

**T.C
MARMARA ÜNİVERSİTESİ
AVRUPA TOPLULUĞU ENSTİTÜSÜ**

AVRUPA BİRLİĞİ İKTİSADI ANABİLİM DALI

**AN ANALYSIS OF THE STATE AIDS POLICY
IN THE EUROPEAN UNION:
THE CASE FOR THE SERVICES OF GENERAL ECONOMIC
INTEREST**

**YÜKSEK LİSANS TEZİ
(MSc Dissertation)**

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Tez Danışmanı: Yrd. Doç. Dr. M. Sait AKMAN

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DISSERTATION TITLE:
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AUTHOR: DORUK TUNCER

ABSTRACT

This dissertation attempts to analyse the State aids policy of the European Union (EU) and the Services of General Economic Interest (SGEI) focussing primarily on the transport sector. The study is the product of an analysis of the evolution of the State aids policy putting it in a single market context. After the 1970s the EU started giving exemptions to the State aids and pursued a more flexible State aids policy. After the secondary legislation was introduced, the State aids policy became more complex. In this respect, the SGEI will be examined and the case study of Altmark and other cases will be studied. The study will lead to an analysis of the policy specifically in the transport sector. The study will lay down a proposition for an alternative of the State aids policy in the transport sector. It is argued that the policy should be simplified to return to its original days in the 1950s. In other words, it should become a restrictive policy giving exemptions only in cases of domestic divergences. In order to serve the other purposes of European integration, the Member States should not be allowed to give out national subsidies. Instead of State aids, Member States should form new funds for common subsidization. The State aids policy should seek the protection of competition in the Single European Market. For the efficient working of the Single European Market it is important not to harm the competitive conditions in different EU Member States. By this way, the EU economy will work in more competitive conditions.

TEZ BAŐLIĐI:

AVRUPA BİRLİĐİNDE DEVLET YARDIMLARI POLİTİKASININ ANALİZİ:
TOPLUMSAL AMAÇLI HİZMETLER SEKTÖRÜ DURUMUNUN İNCELENMESİ

TEZ YAZARI: DORUK TUNCER

TÜRKÇE ÖZET

Bu tez, Avrupa BirliĐi'nin (AB) devlet yardımları politikasını ve toplumsal amaçlı hizmetler sektörünü inceleyip ulařtırma sektörüne yoğunlařmaktadır. Çalışma devlet yardımları politikasının tarihsel gelişimini analiz ederek politikayı Tek Pazar çerçevesi içinde ele almaktadır. AB 1970'lerden sonra devlet yardımlarına istisnalar getirmeye ve daha esnek bir devlet yardımı politikası uygulamaya başladı. İkincil yasalar yürürlüĐe girdikten sonra, devlet yardımları politikası daha karmařık hale geldi. Bu bağlamda çalışma, toplumsal amaçlı hizmetler sektörünü, Altmark davasını ile diĐer davaları incelemektedir. Avrupa Komisyonunun ulařtırma alanında uyguladıĐı devlet yardımları politikası eleřtirilmekte ve halen uygulanmakta olan politika yerine alternatif bir politika önerilmektedir. AB'nin devlet yardımları politikasının 1950'lerde ilk kurulduĐu yıllardaki gibi kısıtlayıcı bir politika olarak uygulanması gerekmektedir. Devlet yardımlarının ülkesel farklılıklar gibi haller dışında yasaklanması önerilmektedir. Bu çalışma, devlet yardımlarını ve Altmark gibi davaları inceleyerek sadece ulařtırma alanındaki politikalarını eleřtirmektedir. AB entegrasyon sürecinin diĐer hedeflerine de ulařmak için; hiçbir AB üye devleti kendi ulusal řirketlerine devlet yardımı yapmaması ve bunun yasaklanması gerekmektedir. Bunun yerine sadece ülkesel farklılıklar gibi durumlarda kullanılmak üzere her üye devletin bütçesinden AB'nin Brükselde oluşturacaĐı bütçeye bir kaynak aktarılması ve bu kaynaĐın Brüksel üzerinden Komisyon tarafından daĐıtılması savunulmaktadır. Tek Avrupa pazarının verimli çalışabilmesi için AB'nin rekabet ortamının bozulmaması büyük önem taşımaktadır. Bu sayede Avrupa BirliĐi ekonomisi daha rekabetçi bir biçimde işleyecektir.

