidies taken by the four nations are discussed in chapter 5.

2.10 Local authorities (LAs), which are represented in Figure 2.1, have powers to carry out discretionary services to meet social, environmental and other objectives. This means that LAs may support business or establish a trading company of their own which performs commercial functions. For example, a LA might form a joint venture with a local university to create and support new business.

\(^{11}\) A subsidy scheme is a fund of money that is disbursed in a number of payments to different firms according to set criteria. A subsidy payment is an individual payment to a firm.

\(^{12}\) In this report, unless otherwise specified, 'Government' refers to central government and devolved administrations and 'government departments' refer to departments of central government and devolved administrations. 'UK Government' is used in reference to reserved areas.
FIGURE 2.1 – SUBSIDY ADMINISTERING BODIES IN ENGLAND

Central government departments

Department of the Environment, Food and Rural Affairs
Department of Culture, Media and Sport
Office of the Deputy Prime Minister
Department for Transport
Department for Education and Skills
Department of Work and Pensions
Department of Trade and Industry

Regional Development Agencies

One North East
North West
Yorkshire Forward
East Midlands
East of England
South East of England
London

Advantage West Midlands

Third party scheme administrators

Local authorities in England

Business

FIGURE 2.2 – SUBSIDY ADMINISTERING BODIES IN THE DEVOLVED ADMINISTRATIONS

Departments of the Scottish Executive
Scottish Enterprise
Highlands and Islands Enterprise
Local enterprise companies

Local authorities in Scotland

Business

Departments of the Welsh Assembly Government
Welsh Development Agency
Local authorities in Wales

Business

Departments of the Northern Ireland Executive
Invest Northern Ireland
Enterprise Northern Ireland
Enterprise Northern Ireland Agencies

Local authorities in Northern Ireland

Business

Source: Office of Fair Trading
UK expenditure on subsidies

2.11 There is no single, definitive source of data about spending on subsidies to businesses in the UK. It is estimated that the UK spent over £6bn or 0.59 per cent of GDP on subsidies to private firms in 2003. Because data are currently collected for accounting and state aids monitoring purposes, they do not present a clear view of how much money is provided by the public sector to private business in the form of grants, low interest loans, benefits in kind and tax relief.

2.12 In its annual Public Expenditure Statistical Analysis, HM Treasury identifies subsidies as ‘unrequited current transfers to market units’. The value of these transfers was £8.2bn in 2003. This figure includes transfers to public bodies (£2.1bn), subsidies for public transport infrastructure and revenue support, and Strategic Rail Authority devolved expenditure (all of which sum to £2.5bn) and transfers through CAP (£2.3bn). However, this figure does not include capital grants, certain types of quasi-equity, loan guarantees and tax relief unless this is classified as public expenditure, as these are accounted for in other ways. It also does not include subsidy payments by local authorities.

2.13 The total figure for the amount of subsidy that meets the European state aid criteria was £2.8bn in 2002. Whilst not all the subsidies we are interested in are state aids, the data gathered from notification of such aid to the European Commission (the Commission) gives some detail on the use of subsidies in the UK (see paragraphs 2.16 to 2.22).

2.14 By collating and publishing more comprehensive data on the level of subsidies, transparency over the use of public money could be improved. This would facilitate greater understanding of the use of taxpayers’ money in direct support to business.

2.15 Developing a more detailed picture of subsidies in the UK would enable greater analysis to be undertaken of the effects of subsidies on the UK economy. As such it would also be easier to assess the competition effects of subsidies at the national level. **The OFT therefore recommends that central government and**

14 An explanation of the European state aids rules is provided in Chapter 4.
15 DTI State Aid Policy Unit return to the Commission.
devolved administrations consider the case for collating and publishing more detailed data on the subsidies provided across the UK.

DATA ON STATE AIDS

2.16 A limited picture of subsidies in the UK can be produced using the information collected on state aids, which as mentioned above totalled £2.8bn in 2002. This sum is made up of all the UK subsidies that meet the state aid criteria and are therefore notified to the Commission, with the exception of payments of less than £60,000.

2.17 In the UK, the Department of Trade and Industry (DTI) State Aid Policy Unit (SAPU) acts a gatekeeper for notification to the European Commission, and collects information on state aid notifications which it provides to the Commission in an annual return\(^{16}\). Because the data are collected for notifications purposes, there is limited information about which firms receive the aid (in the case of aids provided through schemes), whether the recipient has received aid previously and the market in which the recipient operates. The data do however reveal which objective the aid is pursuing, and how the aid is delivered (the aid instrument), since these criteria are reflected in the European rules on state aids.

2.18 As indicated above, the UK notifications to the Commission in 2002 amounted to £2.8bn (or 0.26 per cent of GDP). This includes grants to Railtrack and Network Rail (£549m), and unusual payments of £492m made to British Energy. We have excluded these payments from the analysis below, as their large size means that they unduly distort the figures, and make it more difficult to assess how the UK normally uses state aids.

2.19 Figures 2.3 and 2.4 provide a breakdown of the UK notifications data. In terms of the stated objectives of the schemes, most money goes to transport, R&D and regional objectives (73 per cent in total). The latter category is, however, too broadly defined to allow us to say which markets are affected by the aid.

2.20 The majority of aid is given as a grant (70 per cent), with other significant categories being tax credits and advice.

\(^{16}\) See Annexe B for a description of the EC rules, and Chapter 4 for a discussion of how these rules are implemented.
FIGURE 2.3 – UK STATE AID BY PRIMARY OBJECTIVE

Transport 27.2%
R&D 25.7%
Regional aid 21.0%
SME 14.5%
Sectoral 6.7%

Employment 2.1%
Training 1.6%
Environment 1.2%
Rescue and Restructure* 0.0%

* Rescue and Restructure excludes the payments made to British Energy, Railtrack and Network Rail

Source: OFT analysis of DTI state aid returns, 2002
INTERNATIONAL COMPARISONS

2.21 The UK spends relatively less money on state aids than other European Member States. Figure 2.5 below shows that, as a percentage of GDP, the UK is amongst the lowest providers of state aid in the European Union (EU).

Source: OFT analysis of DTI state aid returns, 2002
The trend in the UK and the EU as a whole has been for reductions in the proportion of GDP spent on state aid, although the reduction has tailed off more recently, as Figure 2.6 shows. The data also confirm that the UK has spent proportionately less than the EU average on state aid in recent years.
FIGURE 2.6 – UK AND EU STATE AID EXPENDITURE, 1992-2002

Source: EU State Aid Scoreboard Spring 2004
3 THE EFFECT OF SUBSIDIES ON COMPETITION

In principle, subsidies can distort markets by changing the behaviour of the firm receiving the subsidy and the behaviour of its competitors. These changes can mean that efficient companies are not suitably rewarded, entry by new firms and exit by inefficient firms is curtailed, and decisions to invest for the future are distorted. The research by Frontier Economics develops a framework for determining the likely competition effects of subsidies. This research is the basis for this chapter.

Almost all subsidies can cause some sort of competition distortion. The extent of this distortion will, however, depend on the design of the subsidy and the characteristics of the market. Subsidies that are large, provided only to selected firms and provided on a recurring basis are more likely to generate large distortions. Subsidies provided to firms that have market power are also likely to generate substantial distortions.

By recognising these facts and addressing them in subsidy design, subsidy providers can reduce the extent to which subsidies cause distortions.

Introduction

3.1 This chapter examines how subsidies affect competition. It is based on the analysis undertaken by Frontier Economics (Annexe C).

3.2 It explains what is meant by distortion to competition, the way in which subsidies can distort competition and why this is a problem. Lastly, it looks at the circumstances that are likely to give rise to greater levels of distortion to competition, and the ways that subsidies can be designed to reduce these effects.

What do we mean by 'competition distortion'?

3.3 Competition refers to the process of rivalry between firms in a market. Firms compete to attract customers by offering lower prices, higher quality of products or services, or innovative products and services. When competition is working effectively, the market will send clear messages to firms (for example,
in the form of the prices they can charge and the profits they can earn) about which goods and services consumers want to buy. Efficient firms offering the products consumers want at low prices will prosper and inefficient ones will not.

3.4 A competition distortion arises when the process of rivalry between firms is disturbed, and firms no longer receive accurate messages from the market. For example, subsidies can reduce a firm's costs, or increase its revenues. These effects insulate the firm, to some degree, from the need to keep costs low and compete effectively for customers in order to stay profitable. If subsidies are available only to some firms, or help some firms more than others, the overall effect may be that inefficient firms prosper and efficient firms suffer. Both will make consumers worse off. This is what we mean by a distortion to competition.

3.5 When examining competition distortions we need to define the market in which the distortion arises. In the case of subsidies this may be the market for the subsidised product or for a related product. Markets can be local, regional, national or international in geographical scope. This chapter considers the impacts on markets, regardless of their geographical definition.

How can subsidies distort competition?

3.6 The competition distortions caused by subsidies arise because the subsidised firm is prompted to change its behaviour. Because subsidies alter costs and revenues, they change the level of profits the firm makes from various activities. In response, the firm may adjust its level of output, change price, or alter levels of research and development (R&D), thus altering the process and outcome of rivalry with its competitors. At the extreme, an efficient competitor might leave (or never enter) the market if it is unable to compete with a less efficient firm that is receiving a subsidy.

3.7 By altering the process and outcome of rivalry in the market, a subsidy will lead to inefficiencies. These arise because the subsidy interferes with the process through which consumers tell firms what they want to buy and what price they

17 See Market Definition OFT 403 (1999), available on the OFT website: http://www.oft.gov.uk
are prepared to pay, for example by artificially reducing prices and so hiding the true cost of the product.

3.8 There are three consequences of competition distortions which would be detrimental to consumers and the wider economy:

- **Allocative inefficiency**: the subsidy could draw resources into less valuable uses. When competition is working effectively, the market will send clear messages to firms (for example, in the form of the prices they can charge and the profits they can earn) about what goods consumers want to buy. If the subsidy prompts the firm to lower its price, the messages sent by the market would be distorted, with more resources used for the subsidised activity. The result could be that resources are allocated to the wrong activities.

- **Productive inefficiency**: the subsidy could also result in less efficient production of goods. This could occur for a number of reasons including the reduction of downward pressure on costs, the ability of subsidised inefficient firms to gain market share at the expense of more efficient rivals and the discouragement of entry by efficient firms, and

- **Dynamic inefficiency**: finally, a subsidy which alters the profitability of investment may cause the firm to invest either too much or too little, and may alter the type of investment the firm undertakes. This could mean that, over time, the firm carries out the wrong types of innovation.

3.9 It could be argued that consumers benefit from subsidies, as the short term effect of a subsidy may be to reduce prices. However, in the long term, if the subsidy distorts competition the inefficiencies thus created can actually make consumers worse off. The mix of products in the economy, the cost of production, and the degree of innovation can all be changed for the worse as a result of a competition distortion arising from a subsidy. In such a case, as the subsidy erodes the efficiency of the market through these three effects, prices
will gradually rise again unless the subsidy continues and increases\textsuperscript{18}. Taxpayers meet this cost of paying for subsidies\textsuperscript{19}.

3.10 A further problem may occur if, instead of competing for the profits gained by attracting consumers through offering the best product, firms devote time and effort to competing for the profits gained by lobbying government for bigger subsidies. This is called 'rent seeking' behaviour, and the effect is that firms spend less of their effort on competing on the merits of their product, to the detriment of consumers.

3.11 Subsidies can distort competition in related markets as well as the market for the subsidised product. This can arise if there are long term agreements between suppliers and their customers and one of the firms receives a subsidy, some of the benefit of which is passed on. The supplier of a product that is consumed with the subsidised product may also benefit from the subsidy. For example, a subsidy to develop computer software may increase the sales of the computer hardware on which the software runs.

THE EFFECT ON FIRM BEHAVIOUR

3.12 We now consider the ways in which firms’ behaviour could change in response to a subsidy. The discussion covers three major decisions which face firms:

- Whether to enter or exit a market,
- What price to charge for its product, and how much to produce, and
- How much to spend on investment, in particular on R&D.

3.13 For simplicity, the analysis in this chapter assumes that the subsidy is available to only one firm in each market. The same analysis will apply if not all firms are subsidised, or if a subsidy is more valuable to some of the competing firms

\textsuperscript{18} Prices could rise after the subsidy has ended because, as production with the subsidy has become less efficient, more resources will have been required to produce the product or service and consumers will need to meet the full cost of these resources.

\textsuperscript{19} The process of taxation also distorts markets. For example, people’s incentives to work may be affected by income tax. The distorting effect of taxation is outside the scope of this report.
than to others. If a subsidy is available to all firms, and affects them all equally, we would not expect the subsidy to have an impact on competition.

Entry and exit decisions

3.14 Subsidies can enable an inefficient firm to enter a market or remain in a market where it is making losses. This reduces the overall level of efficiency in the market and also disadvantages efficient competitors that do not receive subsidies.

3.15 When a firm is deciding whether or not to enter a market, it is usually concerned with how much profit it could make if it entered. If it thinks it would not make enough profit, it will not enter. By altering costs or revenues, subsidies alter profitability, and can therefore affect the firm’s entry decision. For example, a subsidy that reduces the initial cost associated with entering the market (such as building a factory, or investing in advertising to create a brand) will make the firm more likely to enter. Similarly, a subsidy that would reduce the ongoing costs of production (such as training for staff) would also make entry more appealing. These types of subsidy could enable firms with otherwise poor commercial prospects to enter a market.

3.16 In deciding whether to enter, the firm will also look ahead to what would happen if, once in the market, it fails to make enough profit. If there is no subsidy available the firm knows that it will incur high costs if it fails and has to exit, so it would be more cautious about entry in the first place. The availability of a subsidy reduces this risk and increases entry of both efficient and inefficient firms.