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ABBREVIATIONS

A	Austria
AEA	Association of European Airlines
ACI	Airport Council International
B	Belgium
CAP	Common Agricultural Policy
CCP	Common Commercial Policy
CM	Common Market
CR	Council Regulation
CU	Customs Union
D	Germany (Deutschland)
DG	Directorate General
DG IV	Directorate General IV (Competition)
DG VII	Directorate General VII (Transport)
DG XVI	Directorate General (Regional Policies and Cohesion)
DG XVII	Directorate General (Energy)
DK	Denmark
DTI	Department of Trade and Industry
E	Spain (Espana)
EC	European Community
ECJ	European Court of Justice
ECSC	European Coal and Steel Community
EEC	European Economic Community
EEI	European Economic Integration
EL	Greece
EP	European Parliament
EU	European Union
GATT	General Agreement on Tariffs and Trade

F	France
FIN	Finland
FTA	Free Trade Area
I	Italy
IRL	Ireland
L	Luxembourg
MILSA	Minas de Lières SA
MS	Member State
MU	Monetary Union
NICs	Newly Industrialising Countries
NL	Netherlands
NUTS	Nomenclature of Territorial Units for Statistics
P	Portugal
PMH	Philip Morris Holland
PSOs	Public Service Obligations
R&D	Research & Development
RTD	Research & Technological Development
S	Sweden
SEA	Single European Act
SEM	Single European Market
SGEI	Services of General Economic Interest
SME	Small and Medium-Sized Enterprises
STP	Strategic Trade Policy
TEU	Treaty on European Union (Maastricht Treaty)
UK	United Kingdom
WTO	World Trade Organization

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Doruk TUNCER

Istanbul, 2006

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- Annex 1** Consolidated Version of the Treaty Establishing the European Community, Article 87, Article 88 and Article 89
- Annex 2** Council Regulation (EC) No 994/98 of May 1998 on the Application of Articles 92 and 93 of the Treaty Establishing the European Community to Certain Categories of Horizontal State Aid
- Annex 3** Council Regulation (EC) No 659/1999 of 22 March 1999 Laying Down Detailed Rules for the Application of Article 93 of the EC Treaty
- Annex 4** The Altmark Case – The European Commission Satisfied with the Court of Justice’s Ruling

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I. INTRODUCTION

State aids policy, which is a sub-branch of competition policy, is one of the most important economic policies of the European Union (EU). It is also one of the most controversial in the context of the Lisbon Agenda and the re-emerging national champions argument. Therefore it is worth taking a deeper look at this policy.

The Rome Treaty clearly indicates that achieving the Common Market is one of the main goals of the Union. The increasing competition between United States, Japan and the EU has made the competition policy even more important.

This study analyses the evolution of the State aids policy by putting it in a single market context. In the early days of the Rome Treaty, the State aids were banned and aids were granted in very exceptional circumstances. However, after the 1970s the EU started giving exemptions to the State aids and so pursued a more flexible policy. Meanwhile the State aids policy became more complex as a body of secondary legislation was introduced. The main reason behind these developments was the fact that as the European integration deepened new policy areas were introduced and integration of markets ceased to be the only objective of the EU. Moreover the basic provisions on State aids in the Rome Treaty included several exemptions right from the beginning.

This situation creates an apparent conflict between the protection of competition and other public policies. Therefore a critique of the State aids policy is necessary. However given the complexity of the issue and sectoral differences, the present thesis concentrates on the transport sector where the conflict in question is unavoidable; because transport is widely accepted as one of those sectors that constitute Services of General Economic Interest (SGEI).