3.17 The availability of a subsidy will also affect a firm’s decision to leave a market where it is already operating. If a firm is making a loss, it will consider whether it would be financially better to stay and battle on, or cut its losses and exit. This decision will partly depend on the extent of the losses it is suffering. A subsidy would reduce the size of its losses and enable it to stay in the market for longer – which may mean that other, more efficient firms that do not get a subsidy would be forced to exit instead.

3.18 The changes in firm behaviour described above distort competition and have an adverse impact on the efficiency of the market. Instead of allowing the market to reward the most efficient firms, subsidies can reward the selected recipient(s) to the detriment of others.
3.19 Subsidies can affect a firm’s pricing decisions by changing its costs or its revenues. In order to compete, rivals may have to change their prices and earn lower profits as a consequence.

3.20 There are two types of costs that a firm incurs in supplying a product:

- **Variable costs** are those which vary with output. For example, a publisher will use more paper and ink for every book produced, and
- **Fixed costs** are those which do not vary with output. For example, a publisher must have a printing press whether one book or ten are being printed.

3.21 A subsidy is most likely to affect the pricing and output decisions of a firm if it affects its variable costs, such as labour. For example, a training subsidy might improve the efficiency of the firm’s labour force, reducing the amount of labour needed per unit produced. Because the firm’s costs on each unit produced are lower, it is able to reduce its price to attract more custom. This would have a knock-on effect on its rivals, who must also meet the price cut or lose market share.

3.22 By contrast, a subsidy that affects fixed costs will not directly affect a firm’s pricing and output decision. This is because these costs are incurred no matter what the price or output levels, so it will have no effect on the choice the firm makes. For example, consider a subsidy for building a new factory. Once the factory is built, the subsidy will not change the costs or revenues from selling an additional unit, so it will not directly affect the firm’s choice of price and output levels.

3.23 In practice, however, it may be difficult to identify whether a subsidy will affect fixed or variable costs. For example, a subsidy to invest in new machinery will reduce the fixed costs to the firm of purchasing that machinery, but if the subsidy also enables the firm to upgrade its choice of machine, it may obtain a more efficient machine, thus also reducing its variable costs.

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20 This is a simplified example. The distinction between variable and fixed cost is less clear cut in reality, and depends on the time frame being considered. For example, over time the publisher might be able to buy or rent additional printing presses, to increase production of a successful book. Then the cost of printing presses would be linked to output.
3.24 A subsidy that enables the recipient to reduce prices or increase output could also affect the entry and exit decisions of other firms. A firm considering entering a market may look at the prices of existing firms, to help it decide whether it would make a profit if it entered. If the existing firms receive subsidies and have been able to reduce prices, the new firm may conclude that it is not able to compete and therefore will not enter the market. Similarly, an existing competitor that does not get a subsidy may not be able to compete in the long term, so may choose to exit the market.

*Research and development investment decisions*

3.25 A subsidy can also affect the investment decisions of firms concerning R&D and product quality. It can do this in two ways: it can make R&D cheaper, in which case more of it is likely to be undertaken; and it can change the type of investment undertaken, by targeting certain types of research or certain products.

3.26 Subsidies for R&D that are given to a single firm or a selection of competing firms may distort competition directly or indirectly. The direct effects on competition will be felt through the results of the R&D. The innovations resulting from R&D fall into two categories:

- **Process innovation** – an innovation which improves the production process, and
- **Product innovation** – an innovation which improves the quality of a product, or results in an entirely new product.

3.27 A successful process innovation will reduce the firm's fixed or variable costs of production, which may affect pricing and entry/exit decisions as set out above.

3.28 The effect of a successful product innovation will depend on whether the innovation improves an existing product, or creates an entirely new product. If an existing product is improved, the firm will gain an advantage over its rivals by being able to offer a better quality product. The subsidised firm would then be able to attract relatively more custom than its unsubsidised rivals, a so-called 'business stealing' effect. The rival firms, which have not been subsidised and so may not have improved their products, will be placed at a competitive disadvantage.

3.29 By contrast, an R&D subsidy which results in an entirely new product will create a new market, so will not affect competition in existing markets. It may,
however, give the subsidised firm the advantage of being the first to market the new product. This ‘first mover’ advantage could raise barriers to entry for other firms, for example if the new product involves building a network or relies heavily on branding.

3.30 These effects may damage consumers’ interests in the longer term, because the effects of the advantages conferred on the subsidised firm may mean it faces less competitive pressure in the future.

3.31 R&D subsidies can also have an indirect effect on competition by changing the incentives of rival, unsubsidised firms to invest in R&D. Depending on the circumstances in the market, rivals may increase their own efforts in order to catch up, or may be discouraged from further investment. Which of these actually happens will depend on a range of factors, including the type of R&D (process or product innovation), the R&D process (for example, whether it is a ‘winner takes all’ or incremental process), and the size of the existing technology gap between the firms in the market.

Under what circumstances will subsidies cause most distortion?

3.32 As discussed above, subsidies will almost always distort competition. However, the extent of the distortion can vary depending on the characteristics of the subsidy and of the market.

3.33 The subsidy characteristics that affect the size of the distortion are:

- Selectivity and asymmetry of subsidy,
- Magnitude of subsidy,
- Whether a subsidy is provided more than once, and
- The effect of the subsidy on costs.

3.34 The relevant market characteristics are:

- Structure of the market, including
  - The concentration of the market,
  - Product differentiation in the market, and
Difference in size of firms in the market

- Importance of R&D in the market, and

- Barriers to entry in the market.

3.35 We now discuss each of these in turn, beginning with the characteristics of the subsidy.

SELECTIVITY AND ASYMMETRY OF SUBSIDY

3.36 Subsidies have the potential to cause a competition distortion if they give a competitive advantage to some firms in a market, relative to their competitors. This is likely to happen if the subsidy is:

- Selective in eligibility criteria, i.e. not available to all competing firms, or

- Asymmetric in effect, i.e. has a bigger effect on some firms than others.

3.37 A subsidy may be selective because it is only available to a subset of competing firms, or because the amount given to each firm varies. In the latter case, those firms that receive a bigger subsidy will have greater scope to change their behaviour relative to the others.

3.38 A subsidy may be asymmetric in effect even if it is not selective in terms of its eligibility criteria. For example, a subsidy which is available to firms in a market in a particular region may be asymmetric, because it will only affect firms that have yet to decide where to locate, or those that can move relatively low cost. A subsidy for a particular type of technology may also be asymmetric in effect, as firms which have already invested in the technology will not benefit. Finally, a subsidy could be asymmetric in effect if it favours a particular business model. For example, a subsidy for training could assist a firm with a labour intensive production process more than a competitor with a more automated process.

MAGNITUDE OF SUBSIDY

3.39 A large subsidy will impact on the behaviour of the recipient and its competitors more than a smaller subsidy of the same type. The absolute magnitude of the subsidy (i.e. its monetary value) will be relevant when thinking about the likely scale of the consequent impact on competition. For
example, a subsidy of £1m to a particular firm is clearly likely to have a bigger impact on competition than a subsidy of £100,000 to the same firm.

3.40 The magnitude of the subsidy should also be considered relative to the cost of the subsidised activity. Broadly, the larger the subsidy relative to the costs of the targeted activity, the larger the competition impact is likely to be. For example, a subsidy of £100,000 to a firm with costs of £2m will have much less effect on behaviour than the same subsidy to a firm with costs of £500,000.

3.41 Subsidies affect competition by altering the firm’s decisions on price and output, entry and exit, and R&D. Price and output will consequently be more affected the greater the size of the subsidy relative to the variable costs of the activity, as will entry and exit. A subsidy to R&D will have a competition impact if it is large enough to make the firm undertake investment it would not otherwise have undertaken.

REPEATED SUBSIDY

3.42 In general terms, repeated subsidies are likely to be more harmful to competition than a one-off payment, as any problems caused by the one-off intervention will be repeated. For example, if a subsidy that reduces the firm’s price is repeated over an extended period of time, the firm’s unsubsidised rivals will have reduced profits for a longer period, and are more likely to exit. A repeated subsidy is also more likely to keep an inefficient firm in the market for longer21.

3.43 Depending on the purpose of the subsidy, payments of the same value but different structure could have different effects on competition. The structure of payments matters when firms’ costs are not evenly spread, making the timing of the subsidy significant22. For example, entry often requires a large initial investment, so a front-loaded payment may encourage more entry than a smoother stream of payments. The same logic may apply to R&D, which also

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21 Subsidies that are provided in staged payments differ from repeated subsidies as the full effects of the former could be considered at the time the subsidy is provided, whereas the effect of providing similar support in the future to a firm is unlikely to be considered.

22 This section assumes that there is some imperfection in the financial markets, so that firms cannot get credit to cover costs in periods of low revenue.
often has a big initial cost. By contrast, a steady stream of payments is more likely to prevent exit.

EFFECT OF SUBSIDY ON COSTS

3.44 A subsidy for a specific activity will often have a smaller effect on markets than a subsidy of the same value that the firm can use as it wants.

3.45 A subsidy will affect competition through changing the recipient’s costs of production, or costs of entry or exit, which then affect its behaviour and that of its competitors (as discussed in paragraphs 3.12 to 3.31). If a subsidy is targeted on a particular activity, its effect on the recipient’s costs may not be as large as a direct subsidy to costs, and so the resulting change in the recipient’s behaviour will be smaller. The reason for this is that when the recipient identifies the purpose of the subsidy, it will be used in the area of greatest competitive benefit, whereas a targeted subsidy may not be eligible for this use.

3.46 For example, a subsidy of £10,000 that must be used for training will affect a firm’s costs, but it will not have as large an effect as tax relief worth £10,000, for which the firm would have discretion to target the funds wherever it feels they would be most effective.

3.47 With a subsidy for a specific activity it may be difficult to anticipate the extent to which it affects fixed or variable costs, and therefore it may be more difficult to assess how significant the effect on competition might be. Business advice could have very little impact on a firm’s costs, or it could prompt significant changes in an organisation that affect its competitiveness.

3.48 It may also be easier to consider whether there will be impacts on related markets when a subsidy is provided for a specific activity. If it is known that the subsidy will prompt the recipient to use more of a certain input, e.g. a specific environmental technology, then the impact on that input market can be considered.

23 The firm may use the tax relief for the same training purposes, or may simply pass the funds onto shareholders.

24 A subsidy of this sort would be highly effective and competition distortions within the market would be insignificant if business advice was offered to all firms in the market.
3.49 We now turn to the characteristics of the market or markets targeted by the subsidy.

STRUCTURE OF THE MARKET

3.50 There are three aspects of market structure that are significant in this context:

- Market concentration,
- Product differentiation, and
- Asymmetric firm size.

*Market concentration*

3.51 The more concentrated the market, i.e. the fewer the number of firms that account for a high proportion of output, the more it is likely to be distorted by subsidy\(^{25}\). With a small number of firms in a market, the decisions of each firm are likely to affect its competitors directly as each accounts for a more significant proportion of supply. Hence, when a firm receives a subsidy and changes its price or output, its competitors will suffer a loss of custom unless they too change their price and output. Similarly, a subsidy which encourages entry will also have more of an effect on competition when there are few firms in the market, as the loss of market share to the entrant will be shared amongst fewer firms.

3.52 With a larger number of firms in the market, a change in behaviour by one firm is less likely to impact on competitors. This is because, relative to the market as a whole, a small proportion of the total production is affected. In this situation, however, a very large subsidy may still distort the market if it is sufficient to change the market structure and allow one firm to dominate. In such a case, the subsidy results in the market becoming more concentrated, and so distorts competition.

*Product differentiation*

3.53 The influence of subsidies on competition is greatest if firms produce similar products which are therefore close substitutes. In this situation, if the recipient

\(^{25}\) Except in the extreme case of a monopoly market in which there is no potential for anyone else to enter. In this situation there is no competition that can be distorted.
of a subsidy reduces price to gain market share, competitors will also be forced to reduce price to prevent losing customers. Because they do not have the subsidy, however, not all will be able to do this to the same extent, and as a result some may be pushed out of the market.

3.54 If the individual firms in the market produce rather different products, a price reduction by the recipient of the subsidy will impact mainly on rival firms producing the most similar products to its own. A lot of the rivals’ customers are likely to switch to the subsidised firm’s cheaper product. However, firms with less similar products will be much less affected, because fewer of their customers will be willing to swap to the recipient’s product unless the price change is reasonably large. Over the market as a whole, the impact on competition may not be as great as in the case in paragraph 3.54. However, those with the most similar product to the subsidised firm might be disproportionately affected by the subsidy.

3.55 Similarly, a subsidy that encourages entry will have a larger effect on those rivals that produce the products most similar to that of the subsidised entrant.

Asymmetric firm size

3.56 Firms can differ substantially in size. For example, a market may have one or two large players and a number of smaller competitors. In such a case the impact of the subsidy on competition will vary depending on whether it goes to a large or small firm.

3.57 A subsidy to the large firm will increase its competitive advantage and enable it to cut prices, which will lead to significant distortions in the market and may push out some of the smaller competitors.

3.58 If, instead, one of the small firms is subsidised, the effect on competition is less clear cut. The subsidy may allow the fringe firm to compete more effectively with the large firm, increasing competition. However, if the subsidy only increases the competition between the small firms, this could lead to the exit of some of these, which could mean that the competitive pressure on the large firm is reduced.

NON-PRICE COMPETITION

3.59 In some markets the customer is interested in other characteristics of the products on offer, such as the innovative nature of products or their branding, as much as the price that is charged for them. In such markets, subsidies can
influence competition other than through price. For example, if firms compete by developing better products, then a subsidy that affects R&D can have significant impacts. In such cases a subsidy to R&D may be more likely to distort competition.

BARRIERS TO ENTRY AND EXIT

3.60 Barriers to entry refer to any significant advantage that incumbent firms have over a new entrant, other than the advantage created by superior efficiency. There are many types of barrier to entry. One example is sunk costs, which are costs that must be incurred in order to enter a market, but are impossible to fully recoup on exit. The higher the cost, the higher the barrier and the more risky entry will be.

3.61 Barriers to exit refer to the costs that must be incurred by a firm leaving the market. When considering the competition effects of subsidies, barriers to entry and exit are important in determining both the magnitude of the competition effect and duration of the effect.

3.62 The higher the barriers to entry in an industry, the higher barriers to exit tend to be. This means that, other things equal, firms facing a subsidised rival will be less likely to exit the market in the face of short run losses if barriers to entry or exit are significant. However, if exit does occur, the effect on competition is likely to be longer lasting, because entry will then be less likely to take place.

Cross subsidy

3.63 Our definition of subsidy includes direct subsidies, such as tax breaks, and indirect subsidies, such as cross subsidy. Cross subsidy occurs when a public body or private firm uses its activities in one market to finance its activities in another market. In practice this often occurs when a firm allocates all or part of the costs of its activities in a highly contested product or geographical market to another product or geographical market which is able to bear these costs. We are interested in the case where commercial activities are funded by activities which either use public funds, or earn revenue through a statutory function.
3.64 Cross subsidy typically arises in two circumstances:

- Where there are common costs shared by more than one output. For example, a printing press may be used to produce both books and magazines. These shared costs have to be allocated proportionately to the two products, to work out the cost of producing each, and

- Where competition is less intense in the market for one of the products relative to the other. If competition is less intense, the firm may be able to charge a higher mark-up over costs, earning higher profits per unit sold. It could use those profits to subsidise the production of the other product.

3.65 From the analytical perspective cross subsidy has the same effect on competition as normal subsidy, since it alters the costs or revenues of the subsidised activity. Public subsidy comes from intervention by government, whereas cross subsidy happens where the source of these funds is another part of the same undertaking. The rules concerning cross subsidies are discussed in Chapter 5.

Conclusions

3.66 In this chapter we have considered the types of distortion that subsidies can give rise to and the impact of that distortion on efficiency, and we have identified the situations in which competition distortion is more likely to be significant.

3.67 Table 3.1 below summarises these findings.
### TABLE 3.1 FACTORS AFFECTING THE SIZE OF THE COMPETITION EFFECT

<table>
<thead>
<tr>
<th>Factor</th>
<th>Competition effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selectivity</td>
<td>If a subsidy is only provided to a small subset of firms in a market, distortion is more likely to arise. To avoid distortion in the targeted market the subsidy must confer the same advantage on all firms, i.e. be available to all and have the same effect on all.</td>
</tr>
<tr>
<td>Magnitude</td>
<td>The larger the subsidy (in absolute terms, or relative to costs) the greater the likely competition effect.</td>
</tr>
<tr>
<td>Duration</td>
<td>Ongoing subsidies are more likely to have competition effects (especially for subsidies affecting pricing).</td>
</tr>
<tr>
<td>Structure of payments</td>
<td>For subsidies aiming to assist entry, a single payment may be more likely to give rise to competition effects, whereas for subsidies aiming to prevent exit, spreading payments may be more likely to give rise to competition effects.</td>
</tr>
<tr>
<td>Effect on costs</td>
<td>Subsidies that target specific activities are likely to affect competition less than subsidies of the same value that can be used at the recipient’s discretion.</td>
</tr>
<tr>
<td>Concentration and product differentiation</td>
<td>Competition effects are likely to be greatest in concentrated markets with similar products.</td>
</tr>
<tr>
<td>Asymmetric firms</td>
<td>Subsidising a large firm may increase its advantage and might be expected to reduce competition. The effects of subsidising the small firm depend on whether it allows the small firm to compete more effectively with the large firm – if so, then competition may be increased. If not, competition may be reduced if the subsidy leads to the exit of rival fringe firms.</td>
</tr>
<tr>
<td>Non-price competition</td>
<td>R&amp;D subsidies will be most important in markets where innovation is the key part of the competitive process. R&amp;D subsidies can affect competition directly, by changing the amount and type of R&amp;D carried out by the subsidised firm. It can also affect competition indirectly, by changing the incentives firms face to innovate in the future.</td>
</tr>
<tr>
<td>Barriers to entry</td>
<td>Barriers to entry are important in determining both the magnitude and length of the competition effect. High entry barriers can reduce the magnitude of effect by</td>
</tr>
</tbody>
</table>
making exit less likely. However, high entry barriers can make the competition effects of subsidies longer lived, by making entry more difficult once the subsidy has ceased.

Source: Frontier Economics

3.68 The analysis by Frontier Economics generates some suggestions about how to design subsidies to minimise any distortions to competition:

- The value of the subsidy should be the minimum necessary to achieve its objectives, especially when the subsidy affects the variable cost of the firm,

- Subsidies to assist a struggling firm should be provided in single payments where possible, to prevent inefficient firms hanging on for the next instalment rather than addressing their own shortcomings or leaving the market,

- Subsidies should only be provided once to any particular firm for a given project or objective,

- Moving to less selective subsidies should reduce distortion. Policy makers should also test whether the same subsidy will affect recipients to a different degree,

- Activity-specific subsidies, provided these still achieve the desired objectives, should be used in preference to general subsidies of the same value, and

- Where selectivity is necessary, there may be a case for competition for the subsidy to be held, so that the firms have an equal opportunity to access the subsidy and it goes to the firm that offers the greatest benefit for the subsidy, which is typically the most efficient firm.

3.69 In providing subsidies there are two characteristics of markets in which adverse competition effects are likely:

- Concentrated markets, and

- Markets with dominant firms, particularly where the dominant firm receives the subsidy.
Subsidies that qualify as state aid have, by their nature, the potential to distort competition. The Treaty of Rome lays down a general prohibition on state aid, with exemptions under certain conditions for aid targeting objectives which are compatible with the Common Market.

To implement the parts of the Treaty relating to state aids the European Commission has drawn up regulations and guidelines setting out the conditions in which aid will be permitted. These conditions go some way to addressing the factors we have identified as being a source of competition distortion, for example by making it harder to give subsidies in a form that is more likely to affect a firm’s costs and therefore its behaviour in the market. There are other factors, however, that are not recognised. The market context and the characteristics of recipients have been identified in our analysis as crucial factors in determining the existence and size of the competition impact. The guidelines do not, for example, address the effects that similar subsidies can have on different types of firm, nor do they generally require policymakers to look at the structure of the markets affected by subsidies.

Overall, our analysis has shown that there are gaps in the European guidelines and regulations that could result in specific aids and aid schemes being approved which distort competition significantly. Therefore, we conclude that the European state aid rules should be improved to take better account of the potential for competition distortions to arise. We support the current review insofar as this results in guidelines that have a more rigorous economic basis.

We urge the UK Government to continue to engage in the European debate to make the case for changes to the rules to further reduce the potential for subsidies to distort competition.

Introduction

4.1 As mentioned in chapter 2, the group of subsidies defined by Articles 87 - 89 of the Treaty of Rome26 (‘the Treaty’) as state aids are subject to a specific set of guidelines and regulations drawn up at the European level.27 This chapter gives a brief introduction to the coverage of the state aids regime and the

27 Further information on the state aids regulations and guidelines can be found in Annexe B.
application of the guidelines and regulations\textsuperscript{28}. It then examines the extent to which these prevent competition distortions arising from state aids and identifies the need for improvements.

\textbf{State aids rules}

4.2 The objective of Articles 87-89 of the Treaty is to prevent state aids that harm the Common Market. The Treaty defines state aid as any government intervention that fulfils four criteria:

- A transfer of State resources – either a cost or loss of revenue,
- Conveys an economic advantage to some firms – i.e. is selective in availability,
- Distorts or threatens to distort competition – even a limited advantage is likely to raise a risk of distortion, and
- Affects trade between member states – i.e. the product or service is or could be subject to intra-Community trade.

4.3 The Treaty places a general prohibition on state aids, but then makes an exception for aids that pursue particular objectives that are held to be compatible with the Common Market. For example, aid is allowed to promote cultural conservation, or to put right the damage caused by natural disasters. Aid may also be allowed, subject to certain conditions, for objectives which cut across the economy (horizontal objectives) such as training, R&D and aid to small and medium sized enterprises (SMEs).

4.4 The criteria for qualification as a state aid set out in the Treaty mean that three types of subsidy that are of interest to this study are not considered to be state aids. These are:

- Subsidies that are provided on a non selective basis but have a different effect on recipients,

\textsuperscript{28} For the purposes of this report guidelines and block exemptions together are referred to as the 'European rules'.
• Subsidies whose value is below a given threshold and so pass through the de minimis block exemption as discussed in section 4.21, and

• Subsidies that do not affect intra-Community trade, discussed below.

4.5 Subsidies that do not affect intra-Community trade are not subject to any controls from the EC because they are not counted as state aids, but still have the potential to distort local markets. In practice we have identified relatively few such subsidies. This is because the threshold for 'effect on intra-Community trade' is set very low in legal terms. The Commission considers that a subsidy to a particular product or service will affect inter-state trade if consumers will travel across Europe to buy the product or service, if a firm chooses to relocate due to the subsidy or if investment by firms shifts between countries as a consequence of a subsidy. For example, there was extensive debate concerning whether aid to The Deep, an aquarium in Hull and aid to restore West Brighton Pier should be treated as state aid because tourists might base their decisions of which countries in Europe to visit on the availability of such attractions.

4.6 In order to clarify state aid policy in a number of areas, the Commission has adopted guidelines that set the conditions in which it considers that aid may be compatible with the Common Market. It has also adopted block exemption regulations relating to de minimis aids, and aids to SMEs, training and employment. Box 4.1 provides a brief overview of the European rules. Annexe B contains a fuller description of these.
BOX 4.1 OVERVIEW OF THE EUROPEAN STATE AID RULES

Whilst the Treaty generally prohibits state aid, it makes exceptions to the ban where the aid would have a beneficial impact on the Common Market. Article 87 of the Treaty allows the following forms of aid in all circumstances:

- Aid of a social character, granted to individual consumers,
- Aid to make good the damage caused by natural disasters or exceptional occurrences, and
- Aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany.

Aid may also be permitted under Articles 87-89 as long as it does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest, if it is designed to:

- Promote the economic development of underdeveloped areas,
- Promote the execution of an important project of common European interest, or remedy a serious disturbance in the economy of a Member State,
- Facilitate the development of certain activities or economic areas, or
- Promote culture and heritage conservation.

The Commission has adopted a number of guidelines that clarify what aid will be judged compatible with the Common Market. In general, the guidelines set out a number of eligibility criteria and caps on the allowable magnitude of state aid. Under these guidelines, aid must be notified to the Commission before it is distributed. Over time, the guidelines have developed in such a way as to place compatible aid into three categories:

- Regional aid (for regions suffering low growth or high unemployment),
- Sectoral aid (with specific rules for sensitive sectors), and
- Horizontal objectives (e.g. aid for R&D).

The Commission has also recently adopted a number of block exemption regulations to reduce the administrative burden of the European rules. Under these guidelines aid which satisfies certain criteria is exempted from prior scrutiny by the Commission, provided it is targeting:

- Small and medium-sized enterprises,
- Training, or
- Employment.

If aid does not conform with the standard guidelines, the Commission may still allow it after having assessed its compatibility with the Common Market directly on the basis of the conditions set out in Article 87.
4.7 The European Rules are centrally enforced by the European Commission\textsuperscript{29}. Proposals to give aid must be notified to the Commission before it is implemented, to allow them to assess whether the aid complies with the Treaty or, in some cases, within twenty days of the aid coming into operation. Most aids proposed by the UK are designed to comply with a particular guideline. However, on occasion a subsidy will be proposed that the Commission needs to consider directly under the principles of the Treaty. Box 4.2 gives an example of such a situation.

4.8 The rest of this chapter looks at the European rules in light of the research carried out by Frontier Economics. Specifically, we discuss whether the rules minimise the competition distortions caused by state aid.

\textsuperscript{29} Aid to business is examined by DG Comp, while aid to agriculture is examined by DG Agriculture and transport schemes by DG TREN.
BOX 4.2 STAMP DUTY EXEMPTIONS

In 2001, the UK Government proposed a stamp duty exemption scheme aimed at contributing to the physical, economic and social regeneration of disadvantaged areas, by reducing the cost of acquiring non-residential property\(^{30}\). The exemption would be worth between 1 per cent and 4 per cent of the purchase price, or (in the cases of leases) up to 24 per cent of the average annual rent\(^{31}\). The scheme was initially intended to last for 10 years, with an estimated budget of £60m per year.

Relief applied to non-residential property purchases over £150,000 was considered to be state aid. As the scheme did not fit under any existing framework, regulations or guidelines, the Commission examined it directly on the basis of Article 87(3)(c). This states that that any proposed scheme must fall within the European objectives of economic cohesion and sustainable development, and the scheme must not affect trading conditions adversely to an extent contrary to the common interest.

In its assessment, the Commission considered the regeneration of rural and urban areas to be part of the concept of social and economic cohesion. Furthermore, due to the low rates of investment in the deprived areas together with the relatively low aid intensity of the scheme, the Commission considered that the aid did not adversely affect trading conditions. The scheme was therefore approved by the Commission in 2003.