With this purpose in mind, the study will examine the concept of SGEI in detail. The infamous Altmark judgment of the Court of Justice in the transport sector and other

important cases such as Enirisorse, Gemo and Ferring will be reviewed in this context. Also taking into consideration the actual impact of subsidies in the transport sector a comprehensive analysis will be presented.

In the conclusion, the study will lay down a proposition for an alternative that involves a simplification of the State aids policy and a somewhat radical overhaul of the economic management of the Community that can be very beneficial in the context of the Lisbon Agenda. It is important to mention that the scope of this study only covers the transport sector in the EU; but the results can be generalized to all sectors and horizontal issues.

However in order to reach that point we have to lay down the necessary background. Therefore in the second chapter the economics of State aid is studied. The questions of why and when governments should intervene in the economy and how is that taken under control by the EU, is answered. This is a theoretical exercise; but the empirics follow right away. Actual forms of State aids are explained and detailed information about State aids given by the Member States of the EU is presented with the help of graphs and tables.

In the third chapter we take a look at the development of the State aids policy. First, the rationale behind the inclusion of such a disciplines in the Rome Treaty is explained. Then the basic provisions about State aids included in the Treaty are explained. Following that the evolution of the actual implementation of the policy is reviewed over decades. The impact of the Altmark case is naturally left to the corresponding chapter.

The following chapter takes a more detailed look at the policy and examine its application. The international dimension and the sub-branches of the policy as well as the institutional and procedural matters are explained with sufficient detail.

The fifth chapter is where the study makes its analysis. After examining the concept of SGEI, its interaction with the State Aids policy is shown. Then the impact of SGEI in the transport sector and the problems caused by the State policy in this context are examined. It is not surprising that the Court of Justice gave important decisions in this area. An analysis of these decisions reveals the weaknesses of the State aid policy. Drawing on the

theoretical framework presented in the second chapter the study then states its findings. The study proposes that the policy should be simplified to return to its original form and it should become a negative policy giving exemptions only in cases of *de minimis* and extraordinary situations such as natural disasters.

The sixth and the final chapter is the conclusion, briefly summarising the study and the proposal for the alternative to the present state of State aids policy.

II. ECONOMICS OF STATE AIDS

The present chapter consists of three sections. In the first section a theoretical approach is taken to shed light on the questions of government intervention in the economy and its control by the EU: In the second section the actual forms of State aids given by the Member States in the EU are explained. We then present statistical information on the amount of subsidies thus distributed.

2.1. Economic Rationality of State Aids

Every State aid constitutes a government intervention in the economy. Since the economy itself constitutes of producers and consumers acting in the framework of markets State aids are interventions to the markets. However economic theory tells us that markets provide the optimal way of allocation of the scarce resources that we have. So why intervene in the markets in the first place?

In order to understand that we have to define certain core concepts. The study will focus on terms such as Market Failure, Distortions, Divergence and Externalities and then examine the issue of domestic divergences.

Corden defines '*Marginal Divergence*' as any divergence between marginal private and marginal social costs, or marginal private and marginal social benefits however caused. He states that if a divergence is caused by government policy of some kind, such as a tariff or other form of tax, then it is a '*distortion*'. Thus a distortion is a particular kind of *divergence*. If a divergence is caused by 'market failure' which is not clearly the result of government policy – for example, a monopoly situation or an externality – in that case it is not a distortion (Corden, 1989, p.13).

Collins Dictionary of Economics defines Market failure as; "*The failure of Markets to achieve an optimum resource allocation.*" This may occur especially where markets are dominated by Monopoly suppliers or where the production/consumption of products causes pollution. Market failure may necessitate government intervention to regulate

markets through competition policy, regional policy and industrial policy. (Collins Dictionary of Economics, 1998, p 332)

Externality is another concept which needs to be defined. Herber in his book defines Externalities as:

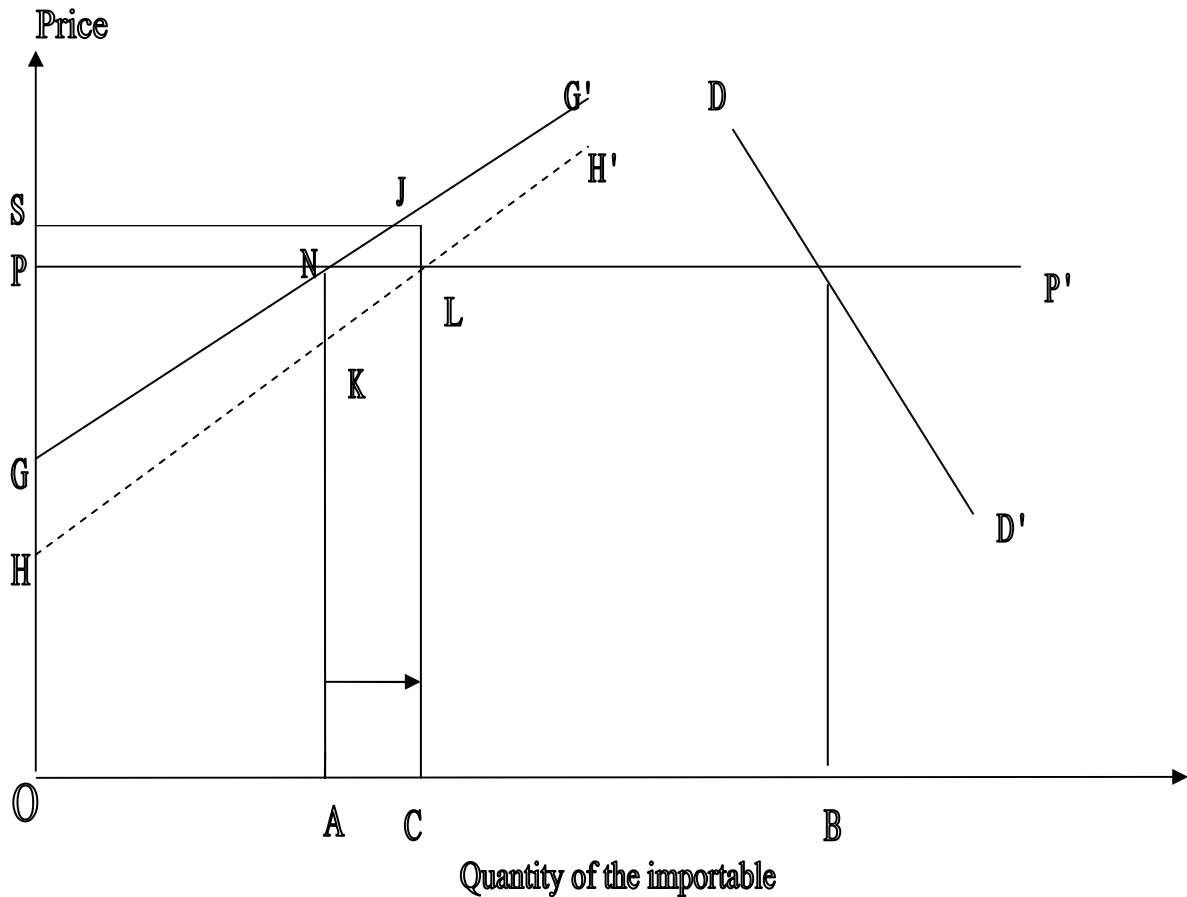
“Externality may be viewed as either an economic gain or loss accruing to one or more ‘recipient’ economic agent – as the result of economic action ‘initiated’ by another economic agent – with the gain or less not being reflected in price. Either the ‘initiating’ or ‘recipient’ economic agent may be either a producer or a consumer.”
(Herber, 1975, p 36)

Pollution is a good example of an external cost imposed on society: national output may only be maintained by allowing a certain degree of pollution which detracts from the quality of life. A firm will include the private costs of materials, labour and capital used in producing goods and services but will not count the social costs of pollution involved.