However, because the scheme fell outside the usual criteria, the Commission considered it appropriate to impose extra conditions on the scheme, including:

- The UK Government must monitor payments, to prevent accumulated payments under this and other investment schemes from exceeding the aid ceilings laid down in the regional aid map\(^{32}\);
- The UK must report annually to the Commission on the progress of the schemes, to allow an evaluation of the effects of the scheme on the physical regeneration of the areas which benefit, and
- The duration of the scheme should be limited to the end of 2006.

These conditions limited the value of the scheme by limiting both the overall magnitude of aid payments to an individual project and the duration of the scheme. This would be likely to limit the competition distortions.

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\(^{31}\)From December 2003, Stamp Duty was replaced by Stamp Duty Land Tax (SDLT) and Disadvantaged Areas Relief is now an SDLT relief. Rates are substantially unchanged, although leases are now charged at 1 per cent on the net present value of the rent.

\(^{32}\)See Annexe B for a description of the European regional state aid rules.
State aids and competition

4.9 Chapter 3 discussed how subsidies may affect competition, and which factors are important in determining the magnitude of this effect. It concluded that the competition effect of subsidies, including state aids, will depend upon:

• The characteristics of the state aid – i.e:
  o is it only available to a selection of firms, and does it have an asymmetric effect on different recipients?
  o What is the magnitude, frequency and payment structure of the subsidy?
  o How does it affect firms’ costs?

• The characteristics of the market targeted by the aid – what is the nature of competition in the market, i.e.
  o levels of concentration,
  o asymmetry of firm size,
  o barriers to entry,
  o product differentiation, or
  o competition based on innovation or other non-price factors

4.10 The following sections discuss the extent to which the current European rules consider these factors, and how the rules approach competition issues more generally.
THE CHARACTERISTICS OF THE STATE AID

Selectivity

4.11 The analysis in chapter 3 suggests that the more selective a subsidy, the more likely it is to affect competition. In general the European rules reflect this conclusion by imposing stricter conditions on aid that is given on a more selective basis. However, the conditions may not fully minimise the distortion caused by providing the subsidy selectively.

4.12 The European rules only apply to subsidies that are available with a degree of selectivity (e.g. available only to a specific firm, a specific sector or in a specific region). Broadly speaking, the rules impose stricter limits the more selective is the aid. For example, the rules on rescue and restructuring aid are particularly strict as the aid may be specifically tailored for an individual firm. In contrast, aid targeting some horizontal objectives (where aid is available to all firms), such as training, have far more relaxed limits and may be implemented without scrutiny by the Commission. The Commission has encouraged Member States to move away from more selective aid towards aid for horizontal objectives33.

4.13 However, although the rules do take some account of selectivity, the additional limits imposed on more selective aid do not necessarily reflect the extent of the competition distortion caused by the selectivity. Many of the additional limits take the form of ceilings on the amount of aid that can be offered, with little apparent link between the distorting nature of the aid and the level of aid that is permitted by the ceilings. Box 4.3 provides an example of a scheme that complied with the guidelines on selectivity.

33 See page 3, State Aid Enforcement in Context: competitiveness, economic reforms and enlargement (speech by Mario Monti 27th April 2004)
BOX 4.3 'BUYING TIME' ASSISTANCE (NORTHERN IRELAND)

In 2001 the UK government proposed a state aid package for Northern Ireland, aimed at the rescue of SMEs from immediate insolvency\(^{34}\). The scheme was coupled with a partner project which assisted with the restructuring of firms on the basis of a plan to restore their long-term viability. Under the scheme, Invest Northern Ireland could distribute loans or loan guarantees to SMEs within Northern Ireland up to an individual payment ceiling of €10m (£6.25m).

The Commission examined the scheme against its guidelines on aid for rescuing and restructuring firms in difficulties\(^{35}\). These guidelines require that rescue aid must be warranted on the grounds of serious social difficulties and have no unduly adverse spill-over effects on other Member States. Although the scheme is highly selective, since only SMEs within one region who are more than one year old may apply, and Invest Northern Ireland has the potential to provide individual aid grants up to €10m, the Commission noted that the Northern Ireland economy was still relatively weak and faced significant structural handicaps (unstable political climate, peripheral location, over-dependence on public sector employment, and low levels of enterprise), and that the total budget of the scheme was modest. It therefore allowed the scheme to go ahead.

Asymmetry

4.14 As discussed in chapter 3, even when state aids are available to all firms, it may have a different effect on the recipients’ competitive positions if they have different business models or production technologies. The European rules do not offer additional competition safeguards when subsidies are implemented that will affect some firms more than others.

4.15 In considering whether a subsidy is asymmetric the important factor to consider is how the subsidy affects the firm’s costs, which will depend on its cost structure. The European rules do not require any assessment of the effects of a state aid on the recipient’s costs, so do not prevent subsidies that, whilst offered to all firms, benefit some more than others.

\(^{34}\)(OJ C C77/45 2002). Case N 718/A/2001

**Magnitude**

4.16 The analysis in chapter 3 indicates that a large subsidy will impact on the behaviour of the recipient and its competitors more than a smaller subsidy of the same type. More specifically, the magnitude should be considered in terms of how it changes the cost of producing an extra unit of output by the recipient. Whilst the European rules place some constraints on the magnitude of subsidies, the level and nature of these constraints are unlikely to minimise potential distortion.

4.17 There are several parts of the European rules that relate to the magnitude of the aid. First, as already mentioned there are ceilings on the amount of aid permitted. Some ceilings are absolute values, such as a total of €15m allowed for a single SME payment, while others are relative to the size of the investment being made by the firm (a relative ceiling is referred to as the aid intensity). For example, Member States may offer state aid for general training equal to 70 per cent of the eligible costs of the project for SMEs.

4.18 We understand that particular ceiling levels are set based on the Commission’s experience of the size of investment aids that are most likely to give rise to complaints, rather than as the result of economic analysis.

4.19 Our research shows that what matters is the extent to which the subsidy alters the cost of producing an extra unit of output. The European state aid ceilings refer to the size of the subsidy relative to the cost of the project, which only indirectly relates to the effect of the project on the firm’s costs. Because different projects affect costs to differing extents, a fixed ceiling is only a rough way of preventing levels of subsidy that will distort competition significantly.

4.20 Absolute and relative limits are set in the Multisectoral Framework on regional aid for large investment projects. These limits are to prevent particularly large aids that would distort competition by exceeding the additional costs incurred by the firm in setting up in a disadvantaged area. Absolute limits also prevent regions from competing for the project by offering higher levels of subsidy.

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36 Under the Multisectoral Framework on regional aid for large investment projects, 2002/C 70/04, the applicable investment ceiling is reduced by 50 per cent for the value of the project between €50m and €100m, and reduced by 34 per cent for the value in excess of €100m.
4.21 There are also special rules for small amounts of aid, known as 'de minimis' payments. These allow government bodies to grant up to €100,000 (approximately £60,000) of aid cumulatively to any individual firm over a rolling three-year period, without informing the EC. The research by Frontier Economics shows that the relative magnitude of a subsidy also matters. Whilst in most cases a de minimis grant is unlikely to effect competition, a grant of €100,000 to an SME, particularly one operating in a market where competition is mainly within a small geographic area, may still have a significant negative effect on competition.

4.22 There is a risk with de minimis payments that firms receive more than the permitted level of subsidy due to shortcomings in centralised recording. At present there is no central database of payments made to individual firms, which makes it difficult to monitor whether the payments are being kept within the limits. This leaves policymakers reliant on the firms themselves to state whether an aid payment would breach the de minimis thresholds. If a firm is found to have received aid above the threshold, it must be repaid – but without a central database of aid, it is difficult to see how this situation would ever be discovered.

Repeated subsidy

4.23 In general terms, repeated subsidies are likely to be more harmful to competition than a one-off payment. The European rules prevent repeated state aid in a few instances but not for all types of aid. Thus a number of situations of repeated aid can still occur.

4.24 A firm could qualify repeatedly for payments under certain state aid guidelines over a period of years. R&D state aid, for example, could be distributed continuously as long as a firm is consistently investing in R&D activities (though subsidy providers would have to verify that the activity provided additional benefits). Similarly, payments could be made to the same company annually under the SME block exemption or regional guidelines (provided it was for different investments under each time). There are some specific rules that prevent the repetition of subsidies for the most distortive aids – e.g. rescue and restructuring aid can be paid only once in a ten year period.

Effect of subsidy on costs

4.25 Chapter 3 indicated that, in general, the greater the effect of a subsidy on the firm’s variable cost, the greater the effect it would have on competition. The European rules recognise this in an indirect way by allowing greater flexibility
over state aids that do not affect costs directly, such as training, and generally prohibiting aid for operating costs that would have a very direct effect on marginal costs.

4.26 The European rules allow aid for 'horizontal objectives' which generally specify the type of activity the aid can be provided for. A state aid for a horizontal objective is unlikely to distort competition as much as the same level of aid given for an investment. This is because horizontal objectives do not tend to be ones that directly affect costs of production. For example, a state aid to improve environmental protection may have a very small effect on the recipient’s resource efficiency and, through this route, only reduce its costs of production by a small amount. A training subsidy, which can be provided easily under the training block exemption, should improve labour productivity, but this is unlikely to reduce costs to the same extent as a state aid of the same value that can be used for any purpose decided by the recipient. Similarly, aid for R&D and venture capital may reduce unit production costs, but this will depend on the success of the investment so the effect on costs is not guaranteed. If the effect on cost is lower than with a direct subsidy, the effect on competition will be less.

4.27 The European rules generally prohibit state aid for operating costs. As such aid would have a very direct impact on costs of production, this prohibition prevents some potentially very distorting aid.

THE CHARACTERISTICS OF THE MARKET

4.28 One of the most important lessons from the analysis outlined in chapter 3 is that the characteristics of the market(s) affected by the subsidy play an important role in determining the existence and magnitude of the impact on competition. The European rules give very little consideration to the market context of a subsidy.

4.29 Only the rescue and restructuring guidelines, sectoral guidelines and Multisectoral Framework on regional aid for large investment projects give different conditions for state aid according to market characteristics, and the

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37 http://europa.eu.int/comm/competition/state_aid/legislation/aid3.htm#D

38 One qualification to this situation is if the subsidy is provided for a specific activity but only displaces an activity that the firm was going to undertake anyway. In this situation the value of the subsidy could be used for any purpose by the firm and could therefore have a more significant effect on competition.
focus of these is generally sector overcapacity rather than the concentration of the market, or the degree of product differentiation. There is also no attempt to consider the impact on linked markets, such as markets for inputs (raw materials, land, energy and labour) to subsidised products or downstream markets.

4.30 The sectoral guidelines set out stricter rules for aid to certain sectors that are considered to be particularly prone to competition distortion. These sectors, which are defined by NACE codes, differ considerably from 'economic markets'\(^{39}\). They are generally singled out because of historical overcapacity – for example, shipbuilding or motor manufacturing. Guidelines for rescue and restructuring aid also refer to the reduction of overcapacity. However, this focus on overcapacity does not capture all the different characteristics of the market that would affect the competition impact.

4.31 For industries with overcapacity it is clear that providing support, other than support for downsizing, would disadvantage rivals that were struggling to survive and possibly push these out of business. Hence, prohibiting support to sectors with overcapacity will prevent this type of distortion. However, this prohibition does not prevent other types of distortions as subsidies could still be provided that assist a firm with significant market power, assist an inefficient firm, deter entry by efficient firms or place a firm at a significant advantage to competitors.

4.32 In the situation of an exceptionally large regional aid\(^{40}\), the aid needs to be notified to the Commission. The aid is not allowed if:

- The beneficiary accounts for more than 25 per cent of the sales of the product (where the product sales include items consumers and producers would substitute for the subsidised product), or

- The capacity created equates to more than 5 per cent of the market, based on consumption data for the product concerned, unless the market is growing particularly rapidly.

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\(^{39}\) The NACE or Nomenclature d’activité dans la Communauté Européenne codes classify business activity into sectors, in a similar way to the UK’s Standard Industrial Classification.

\(^{40}\) Regional aid is exceptionally large if the value of the regional aid is more than the level of support that can be provided to a €100m investment project under the framework.
4.33 Hence, in very unusual circumstances the European rules require definition of the market and assessment of the role of the recipient in the market. The economic analysis in chapter 3 would support this sort of assessment for a much greater proportion of subsidies.

4.34 Our position, that the market that will be affected by a subsidy should be considered, is supported by existing literature. For example, a paper by Fingleton et al contrasts the approach taken under the state aids regime with that taken under competition law enforcement, and argues that an assessment of the relevant market is necessary to determine the effect of a state aid.41

Consideration of competition effects

4.35 In general, when considering a state aid, the Commission only considers whether the aid is consistent with the European rules. The competition effects of aids are only considered on a case by case basis for rescue and restructuring aids. Current proposals for a new guideline for 'Lesser amounts of state aid' (LASA), indicate a slight shift in this position (as discussed below).

4.36 Although the Commission undertakes more detailed analysis for more significant schemes, this focuses on whether the aid complies with the rules. The Commission would not prohibit a subsidy on the basis that it caused particularly significant distortions, if it was consistent with the rules. The standard information which Member States must submit to the Commission in advance of implementing an aid only indicates the NACE sector, rather than presenting characteristics of the effected market. Nor does it require details on the cost structure of the recipients, for example, so the Commission cannot currently detect whether the proposed aids could distort competition significantly.