It is important to understand the definitions as stated above to move on the interpretation of a graph by Corden. Corden in his study of ‘Trade Policy and Economic Welfare’ in 1989 examines ‘The Theory of Domestic Divergences’. In his simple model: ‘Marginal Divergence and the Optimum Subsidy’ he explains why some governments intervene in the economy and gives subsidies as a method of protection. A diagram will be used to illustrate the argument that in certain conditions a subsidy is to be preferred to a tariff as a way of protection. (Corden, 1989, p 9) In the figure below, the quantity of a particular product, an importable product is shown along the horizontal axis, and its price along the vertical axis.

The domestic demand curve for the product DD' , the foreign supply curve for imports of the product is PP' and the supply curve of the domestic import-competing producers is GG' . In the absence of any tariffs, subsidies or other intervention, domestic production would be OA , demand would be OB , and the excess of demand over production, AB , would be imports. (Corden, 1989, p.9)

Figure 2.1.1
The Theory of Domestic Divergences



Source: Corden, *Trade Policy and Economic Welfare*, 1989, p 9

The next and vital stage is to introduce a *marginal divergence* between private and social cost. This will be the justification for some kind of government intervention in the economy. GG' can be regarded as indicating the marginal private cost of production for various levels of output. But the social cost is assumed to be less. We can imagine that external economies of some kind attach to production of this product: there are social benefits that are not taken into account in the private cost calculus. The value of these benefits should be deducted from the costs from a social point of view. Therefore we obtain a curve showing the marginal social cost of production at various outputs, namely HH' . Its general characteristic is that it is below GG' . It is obviously possible that external

diseconomies attach to this particular type of output; in that case HH' would be above GG' . (Corden, 1989, p 10)

Two more assumptions have to be made at this stage. (i) The demand curve, DD' specifies not only the private but also the social value at the margin of various quantities consumed. Thus there is no marginal divergence on the demand side. (ii) The price of imports, OP , facing private producers and consumers correctly specifies not only the private but also the social costs of imports. The price is assumed to be unaffected by the quantity of imports the country wishes to purchase, so that average and marginal social cost of imports coincide. This is the small country assumption. (Corden, 1989, p 10)

The marginal value of extra consumption is equal to the marginal cost of imports when consumption is OB . Hence OB is the socially desirable level of consumption; it is obtained without intervention. The marginal social cost of production is equal to the marginal cost of imports at output OC . This is greater than actual output in the absence of intervention. Hence intervention, designed to increase output or protect the industry, is required. But this intervention should not, ideally, alter the level of consumption (Corden, 1989, p 11)

The purpose would be achieved by a subsidy on output at the rate PS per unit, or otherwise, the *ad valorem* rate PS/OP . It would increase the price received by producers and lead them to raise output to OC . The marginal private cost of production would become CJ . The total cost of the subsidy to the Treasury would be $PSJL$. Consumers would continue to pay a price OP for the product. (Corden, 1989, p 11)

In addition to the two assumptions listed above, four important assumptions are involved. (a) The act of financing the subsidy through taxation does not upset any marginal conditions, for example through making leisure more attractive than the margin than the rewards from the effort, and hence reducing incentives. (b) There are no collection costs of taxation. (c) There are no disbursement costs of the subsidy. (d) The redistribution of income from the relevant tax-payers towards the factors of production that produce the protected product and that will gain in income from the subsidy does not represent a net social gain or loss and so can be neglected. From a social point of view, pure income

distribution effects either cancel out or are costless offset in some way. (Corden, 1989, p 11)