4.37 The Commission is considering implementing a guideline that applies to lesser amounts of state aid (LASA) 42. For aids that are permitted under the guideline, Member States will have to put in place safeguards that reduce the risk of a distortion to competition. This is the first time a requirement of this sort has

41 A Study of Market Definition in Practice in State Aid Cases in the EU, John Fingleton, Frances Ruane and Vivienne Ryan (1998)

been introduced. Whilst it could minimise the distortions associated with aid granted under this guideline, the enforcement of this provision is unclear.

4.38 The LASA guideline proposes to permit contributions of 30 per cent of project costs (including investment costs and consultancy costs) up to a ceiling of €1m over 3 years. Member States would need to notify the Commission, but would have to provide less information than for larger aids. The Commission has proposed this guideline based on its view that it will permit aids that do not distort competition and trade significantly (based on previous complaints). From a theoretical perspective the likely effect of state aids provided under this guideline is uncertain. On one hand, the guideline gives greater opportunities to provide aid with less scrutiny by the Commission. On the other hand, Member States are required explicitly to consider and safeguard against distortion.

Conclusions and recommendations

4.39 Our analysis shows that although the European rules on state aids control some subsidies that would have an adverse impact on competition, there are gaps which could allow through some aids which have a significant negative impact. In particular, there is a lack of consideration of the characteristics of the relevant markets in the rules themselves, and their implementation by the Commission. This is key to a full assessment of the competition impact and remains unaddressed in the rules on state aids, so it is impossible to conclude that the European rules on their own could minimise the competition distortions arising from state aids in the UK.

4.40 The European state aid rules are reviewed on an ongoing basis, and are currently being revised in pursuit of the European Commission’s stated aim of ‘less and better state aid’, as set out in Mario Monti’s speech earlier this year\textsuperscript{43}.

\textsuperscript{43} State Aid enforcement in context: competitiveness, economic reforms and enlargements, Mario Monti, 2004.
The European state aid rules should be improved to take better account of the potential for competition distortions to arise. We support the current Commission review insofar as this results in guidelines that have a more rigorous economic basis.

We urge the UK Government to continue to engage in the European debate to make the case for changes to the rules to further reduce the potential for subsidies to distort competition.
5 CONTROL OF SUBSIDIES IN THE UK

In the UK, subsidies are provided by central government, devolved administrations, government agencies and local authorities. Most bodies design their subsidies independently using the appraisal guidance provided by HM Treasury, the Green Book, or the Scottish Public Finance Manual, and their own sets of guidance, where such exist. In general, the available guidance does not consider adequately the adverse competition effects subsidies can generate. Thus, where there are gaps in the European state aid rules that allow distorting subsidies to be implemented without appropriate consideration of their potential to distort competition, or where subsidies do not qualify as state aids, these are not generally addressed at the national level.

The OFT recommends that consideration should be given to ways of supplementing policy appraisal guidance to ensure that competition considerations are included as one of the factors to be taken into account when designing a subsidy.

It may sometimes only be possible to identify the competition impact associated with a subsidy after the subsidy has been given. This could be picked up through regular monitoring of existing and new subsidies. However, current monitoring arrangements focus on ensuring the effectiveness and value for money of the scheme or subsidy and do not generally consider competition effects.

The OFT therefore recommends that once appraisal guidance has been supplemented, all subsidy providers should ensure that monitoring procedures assess the impact of the subsidy on competition as well as its effectiveness and value for money.

Introduction

5.1 This chapter examines the process through which subsidies in the UK are developed and provided. It covers:

- which bodies provide subsidies in the UK,

- how the design and provision of these subsidies is controlled and monitored, assessing the extent to which the existing controls minimise any competition distortions these subsidies may cause, and

- conclusions about how well competition distortions are currently addressed, with broad recommendations about how the situation could be improved.
Who provides subsidies in the UK

5.2 Subsidies in the UK are given by a range of central and devolved government departments and agencies. Regional agencies responsible for economic development are important providers of subsidy, as well as heritage and culture agencies. Local authorities (LAs) also have some powers to provide business support.

5.3 Government departments may develop subsidies and implement them directly themselves, or they may use others to administer the subsidy. Figure 5.1, below, summarises this arrangement in broad terms and gives some examples. It should be noted that sometimes the provision of subsidy is delegated by the bodies listed on the right hand side below to other, often local, organisations. For example, Enterprise Northern Ireland provides some subsidies using funds from the development agency, Invest Northern Ireland.

FIGURE 5.1 EXAMPLES OF SUBSIDY DESIGN AND SUBSIDY ADMINISTRATION AT DIFFERENT LEVELS OF GOVERNMENT

Who designs subsidy

Central Government and Devolved Administrations

Agencies

Local authorities

Who administers subsidy

Central Government and Devolved Administrations

Agencies

Local authorities

Source: Office of Fair Trading

5.4 In England, RDAs have a particularly important role in the administration of subsidies. They are responsible for providing Selective Financial Investment grants for projects up to £2m and for running most subsidy schemes that
involve state aid to SMEs (e.g. regional Venture Capital Funds)\textsuperscript{44}. Their responsibility is soon going to increase as R&D grants and Businesslink are being transferred from the regional offices of DTI’s Small Business Service to RDAs.

5.5 In Scotland, enterprise agencies play a major role. Scottish Enterprise and Highlands and Islands Enterprise have a remit to deliver the Executive’s strategy ‘Smart, Successful Scotland’\textsuperscript{45}.

5.6 In contrast, Invest Northern Ireland has less autonomy than its counterparts in other regions of the UK, acting mainly as the Department of Enterprise, Trade and Investment’s delivery arm for subsidies.

5.7 In Wales, the Welsh Assembly Government has a direct role in the administration of the larger subsidies, such as Regional Selective Assistance (RSA) and Assembly Investment Grants; whereas the Welsh Development Authority deals with smaller subsidies and Enterprise Agencies are used to administer funding for business start-ups.

How is subsidy design controlled?

5.8 This section discusses how subsidy design in the UK is controlled, and the extent to which existing controls take account of any competition distortions subsidies may cause. It covers:

- guidance on project appraisal for all government departments and executive agencies, through the HM Treasury Green Book and the Scottish Public Finance Manual,
- guidance for the design and provision of particular subsidies, such as the Regional Selective Assistance (RSA) and Selective Finance for Investment (SFI) Guidelines,
- the Regulatory Impact Assessment (RIA), which applies to subsidies or subsidy schemes that are introduced by statute,

\textsuperscript{44} The Industrial Development Unit at DTI deals with the larger SFI projects (above £2m).
\textsuperscript{45} Available on the Scottish Executive website: http://www.scotland.gov.uk/Home
• fees and charges guidance, which address the issue of cross subsidies when public sector bodies perform commercial activities, and
• the role of the State Aids Policy Unit (SAPU) of DTI.

5.9 Figure 5.2, below, sets out in stylised terms the process that applies to subsidies designed by government departments and most agencies. The order in which guidance is applied may vary depending on the subsidy provider and does not affect any competition distortion from the subsidy.

FIGURE 5.2 – PROCESS OF GOVERNMENT SUBSIDY DESIGN

Source: Office of Fair Trading

PROJECT APPRAISAL

5.10 Guidance on project appraisal for government departments and executive agencies (which include regional agencies but not LAs) is given by the Green Book in England, Wales and Northern Ireland and by the Scottish Public Finance Manual in Scotland. These are best practice guides on how the assessment of any proposed new policies, programmes and projects should be performed and also apply to the provision of subsidies\(^{46,47}\). In practice, the approach to appraisal in these guides is identical, so we will refer to them together as 'project appraisal guidance' in this section. There is a high level of awareness of these guides, though their use is not compulsory.

\(^{46}\) The Green Book, HM Treasury, April 2003
\(^{47}\) http://www.scotland.gov.uk/library5/finance/spfm/spf-00.asp
5.11 The aim of an assessment according to the project appraisal guidance is to consider whether the proposed approach is the best way to achieve the given set of objectives by assessing all the costs and benefits of the approach and examining alternative options.

5.12 The appraisal method hinges around an assessment of the costs and benefits of a number of alternative options relative to a baseline. The assessment should include all the relevant costs and benefits to the Government and to UK society generated by each policy option.

5.13 The project appraisal guidance recommends that policy-makers consider financial, social and environmental costs in their assessment of costs. It does not, however, indicate that the competition distortions in the market(s) affected by the policy intervention, including subsidy, should be included as a (potential) cost.

5.14 The project appraisal guidance requires policymakers to examine and compare different options that could achieve the same set of objectives to ensure that the one that brings the highest net benefit is chosen. By not including competition in the assessment, an approach could be chosen that has significant competition distortions in preference to one with similar costs and benefits that does not give rise to as significant an effect.

DEPARTMENTS’ AND AGENCIES’ GUIDELINES

5.15 The project appraisal guidance represents a general framework for appraisals and ex-post evaluations of all new policy interventions. However, departments and agencies can develop their own guidelines concerning the appraisal of their own specific policies and projects to supplement the project appraisal guidance.

5.16 We have found limited evidence of guidelines for subsidy developers and providers that deal with the assessment of competition distortions caused by subsidies.

5.17 This overall lack of guidance means that there is no consistent and pervasive mechanism to ensure that subsidy providers are aware of the need to consider the competition distortions that subsidies may generate, and the need to

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48 The guidance does not preclude consideration of competition effects – it does not mention them.
minimise them. It also implies that subsidy providers do not have access to the tools necessary to assess such effects.

5.18 Despite this lack of guidance, we have found evidence of cases where subsidy providers have given some consideration to the possible competition impacts of subsidies, such as DTI when it reviewed its Business Support Programme (see Box 5.1). However, the lack of general guidance implies that there is no guarantee that consideration will be given to competition distortion when subsidies are developed and implemented.

BOX 5.1 DTI’S EVALUATION OF THE CHANGES TO BUSINESS SUPPORT SCHEMES

In developing its new Business Support products, the DTI made an assessment of each scheme. The assessment process was informed by a review of relevant evidence, including evaluations of previous schemes, and the issues addressed included consideration of the potential impact on competition. For each scheme, a range of options for providing business support were considered. The objectives for each scheme and the measures to test if it was meeting these objectives had to be clearly specified, and competition effects had to be included.

5.19 In our analysis of guidance we have focused, in particular, on regional bodies, since these administer a considerable number of subsidy schemes, some of which they design themselves and others which have been designed by government departments. The next section discusses in more detail the two main sets of guidelines relevant to the provision of subsidies that apply to these bodies. These are:

- the guidelines for the provision of Regional Selective Assistance and Selective Finance for Investment, and
- the guidelines for subsidies that are not classified as Regional Aid.

REGIONAL SELECTIVE ASSISTANCE AND SELECTIVE FINANCE FOR INVESTMENT GUIDELINES

Regional Selective Assistance (RSA) and its successor in England, Selective Finance for Investment (SFI), are two major subsidy schemes that provide grants to firm in underperforming areas (the so-called Assisted Areas or AAs) of
They are regulated by the European state aid rules on regional aid. In 2002, £196.8m of subsidies were provided through these two schemes across the UK\(^{50}\).

5.21 These schemes are administered at regional level, but there are national guidelines developed by the DTI. The DTI has a concordat with Northern Ireland, Scotland and Wales by which these administrations have all agreed to follow common RSA guidelines in order to ensure consistency in the running of the scheme across the UK.

5.22 The RSA/SFI guidelines are of interest because the EC rules give Member States the greatest level of flexibility in the design and provision of subsidy to AAs\(^{51}\) (as specified in the EC Regional Aid Guidelines - see Annexe B) and because they are the most developed set of guidelines for providing subsidy in the UK.

5.23 These guidelines provide detailed operational guidance on the criteria a project needs to meet to be eligible for a grant, and on the assessment that should be performed to make sure these criteria are met.

5.24 The criteria set out in the guidelines reflect the requirements of the European state aid rules. We consider four of these in particular:

- the acceptable cost per job created cannot be above a specified maximum level,
- the project must not have been viable in the Assisted Area without the grant,
- the jobs created through the grant must meet a minimum quality requirement (this applies only to SFI), and
- the extent to which the project displaces jobs in competing firms rather than creating new ones should be considered.

5.25 The first three conditions set some clear hurdles which, if not met, will prevent a subsidy from being given. These conditions limit the relative magnitude of the

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\(^{49}\)Financial Assistance to Industry – GB Guidelines. These guidelines are only for internal use and are not published.

\(^{50}\)UK state aids returns, 2002

\(^{51}\)http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#F
subsidy and ensure that the project is 'value for money', but do not consider the other aspects of the subsidy that are likely to affect competition.

5.26 The fourth criterion, the so-called displacement effect, is designed to assess two effects of the subsidy. First, it enables the subsidy provider to consider the net number of jobs created in the AA. This allows a correct assessment of the cost per job created and prevents projects being implemented that have more than 100 per cent displacement nationally. Thus it ensures that the project creates lasting jobs and provides value for money.

5.27 Secondly, for larger projects, the displacement effect also helps to measure competition distortion, because it provides a measure of the impact of a subsidy on competitors. However, displacement is only a weak proxy for measuring competition distortions for the following reasons:

- The displacement effect only measures the effect of the subsidy on existing firms so does not assess the extent to which entry may have been deterred
- The guidelines only require that displacement is less than 100 per cent nationally. However, this level represents significant competition distortions which would impact adversely on efficient firms in the market, and
- The displacement effect does not identify the other changes in behaviour that might result from a subsidy to a firm. For example, competitors might change their investment or R&D decisions in order to compete with the subsidy recipient.