The following principal result can be stated. The social cost of the protected output is the area under the social marginal cost curve, *AKLC*. Hence, the import replacement cost is less than the value of the imports by the shaded area *KNL*. This is the social gain brought about by the subsidy. A higher subsidy would reduce this total gain since at the margin there would be a social loss indicated by the excess of the social cost curve over the import price *OP*. A lower subsidy would not fully exploit the potentialities of gain. The relevant taxpayers lose *PSJL*, which is the cost of the subsidy to them (but not to society). Producers of the product gain *PSJN*. The beneficiaries of the external economies created by the extra output, whoever they might be gain *KNJL*, which is the extent to which social cost of the protected output falls below private cost. (Corden, 1989, p 12)

Another important study is also by Corden in his book 'The Normative Theory of International Trade'. In his study he examines the theory of domestic distortions. The main development in the normative theory of international trade in the post-war era is the theory of domestic distortions. A major result has been to downgrade the role of trade policy and therefore to rehabilitate the argument for free trade, at least aside from the orthodox optimal tariff argument. The majority of arguments for protection – except the terms of trade argument – end up originating in some market failure in the domestic economy – some domestic divergence between prices and marginal costs (Corden, 1984, p 86)

Free Trade requires all trade barriers to be removed. By this way, the overall production will maximise. In a free market economy ideally government intervention should be avoided. Corden in his study defines Free Trade as the absence of all trade taxes, subsidies and regulations, but still allowing non-trade interventions – e.g taxes and subsidies on specific types of domestic production or consumption which may still incidentally affect trade. Trade interventions could still be better than nothing in the absence of first-best domestic policy interventions. (Corden, 1984, p 87)

According to Corden, the central argument is that any intervention should be close as possible to the source of the appropriate divergence or distortion. Subsidies and taxes should be aiming to offset the distortions created. Thus a production subsidy need to deal with a production distortion, a consumption tax with a consumption distortion, a factor subsidy or a tax with a particular factor- market distortion. In terms of the simple trade model, the aim is to make sure that production is on the transformation curve. (Corden, 1984, p 87)

The debate of Domestic Distortions Theory has been studied by several economists. The principal contributions of domestic distortions theory have come from Haberler (1950), Meade (1955a), Corden (1957a), Hagen (1958), Bhagwati and Ramaswami (1963) and Johnson (1965a). The theory, with several examples and extensive discussion of qualifications, is developed in Corden (1974). A neat consolidation – but with less emphasis on limitations is in Bhagwati (1971). There is also an exposition in Hazari (1978). While Haberler and Meade must be regarded as the pioneers, especially the most significant modern contributions have been the studies by Bhagwati and Ramaswami and by Johnson. (Corden, 1984, p87) It is very important to understand the Theory of Domestic Divergence in order to cover the economic rationality of State aids.

The various distortions or divergences are marginal, and can be classified in a variety of ways. Especially, it is important to distinguish *policy-imposed distortions* from *endogenous distortions*. '*Policy-imposed distortions*' are created by governments' policies, and are thought not to be directly removable. They include distorting taxes, as well as regulations which create situations that allow monopolies to be formed. Government should avoid causing '*policy-based distortions*' in order not to harm the economy. '*Endogenous Distortions*' do not result from government policies, and would include certain strictness in the labour market and those that result from non-convexities (economies of scale) in the system. (Corden, 1984, p 87)

Corden examines different cases of distortions. It is beneficial to examine the concept of private cost and social benefit cost. Let's suppose that the private cost of labour to manufacturing industry (assumed importables only) exceeds its social opportunity cost.

First-best policy then requires a subsidy to labour cost in manufacturing. The government intervention will create the *by-product distortion*. Now let's suppose that the government actually prefers to subsidise manufacturing production. This will impose the *by-product distortion* of over-encouraging the use of non-labour factors in manufacturing. A *by-product distortion* is the undesirable result of seeking to offset an original (endogenous or policy based) distortion. Johnson (1965a) and Bhagwati and Ramaswami (1963) stressed that if the subsidy were actually sufficient to offset the original distortion, the by-product distortion might be so large that there would be a net loss in welfare. (Corden, 1984, p 89) A net loss in welfare is not desirable as well. The government subsidy should be in appropriate levels so that by-product distortion will not be in excess levels.