5.28 The RSA/SFI Guidelines require different levels of assessment for different sizes of subsidy. For subsidies less than £250,000 a simplified cost-benefit analysis

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52 In measuring the 'value for money' of a project the National Audit Office examines 'Economy: minimising the cost of resources used or required – spending less, Efficiency: the relationship between the output from goods or services and the resources to produce them – spending well; and Effectiveness: the relationship between the intended and actual results of public spending – spending wisely.' (http://www.nao.org.uk/about/role.htm#Value) This approach, which is a standard way of measuring value for money, does not cover the wider effects of projects, such as competition impacts.

53 In some cases the displacement effect is measured by interviewing rivals about the potential effect of the subsidy, and hence this information could be obtained.
is undertaken and only job displacement within the AA is considered. For subsidies between £250,000 and £2m an efficiency test is undertaken and the displacement of output and jobs is assessed as described above. The guidelines indicate that the recipient should identify its competitors and these can be surveyed in order to assess the displacement effect, rather than taking a more theoretical approach to market definition and the assessment of likely displacement.

5.29 For subsidies greater than £2m a full cost-benefit analysis is undertaken by the government department responsible for business support in each country. In the current study we have not been able to examine this sort of assessment to analyse the way in which competition is considered. Based on the guidelines it is not clear whether competition would be considered or just displacement and overcapacity.

5.30 In summary, the RSA/SFI Guidelines focus on ensuring the effectiveness of aid at assisting with regional growth and the provision of sustainable skilled jobs in AA. The criteria for eligible aid would reduce competition distortion to some extent but providers are not required to consider competition distortions explicitly. Competition was identified as one of the regional drivers of productivity in a recent review of productivity in the UK54. As such, a stronger focus on competition distortions associated with subsidies should enhance productivity within the region and beyond.

GUIDELINES FOR NON-RSA SUBSIDIES FROM REGIONAL AUTHORITIES

5.31 For subsidies which are not RSA and SFI, the available guidance is much more limited and also tends to address value for money issues rather than to encourage subsidy providers to take competition distortions into account.

5.32 The Single Programme Appraisal Guidance applies to all policy interventions, including subsidies (apart from RSA/SFI), introduced by the English RDAs55. It requires RDAs to clearly identify the market failures that the proposed policy intervention is meant to address and to consider whether there are better ways to tackle them. This entails performing a cost benefit analysis (CBA) of the alternative policy options to inform the policy decision. The requirements for the economic appraisal included in the guidance are taken from the Green

54 Productivity in the UK: The Regional Dimension, HMT 2001
Book. Hence, competition distortions are not included among the costs that feed into the CBA.

5.33 In Scotland, in addition to giving guidance on project appraisal in general, the Scottish Public Finance Manual requires the provider of assistance to industry to minimise the risks of the project to the recipient and the Scottish Executive. Subsidy providers are required to produce a Pre-Expenditure Assessment summarising the aims and objectives of the proposal, the alternative options available for addressing these objectives, the likely impacts of the proposal, including a CBA where appropriate, its financial cost, and the plans for its monitoring and evaluation. However, no specific requirements are set concerning the assessment of competition distortions.

5.34 In Wales, there is guidance on the provision for the Assembly Investment Grant Scheme, under which financial support for fixed assets or one-off costs up to £50,000 can be provided to SMEs based in Wales. The eligibility criteria for projects are viability, additionality (i.e. without the grant the project could not go ahead) and low levels of displacement. Other qualitative factors such as innovation and environmental sustainability are also taken into account. The scheme is to be evaluated in 2005, focusing on value for money and effectiveness.

5.35 Northern Ireland does not have a specific set of guidelines for subsidies, but the Department of Enterprise, Trade and Investment appraises the proposals for specific subsidies and subsidy schemes developed by Invest Northern Ireland. Our understanding of this assessment is that it focuses on whether the proposed intervention is 'value-for-money', which considers criteria such as cost per job created and that competition issues are not given explicit consideration.

FEES AND CHARGES GUIDANCE

5.36 As discussed in Chapter 3, a cross subsidy arises when a public body uses equipment, facilities or information that it has for a statutory purpose to engage in a commercial activity and does not charge the full cost for undertaking this activity. Cross subsidies have the same effects on competition as normal subsidies.

57 Assembly Investment Grant Guidelines, 2002 - internal
5.37 The Scottish Public Finance Manual, Fees and Charges section\textsuperscript{58} and the Treasury’s Fees and Charges Guide\textsuperscript{59,60} aim to prevent public sector bodies from cross-subsidising their commercial activities with funds they receive for their public sector activities, as this would provide them with an unfair competitive advantage. Cross subsidies should therefore not distort markets, provided that public sector bodies adhere to this guidance. However, application of this guidance has been imperfect owing to a lack of awareness.

5.38 The issue of cross-subsidies is of increasing importance, as public bodies are encouraged to exploit any spare capacity they may have for commercial purposes, if they cannot dispose of it. The policy and guidance note 'Selling government services into wider markets' addresses this situation and requires public bodies to refrain from any anti-competitive behaviour in allocating common costs between commercial and non-commercial services\textsuperscript{61}.

5.39 The guidance on fees and charges requires public bodies to set fees and charges that reflect the full costs of providing a service, unless legislation provides differently\textsuperscript{62}. In addition, if there are commercial competitors, the guide requires public bodies always to charge a market price for their services in order to avoid any distortion to competition.

5.40 To ensure implementation of the guidance a network of fees and charges co-ordinators located in all government departments has been set up. However, a recent case involving Companies House indicates that there is still limited awareness of the guidance\textsuperscript{63}.

5.41 The Treasury Fees and Charges Guide is currently being revised and it is our understanding that it will focus more on the prevention of cross-subsidies. The

\textsuperscript{58} http://www.scotland.gov.uk/library5/finance/spfm/spfm-46.asp
\textsuperscript{59} Treasury’s Fees and Charges Guide, HM Treasury, 1992
\textsuperscript{60} The HM Treasury Fees and Charges Guide applies to England and in the case of non-devolved services (like national security) to Scotland, Northern Ireland and Wales. This guide has also been adopted by Northern Ireland and Wales.
\textsuperscript{61} Selling government services into wider markets, HM Treasury, 1998
\textsuperscript{62} The Fees and Charges Guide applies where a fee or charge is set by a Minister, a government department (including an executive agency or a trading fund), non-departmental government body or public corporation. It does not apply to self financing public corporations, devolved services or charges set by local authorities.
\textsuperscript{63} See the OFT press release PN 65/02 at http://www.oft.gov.uk/news/press + releases/2002/pn + 65-02 + companies + house + gets + all + clear.htm
new guide should render policy administrators, who set fees and charges for products and services that compete with private providers, better equipped to avoid generating competition distortions in future. It is our understanding that revisions to this guide will be reflected in the Scottish Public Finance Manual.

REGULATORY IMPACT ASSESSMENT

5.42 Since 1998, all proposals by central government and devolved administrations for regulations that affect business, charities or voluntary bodies have to undergo a Regulatory Impact Assessment (RIA). Following the White Paper, ‘Opportunity for all in a world of change’64 in 2001, all RIAs have to include a competition assessment. Box 5.2 gives details of the process for competition assessment.

5.43 At present the RIA process is only required for measures that are to be introduced through legislation. Very few subsidies are introduced using legislation – more often legislation will enable a problem to be addressed but will not specify the means for doing so65. Thus the scope of the RIA process for capturing subsidy is limited.

BOX 5.2 THE COMPETITION ASSESSMENT IN THE RIA

The RIA process is overseen by the Cabinet Office. The OFT assists policy makers with the competition assessment and checks the quality of that assessment.

The OFT has published guidelines to help policymakers in performing such assessments66. These guidelines outline a two step process to establish the implications of new legislation for competition. Step one is a competition filter that identifies proposals with the greatest risk of having a negative competition impact. Step two is only followed if the filter indicates that there is a risk of detrimental impact on competition. It consists of a detailed assessment that requires the identification of all the markets affected directly and indirectly by the policy intervention being assessed, an analysis of the nature of competition in these markets, and an appraisal of the likely effects of the proposed intervention on these markets.

64 http://www.dti.gov.uk/opportunityforall/
65 Some subsidies may occur when government seeks to compensate a sector that is particularly badly affected by the introduction of a new regulation.
DTI STATE AID POLICY UNIT

5.44 The State Aid Policy Unit (SAPU) of the DTI provides the link between the European Commission and the UK subsidy providers for all state aids. To fulfil its remit the unit does not need to consider the competition effects of these subsidies, unless compliance with the State Aids Rules specifically requires this.  

5.45 The SAPU 'provides advice on the State aid rules and procedures for all Government departments, agencies, local and regional bodies and devolved institutions providing aid to business. All notifications of state aid are routed through the State Aid Policy Unit (the Department for Food and Rural Affairs and the Department for Transport, Local Government and Regions carry out the same function in respect of agricultural and transport aid respectively). The Unit leads on the development of State Aid policy.'  

5.46 The SAPU centralises communications with the Commission, but it is not responsible for ensuring adherence to the State Aid Rules (e.g. for verifying that rescue and restructuring aid is used for the correct purpose). This responsibility remains with the subsidy provider. Responsibility for monitoring and enforcing the European state aid rules lies with the Commission. In the few cases that the European rules require a competition assessment for a subsidy this is performed by the subsidy provider and the SAPU reviews it before forwarding it to the Commission as part of the notification of the aid.  

5.47 Other Member States have different approaches to managing their state aids. In a number of countries, subsidy providers communicate directly with the Commission, rather than routing their information through a dedicated part of the national government. The Commission has required that the ten accession countries have national co-ordination units responsible for monitoring existing state aids. In Denmark the competition authority has the power to consider non state aid subsidies from the competition angle and advise government on state aids. This is discussed in Box 5.3.

67 This is required when:
- it needs to be established that a subsidy is a State Aid,
- the notification involves potential rescue and restructuring aid, or
- aid is provided under Article 87 (3)(c) or (d), i.e. to facilitate the development of certain economic activities or to promote culture and heritage conservation.

68 DTI State Aid website http://www.dti.gov.uk/europe/stateaid/
BOX 5.3 SUBSIDY CONTROL IN DENMARK

Under the Danish Competition Law of 2002, the Danish Competition Council (DCC) can investigate private and public enterprises that provide or receive subsidies that do not qualify as state aid, to find out whether their activities distort competition. The Council may terminate any such subsidies which it finds to have an adverse effect on competition (there have been two such cases to date) and order it to be repaid. The DCC can also consider complaints about subsidies.

The DCC does not have formal competence in state aid cases, although it does provide advice on the competition effects of proposed state aids to the relevant Ministry. Notification of aid to the DCC does not replace notification to the European Commission.

The DCC is currently working to improve the availability of information on subsidies in order to ensure greater transparency. It is also improving state aid monitoring and is trying to make it easier for companies to complain.

5.48 In contrast to the centralised enforcement of the state aids regime, where the Commission deals with monitoring and enforcing European rules, the enforcement of European competition law has recently been decentralised. EU Regulation 1/2003 (the Modernisation Regulation), which took effect on 1 May 2004, enables the national competition authorities and the courts of the Member States to apply and enforce Article 81 and Article 82.

Monitoring of subsidies

5.49 Monitoring can be used to identify the competition effects associated with existing subsidies by reviewing how the recipient has used the subsidy and the effects of this on competitors and market structure. Information about subsidy effects gathered from monitoring can feed into the design of new subsidies. In addition, it may sometimes be difficult to anticipate the competition effects of a particular subsidy and hence monitoring can identify concerns that have slipped through an appraisal. However, current monitoring of subsidies does not generally examine competition effects.

69 Although the Commission retains jurisdiction to apply Articles 81 and 82.
5.50 Within the UK, responsibility for monitoring the use of subsidies lies with the subsidy provider. Guidelines and practice on this varies, but all tend to focus on appropriate use of the funds by the recipient and the value for money of the subsidy and do not include a requirement to monitor how subsidies affect competition\(^70\). For example, the RSA/SFI Guidelines set out the need for monitoring of grants by the granting body, but this ex-post check is only meant to ensure compliance with the conditions under which the grant was given. Similarly, when the DTI has performed ex-post assessment of RSA (the last assessment was for the period 1991-95), this has focused on the ability of the scheme to deliver additional jobs in the Assisted Areas and its cost-effectiveness.

5.51 The current focus of monitoring therefore means that subsidies that distort competition are not identified or amended to reduce the impact of the subsidy on competition. It also means that providers do not build up a knowledge base of the extent of competition distortion associated with different subsidies to inform future subsidy design.

Conclusions and recommendations

5.52 The guidance to subsidy providers in the UK tends to focus on the effectiveness of subsidies, measured through cost benefit analysis and cost per job requirements. Whilst some subsidy providers do consider competition effects, there are no requirements for them to do this and few tools are available to help with competition assessment.

5.53 Subsidies can be a very powerful policy tools that can increase social welfare by correcting ‘market failures’. However, the OFT believes that is essential that the costs of distorting competition are fully recognised in assessing subsidies and, where possible, minimised.

5.54 Hence, the OFT recommends that consideration should be given to ways of supplementing policy appraisal guidance to ensure that competition considerations are included as one of the factors to be taken into account when designing a subsidy.

\(^70\) The DTI’s Business Support team is currently considering how to include competition in the evaluation of the new business support schemes.
5.55 The appraisal process used by central government and devolved administrations could involve a 'competition filter', as is the case already in the Regulatory Impact Assessment process. The filter could set certain thresholds below which no further competition analysis is required. This would have the advantage of focusing resources on the subsidies that have the biggest potential to cause competition distortions.

5.56 In appraising a subsidy there may be situations in which the product to be subsidised competes in an international market. If the international market is already being distorted by subsidies from another country this needs to be recognised in the appraisal process. The OFT hopes that by encouraging the Commission to revise its state aid guidelines to minimise the risk of competition distortion, such circumstances will be less common in the future.

5.57 The competition distortion associated with a scheme or a particular subsidy may sometimes only be identified once the subsidy has been given. However, current monitoring arrangements focus on how effective the scheme has been in achieving its main objectives and whether it has proved to be 'value for money' and, as with appraisal, the relevant guidance makes no mention of the need to consider the competition effects of the schemes as well.

5.58 The OFT therefore recommends that once appraisal guidance has been supplemented, all subsidy providers should ensure that monitoring procedures assess the impact of the subsidy on competition as well as its effectiveness and value for money.

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71 Roughly speaking, a market for a product is international if customers switch to purchasing the product from an overseas company if the price charged for it by a UK company increases. The market for a large number of products and services is only regional (customers will only switch to a supplier in the same region) or national (customers will only switch to between suppliers in the UK).
6 FURTHER WORK

6.1 Little analytic research exists concerning the distortion to competition caused by subsidies. In the first stage of this study we have sought to address this gap by developing an economic framework for the consideration of the competition effects of subsidies. We have applied this economic framework to the existing rules and guidelines on subsidies to examine whether subsidies have the potential to distort competition in the UK. As we have identified that, in principle, there is the potential for subsidies to distort competition, we now propose to undertake a second stage of research that examines how subsidies can affect competition in practice and develops the broad recommendations contained in this report in a detailed and proportionate manner. We seek the support of the UK government and devolved administrations in this work.

6.2 Empirical work would test the extent to which our theoretical findings are borne out in practice. We intend that the empirical work will take the form of case studies into a diverse range of subsidies, including examples of best practice. Depending on suitable candidates being available we would examine subsidies of different magnitude and selectivity to firms with different levels of market power. This would enable us to understand the extent to which the characteristics identified through our research affect markets in practice. We would welcome views from subsidy providers and other stakeholders on suitable examples for study.

6.3 In this report we have made broad recommendations, targeting the areas in which we think the rules and guidance could be improved. We would aim to use the results of our case studies to assist with the development of more specific recommendations as to how competition distortions arising from subsidies can be appraised and addressed. Most importantly, recommendations can be made that are proportionate to the scale of the problem. For example, if we learnt that a selective subsidy has very significant competition effects but that, in practice, the repetition of subsidies makes very little difference, we could then target our recommendations accordingly. Through case studies, there is also scope for us to work with subsidy providers to test the feasibility of possible recommendations.

6.4 We have not fully refined the scope of this second stage of work. We will consider the case for including other issues such as complaints mechanisms and data and transparency issues. We would value specific suggestions on the scope of our work. These may be sent to Lindsay Chalmers (lindsay.chalmers@oft.gsi.gov.uk) by the end of December, 2004.
6.5 By developing a good understanding of the effects of subsidies on competition in practice the UK should also be placed in a stronger position when making the case for changes at the European level.
ANNEXE A: LIST OF CONSULTED PARTIES

**Government organisations**

- Department of Culture, Media and Sport
- Department of Enterprise, Trade and Investment (NI)
- Department of Trade & Industry
- Department for Education and Skills
- Department for Work and Pensions
- HM Treasury
- National Assembly for Wales
- Office of the Deputy Prime Minister
- Scottish Executive
- Secretary for State for Northern Ireland
- Small Business Service
- UK Permanent Representation to the EU

**Regional Development Agencies in England**

- North West Development Agency
- South West of England Regional Development Agency
- Yorkshire Forward

**Development Agencies in the other nations of the UK**

- Scottish Enterprise
- Welsh Development Agency
- Invest Northern Ireland

**Others**

- Confederation of British Industry
ANNEXE B: EUROPEAN STATE AID RULES

B.1 This annexe aims to outline the current European state aid (SA) rules\(^1\). This annexe is split into two parts:

- **Part I** - an overview of the rules including relevant legislation, the notification process, and challenges and complaints, and

- **Part II** - a description of the SA guidelines published by the Commission.

B.2 This annexe provides an overview only. For the detail, refer to the full copies of the provisions of the Treaty, regulations and guidelines, which can be downloaded from the Commission website\(^2\).

Part I: Principles of the European State Aid Rules

B.3 Articles 87-89 of the Treaty of Rome (‘the Treaty’) underpin the European SA rules. The Treaty starts from the principle that all SA should be prohibited. Thus, Article 87(1) states that ‘...any aid granted by a member state or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between member states, be incompatible with the common market.’

B.4 There is no definition given of what constitutes aid. However, Article 87(1) can be broken down into four tests which the Commission considers in order to establish if a measure constitutes a SA. A SA is a government measure which fulfils four criteria:

- **A transfer of State resources** – either a cost or loss of revenue,

- **Conveys an economic advantage** to certain undertakings or the production of certain goods, i.e. is selective in availability,

- **Distorts or threatens to distort competition** – even a limited advantage is likely to raise a risk of distortion, and

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\(^1\) Here we refer to the European rules as covering the relevant legislation, block exemptions and guidelines.

\(^2\) [http://europa.eu.int/comm/competition/index_en.html](http://europa.eu.int/comm/competition/index_en.html)
- **Affects trade between member states** – product or service is or could be subject to intra-Community trade.

B.5 All SAs which distort competition are in principle prohibited. However, the rules make allowances for instances where SA may be justified according to the aims of the Common Market. Articles 87(2) and 87(3) provide for a number of exemptions where SA is, or may be, permitted.

B.6 Article 87(2) states that the following types of aid **shall** be allowed:

a. Aid having a social character, granted to individual consumers, granted without discrimination related to the origin of the product concerned,

b. Aid to make good the damage caused by natural disasters or exceptional circumstances, and

c. Aid granted to compensate for the economic disadvantages caused by the division of Germany into East and West.

B.7 Article 87(3) states that the following **may** be allowed:

a. Aid to promote development of areas with abnormally low standards of living or serious unemployment,

b. Aid to promote an important project of common European interest, or to remedy severe disturbances in the economy of a Member State,

c. Aid to facilitate the development of certain economic activities, or certain areas, where the aid does not significantly distort inter-state trade,

d. Aid to provide heritage and culture conservation where the aid does not significantly distort inter-state trade, and

e. Such other categories of aid as may be specified by the European Council.

B.8 The Commission passes regulations and publishes procedural guidelines that describe in more detail the type and level of aid that are likely to be considered acceptable, and the procedures they intend to follow when looking at SA proposals. These regulations and guidelines are discussed in more detail in Part II of this annexe. It is however useful to give a very brief overview here.
Currently the European regulations and guidelines can be separated into:

- Block exemption regulations, where the presumption is that the aid is compatible with the Common Market as long as it fulfils certain criteria,
- Generic horizontal guidelines, which apply to specific types of firms such as SMEs or to activities across the whole economy,
- Rescue and restructuring guidelines which are used to aid firms whose closure would cause detriment to the economy,
- Services of general economic interest, are market services on which Member States are subject to specific public service obligations by virtue of a general interest criterion. This would tend to cover such things as transport networks, energy and communications,
- Regional guidelines, determining where and how regional aid may be granted, and
- Specific sectoral guidelines, which adapt community guidelines to take account of specific sectoral features.

Generally, a SA measure has to adhere to one of the regulations or guidelines in order to comply with the Treaty. However, a Member State (MS) may also submit a scheme to which no regulations or guidelines apply. In this situation the Commission must examine it directly on the basis of Article 87(3), and may choose to allow the aid.

The powers of the Commission to act on these principles are set out in Article 88. This gives the Commission the powers to:

1. Carry out reviews and to issue new guidelines and frameworks to take account of the developing needs of the Common Market,
2. Require MSs to abolish or change aid if, after investigation, the aid is judged by the Commission to be incompatible with the Common Market, and
3. Require MSs to notify proposed aid in advance for clearing.
B.12 Under powers granted by Article 88(3), MSs must notify proposed aid to the Commission in advance for clearance, allowing the Commission time to investigate whether the aid is compatible with one of the existing guidelines\(^3\). Aid which is not notified is illegal, and the Commission can insist that non-notified aid be repaid with interest.

THE NOTIFICATION PROCESS

B.13 Notification is made through a standard form, which asks for certain information about the aid. This information includes:

- Aim of the scheme, e.g. horizontal, regional or sectoral,
- The forms of aid, e.g. grant, low interest loan, tax relief etc,
- The costs which the aid may contribute to,
- The level of expenditure and the period it covers,
- Whether recipients may cumulate the aid with that from other sources, and
- The justification of why the scheme is compatible with the Treaty.

B.14 Once a notification is received, the Commission must make a decision within two months whether to allow the aid, or start a fuller investigation. However, the Commission may, and usually does, seek further information during the two month period if it considers that the notification is incomplete. Any questions will re-set the clock and a fresh two-month period begins from the date of receipt of the reply. It may decide to allow the aid on the basis of the notification form, supplemented where appropriate with further information requested from the MS.

B.15 Alternatively, the Commission may decide that a more in depth investigation is necessary, at which point it would start the procedure referred to in Article 88(2). This involves inviting comments from other MSs and interested parties, and publication of a summary of the notification in the Official Journal of the European Union (OJEU). The whole process may take up to 18 months. There are four possible results:

- The measure is not a SA, and is therefore not prohibited,

\(^3\) This applies all aid not covered by the block exemptions, which can be implemented without prior notification.
- The measure is a SA but is compatible with the Common Market, and is therefore allowed,

- The measure is a SA but is compatible with the Common Market under some conditions laid down by the Commission, and is therefore allowed under those conditions, or

- The measure is a SA and is not compatible with the Common Market, and so is not allowed.

CHALLENGES AND COMPLAINTS

B.16 The Commission’s decision to allow or refuse aid can be challenged by any MS or interested party within two months of the decision, under Article 230 of the Treaty. To be successful, the appeal must demonstrate that the Commission did not follow its own requirements when making the decision. The party who submits the complaint will need to show that, had the Commission followed its own obligations and procedures properly, it could not have reached the decision it did.

B.17 The European Court of First Instance (CFI) judges complaints about SAs, while the European Court of Justice (ECJ) deals with cases concerning the interpretation of the law and procedural issues. The ECJ also looks at SA issues which have been referred to it by the national courts under Article 234 of the Treaty.

B.18 Concerning the enforcement of state aid decisions Article 88(2) gives the Commission or any MS the right to refer directly to the ECJ if they do not feel a Commission decision is being complied with at the end of the scrutiny procedure. Under Article 228 the ECJ and the Commission both have the power to fine MSs for failure to comply with decisions made by the Commission.

Part II: State Aid Regulations and Guidelines

B.19 This part outlines the various European regulations and guidelines that set out the criteria under which the Commission will recognise that a SA is compatible with the Common Market. Two types of aid are identified by the Treaty that may be compatible with the Common Market: a limited set of very exceptional forms of aid which ‘shall be compatible’ with the Common Market; and a broader group which, at the Commission's discretion 'may be' compatible with the Common Market.
B.20 In describing the regulations and guidelines, this annexe distinguishes between two sets of exemptions:

- **Block exemptions** – SAs that meet the criteria set out in these regulations are presumed to be compatible with the Common Market, and
- **Discretionary exemptions** – where the Commission decides on the compatibility dependant upon the specific circumstances of the aid, considered against published guidelines.

**BLOCK EXEMPTIONS**

B.21 The block exemptions described in this section set out a small group of SAs that are seen to be compatible with the Common Market. The regulations were passed by the Commission (under powers given to them by the European Council, regulation 994/98) to allow MSs to distribute certain forms of aid without prior notification, so long as the requirements of the regulations are met. Schemes or payments that conform to block exemption regulations are, therefore, not subject to any additional assessment by the Commission.

B.22 The key features of the regulations are:

- There is no need to pre-notify the European Commission of aid which fits all the terms of the regulation, and
- The regulations are legally binding and directly applicable in MSs. This means that aggrieved third parties could bring actions in a national court. If the court were to agree with the aggrieved parties, the aid would be unlawful and might have to be repaid with interest.

B.23 There are two types of block exemption: de minimis (DM) rules which completely exempt very small payments, and specific rules which define when aid to small and medium sized enterprises (SME), training aid, and employment aid are exempt. These are described in more detail below.

*De minimis aid*

B.24 Under DM regulations government bodies can grant up to €100,000 (£60,000) of aid cumulatively to a firm over a rolling three-year period without notification to the Commission at any point. This aid can be granted regardless of the size of the

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4 All SAs passing through a block exemption must however be notified after implementation, except de minimis aid which is not considered to be a SA.
firm and may be used for a range of purposes\(^5\). Enterprises must be informed that the aid is de minimis and government bodies must ascertain that the new award does not breach the threshold. The government body is also required to keep detailed records of the awarded aid for 10 years.

B.25 The rationale underlying the DM regulations is that small amounts of aid are likely to have a negligible impact on trade and thereby inter state competition. DM payments are therefore not considered to be SA for the purposes of Articles 87-89 so there is no requirement to notify the Commission before or after implementation, unlike the other forms of block exemption aid.

\(^5\) De minimis aid cannot be given for export related activities (except attendance at trade fairs), transport, agriculture and fisheries or aid favouring domestic goods over imports.
Specific block exemptions

B.26 Three further block exemptions exist, covering SMEs, training and employment on the basis that benefits are seen to outweigh any potential cost from the loss of competition\(^6\). Each exemption has a specific set of characteristics, in terms of the forms of aid that are permitted. These are set out in the table below.

TABLE B.1: FORMS OF AID PERMITTED UNDER BLOCK EXEMPTIONS

<table>
<thead>
<tr>
<th>Region specific</th>
<th>Sector specific</th>
<th>Firm specific</th>
<th>Unlimited time period</th>
<th>Aid to large enterprises (in all circumstances)</th>
<th>Uncapped intensity(^7)</th>
<th>Uncapped total value</th>
<th>Aid to non-assisted areas(^8)</th>
<th>Aid to all sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Training</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>SME(^9)</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Employment</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
</tr>
</tbody>
</table>

Source: OFT analysis

B.27 The scope for passing schemes under the existing block exemptions is relatively broad. Under the SME and training block exemptions, SA can be distributed in any form, for any period of time to almost any market; with accessibility restricted on regional, sectoral or firm specific criteria. Scope is somewhat narrower for employment aid, where firm specific and sector specific payments are not exempt from notification, and a maximum two year time period is put on payments.

\(^6\) For the purposes of SA, the Commission defines an SME as a firm that:
- has fewer than 250 employees,
- has an annual turnover of less than 40 million euros (approx. £25 million in 2001), or an annual balance sheet total not exceeding 27 million euros (approx. £17 million in 2001), and
- is less than 25% owned by one or more companies not falling within this definition.

\(^7\) Intensity refers to the proportion of cost that can be subsidised.

\(^8\) The way in which assisted areas are defined is explained in the regional guidelines section.

\(^9\) The SME block exemption has recently been extended to include R&D aid.
DISCRETIONARY EXEMPTIONS

B.28 If SA does not qualify for one of the block exemptions it must undergo the full notification process (described in paragraphs B.13 to B.15). The Commission has published a series of guidelines setting out the various circumstances in which aid will be allowed, and the criteria which the aid must meet. These are split into five sections:

- Horizontal guidelines, which apply to specific types of firms or of activities across the whole economy,
- Rescue and Restructuring (R&R), which are used to aid firms whose closure would cause detriment to the economy,
- Services of General Economic Interest (SGEI) are market services on which Member States are subject to specific public service obligations by virtue of a general interest criterion. This would tend to cover such things as transport networks, energy and communications,
- Regional guidelines, which deal with aid to specific areas of the European Union, and
- Specific sectoral guidelines, which adapt community guidelines to take account of specific sectoral features.

B.29 A brief description of the characteristics of each of these guidelines is set out below outlining the aim of each exemption, as specified in the guideline, followed by a brief description of the criteria necessary for aid to be allowed under the guidelines.

Horizontal guidelines

B.30 Horizontal guidelines apply to specific types of firm or activities across the whole economy. The horizontal guidelines are split into four areas: research and development (R&D); environmental and risk capital. These are described in turn below.
Research and development

B.31 R&D guidelines enable MSs to provide aid aimed at fostering innovation, research and technological development. This framework aims to encourage new technology to be developed and disseminated between MSs.

B.32 The guidelines work on the premise that the closer the R&D is to the market, the more significant may be the competition distortion caused by the aid. As such, the Commission makes a distinction between fundamental research, industrial research and pre-competitive development activity\(^\text{10}\). Different aid intensities are permitted depending on the category into which the R&D falls into.

Environmental

B.33 MSs cannot give aid to help firms to meet mandatory Community environmental standards, or give tax exemptions which lead to lower tax rates than binding minimum community rates. However, aid aimed at achieving environmental standards over and above the minimum community standards will be considered compatible, under certain conditions\(^\text{11}\). Provided that the aid meets this requirement, the environmental guidelines permit aid for:

- Investments in land, buildings, plants, production methods and equipment intended to reduce pollution,
- Consultancy or advisory services to SMEs concerning environmental protection, and
- Operating costs for the management of waste and in the energy-saving field.

\(^{10}\) The activities are defined on the basis that:
- **Fundamental research** is an activity designed to broaden scientific and technical knowledge not linked to industrial or commercial objectives;
- **Industrial research** is planned research of critical investigation aimed at the acquisition of new knowledge, the objective being that such knowledge may be useful in developing new products, processes or services; and
- **Pre-competitive development activity** is the shaping of the results of industrial research into a plan, arrangement of design for new, altered or improved products, processes or services, whether they are intended to be sold or used, including the creation of an initial prototype which could not be used commercially.

\(^{11}\) These conditions include the requirement that SA must be considered necessary to ensure environmental protection without having disproportionate effects on competition and growth within the common market.
B.34 The allowed intensity of the aid is dependant upon its aim and the recipient. For example, where aid helps SMEs meet the transitional investment costs of new environmental standards, the maximum is 15 per cent of eligible costs for a maximum of three years. However where investment aid helps firms to improve on European standards the maximum is 30 per cent of eligible costs (40 per cent for SMEs).

Risk capital

B.35 The Commission may authorize risk capital measures aimed at addressing the difficulties SMEs face in obtaining capital and credit. This is seen as one of the main handicaps suffered by SMEs, in particular for small enterprises and start-ups.

B.36 The form of aid is chosen by the MS. The Commission’s assessment of such aid will consider whether it encourages market investors to provide risk capital to the ‘target enterprises’ and is likely to result in decisions to invest being taken on a commercial basis.

Rescue and Restructuring Guidelines

B.37 Rescue and restructuring guidelines allow MSs to assist firms that are unable to stem losses that would almost certainly condemn them to go out of business, to the serious detriment of the economy.

B.38 Rescue aid is by its nature temporary assistance, aimed at keeping the firm afloat long enough to work out a restructuring or liquidation plan, and must be reimbursed\(^\text{12}\). It can only be warranted on the grounds of serious social difficulties, and must not have any serious spill-over effects on other MSs.

B.39 Restructuring aid has to be based on a feasible, coherent and far-reaching plan to restore a firm’s long term viability, usually involving at least one of:

- Reorganisation and rationalisation of the firm’s activities, typically involving the withdrawal from loss-making activities,
- Diversification towards new a viable activities, and
- Financial restructuring, although this cannot simply be aid designed to make good past losses without tackling to causes of those losses.

B.40 The Commission recognises that restructuring aid raises particularly serious competition concerns because of its potential to keep inefficient firms in the

\(^{12}\) Rescue aid must be limited to loans or loan guarantees.
market. It therefore considers that this aid can only be granted if it can be demonstrated that the competition distortions thus caused will be offset by the benefits flowing from the firm’s survival (e.g. the associated redundancies would exacerbate employment problems, or disappearance of the firm would result in a monopoly or tight oligopoly situation).

**Services of General Economic Interest**

B.41 SGEI guidelines allow MS to subsidise services that may not be adequately provided through market forces, but that the MS considers need to be provided to a certain standard. Satisfactory provision includes all aspects of provision such as quantity, quality and means of delivery. SGEIs tend to cover such things as transport networks, energy and communications.

B.42 SA rules, when applied to public service obligations, address two sets of issues:

- The manner and extent to which MSs can compensate an operator; and
- How to avoid aid “over-spills” between the area of public service obligation and other areas of economic activity.

B.43 The impact of SGEI rules depend upon whether the aid is considered to apply to an economic or non-economic activity\(^\text{13}\). If the aid is aimed at a non-economic activities the “compensation approach” is applied however if economic activities are involved then the SA approach is used.

B.44 Under the compensation approach, the SA rules are not applied, as European case law dictates that compensation for public service obligations does not constitute SA as long as it does not exceed the ‘additional cost’ of providing such service\(^\text{14}\).

B.45 However, under the SA approach all funds provided from state resources are SA, irrespective of the purpose for which they are paid. As such compensation for

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\(^{13}\) Non economic activities include matters which are the prerogative of the State e.g. foreign relations; and where the State is not engaged in gainful activity such as the provision of national education and compulsory basic social security systems. Other entities which perform non-economic activities include charities, religious organisations, trade unions, political parties.

\(^{14}\) This approach can be seen in the ECJ judgement in the Ferring (regarding tax benefits to certain pharmaceutical wholesale distribution companies) and Altmark (regarding compensation for public services to transport companies) cases.
services of general economic interest must be justified through the normal European SA rules.\(^{15}\)

B.46 There is some debate on precisely when either approach should be applied.

*Regional Guidelines*

B.47 MSs are allowed to give regional aid to address market failures that cause underperformance in specific areas of the country. Specifically, the Treaty allows two types of regional aid:

- Article 87(3)(a) - to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment), and
- Article 87(3)(c) - to facilitate the development of certain economic activities or areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

B.48 Regional aid must meet a number of criteria. It must:

- be exceptional in nature and limited in time,
- be concentrated on the most disadvantaged regions, and
- ensure that the resulting distortions of competition do not outweigh the advantages of the aid in terms of economic development.

B.49 The areas where regional aid is allowed are generally referred to as Assisted Areas (AAs). These are defined according to which Article they are being considered under:

- **Tier 1 AAs** considered under 87(3)(a) are very tightly defined as areas that had a GDP per capita below 75 per cent of the EU average (between 1994 and 1996), and
- **Tier 2 AAs** considered under 87(3)(c) are less clear-cut, as no specific quantitative thresholds are set; hence MS have greater discretion in designating them.\(^{16}\)

\(^{15}\) This view was expressed by the CFI in the Fédération française des sociétés d’assurances (regarding tax exemptions to companies providing postal services) and Sociedade Independente de Comunicação SA (regarding financial support to television broadcasting companies) cases.
In evaluating aid given to AAs, the three key considerations are:

- The income generated directly by the project,
- The displacement effects on firms (in terms of jobs and market shares) both in and outside the AAs, and
- The wider benefits to the “competitiveness” of the economy at large.

The amount that can be provided varies depending upon the size of the intended recipient and the aim of the aid. For example, the aid ceilings are higher for aid to SMEs. Regional aid can be for both capital investment and as an aid to employment creation. Aid is available to most sectors of industry and commerce but restrictions apply to certain sectors where over-capacity exists in the market, as set out in the sectoral guidelines, outlined below.

The set of areas that are eligible for regional aid is being reviewed following the expansion of the European Union. This review may also give rise to changes in the aid ceilings permitted for different types of firms.

**Sectoral guidelines**

Specific sectoral guidelines exist in order to take account of the sensitive or unique nature of some economic sectors. The guidelines aim to control aid to sectors where SA may be particularly distortive, for example because it would prevent natural market rationalisation in the presence of over-capacity.

Guidelines vary significantly in terms of the aid they permit within a sector, but can be broadly categorised as enabling or restricting. Enabling guidelines increase the possibility to give SA in order to facilitate services of general economic interest or to tackle social objectives, whilst restricting guidelines are used to reduce SA to strategic industries within the common market.

Sectoral guidelines exist in a number of different sectors. These are:

- **Agriculture** - Generic SA rules do not apply to the agricultural sector due to its historic significance and importance for the rural economy. In their place exist a specific set of enabling guidelines, which offer MSs fairly

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16 The Commission however stipulates that the means of identifying Tier 2 areas must be objective, transparent and based on up to 5 reliable indicators, and that identified areas must be display significant disparities from the average and have a minimum population of 100,000. The UK for example designated Tier 2 AAs based on four criteria: employment rate, unemployment rate, workforce unemployment rates, and local dependence on manufacturing.
broad scope to distribute aid to the agricultural sector subject to specific intensity caps.

- **Broadcasting** - guidelines on the broadcasting sector permit SA payments to facilitate the provision of public service programming.

- **Coal** – The Coal guidelines allow aid to this sector on the basis that a minimum level of coal production is necessary for energy security, and that the social and regional detriment caused by coal industry restructuring can be high. The level of support allowed is decreasing over time.

- **Electricity** - Aid aimed at compensating eligible stranded costs in the electricity sector is considered by the Commission to be compatible with the common market. Guidelines are likely to become obsolete, as the stranded costs must predate 1997.

- **Fishing** - The Commission permits SA that promotes sustained growth within the fisheries sector, as long as the programs thus funded are compatible with the common fisheries policy. Allowed payments are subject to specific intensity caps.

- **Motor vehicles** – The importance of this sector to employment, trade and technological development has lead to the level of scrutiny being increased substantially. Each significant payment must be notified, rather than each scheme (as is the case under other guidelines). This applies to all significant payments made under existing schemes, any aid which the public authorities intend to grant outside an approved scheme, and any rescue and restructuring aid which public authorities plan to grant.

- **Ship building** – SA to shipbuilding is subject to special guidelines due to the existence of overcapacity and depressed prices. These include a combination of restrictions and more lenient provisions. In particular, these guidelines enable MSs to deliver export credits, closure aid, and development aid for shipping yards.

- **Steel** - Under the Commission’s 2002 Communication on a multilateral framework on regional aid for large investment projects, no investment in the steel industry is eligible for regional investment State aid during the

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17 Stranded costs are investment or other commitment costs incurred by the electricity industry prior to the liberalisation of the electricity sector, which can not be recovered due to the liberalisation process. For example, commitments or guarantees of operation
lifetime of the framework (until 31 December 2009). The Communication on rescue and restructuring aid for the steel sector, indicates that it regards closure aid as compatible with the common market but rescue and restructuring aid to the steel industry as incompatible

- **Synthetic fibres** - Under the Commission’s 2002 Communication on a multi-sectoral framework for large investment projects, no investment in the synthetic fibres sector is eligible for regional investment State aid. The Commission is considering whether and to what extent the synthetic fibres sector is to be included in the list of sectors with serious structural problems (to which more restrictive rules apply from 1 January 2004).

- **Transport** – Sectoral rules for the transport sector authorise aid that enables the coordination of road, rail and inland waterways transport; reimburses for certain public service obligations; or boosts the competitiveness of inter-state shipping. More stringent rules apply to the air transport sector, where aid can only be granted if it forms part of a self-contained one off restructuring package aimed at reducing capacity.

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such as long term purchase contracts or investments undertaken with an implicit or explicit guarantee of sale.