However in reality in many cases subsidies are in excess levels. Therefore they distort the way markets work instead of correcting them. In other words the market failure is replaced by a government failures. It is beneficial to control subsidies because of this reason.

Moreover in international relations States try gain market access or provide protection for their national champions in order reach strategic or political objectives. They use subsidies for this purpose. Such strategic policies lead to subsidy wars. Just like real wars subsidy wars are harmful for the welfares of respective societies. If the States can instead cooperate and make binding commitments not to give aids then markets can function in the optimal way and social welfare is protected (Grossman and Helpman, 1995).

2.2. Types of State Aids

The above analysis was theoretical and thus does not fully capture the complexity of subsidies as policy instruments. The reason is that subsidies come in many different forms and it is not always easy to understand or distinguish the.

There are several forms of state interventions used by the EU Member States. Different forms of State aids are known as grants, tax exemptions, soft loans, equity participations, guarantees, tax deferrals, government capital injections and private authorities' holdings, and the aid elements in land sales by public authorities. This section of the dissertation will

examine the forms of state interventions namely as the Government Capital Injections and Private Authorities' Holdings, Guarantees and the Aid Elements in Land Sales by Public Authorities.

2.2.1. Government Capital Injections and Private Authorities' Holdings

The following definition has been given for the public holdings by the commission: 'Public holding means a direct holding of central, regional or local government or a direct holding of financial institutions or other national, regional or industrial agencies which are funded from State resources within the meaning of Article 92(1) of the EEC Treaty, or over which central, regional or local government exercise a dominant influence' (Hellingman, 1986, p. 130). It is stated in the competition policy rules that the commission does neither penalise nor favour public authorities, which provide companies with equity capital.

Hence four types of situation has been distinguished in the policy guidelines in which public authorities may have occasion to acquire a holding in the capital of companies and these situations are as follows:

- The setting-up of a company,
- Partial or total transfer of ownership from the private to the public sector,
- In an existing public enterprise, injection of fresh capital or conversion of endowment funds into capital
- In an existing private sector company, participation in an increase in share capital (Competition Law in the European Communities, 1999, p. 135).

On the basis of this, four different cases have been distinguished by the Commission. First, if the existing capital of a company is totally or partially acquired without any fresh capital being injected then the case is not considered as state aid. There are also the several different cases of fresh capital injection to private firms which operate under normal market condition and in these cases the fresh capital injection is also not considered as state aid. But there are also the circumstances of several firms operating under the normal market condition to which injection of fresh capital is considered to be state aid. Lastly

there is the situation of those firms, which do not fall within the categories listed so far (Competition Law in the European Communities, 1999, p. 135-136).

2.2.2. Guarantees

In the related Commission letter to the Member States it is stated that all state guarantees fall under the Article 92(1). Each case of the state guarantee should be notified and the following should be made clear: whether the granting is done in application of an existing general scheme or in application of a specific measure. The following is stated in the mentioned letter about the acceptance of the state guarantees: The Commission will accept the guarantees only if their mobilization is contractually linked to specific conditions which may go as far as the compulsory declaration of bankruptcy of the benefiting undertaking or any similar procedure. These conditions will have to be agreed at the initial and only, examination by the Commission of the proposed guarantee/State aid within the normal procedures of Articles 93(3), at the granting stage (Competition Law in the European Communities, 1999, p. 164). If the state would mobilise the guarantee at a different date than stated at the granting stage then the guarantee will be considered as a state aid.

2.2.3. Aid Elements in Land Sales by Public Authorities

The sale of land has also been considered whether it was a form of state aid or not. The general principle of land sales is as follows: the sale should be well-publicised, open and should be done with unconditional bidding procedure comparable to an auction. The value of the land before the bidding procedure should not be different than the value at the bidding. Such a case is considered to be irrelevant. Other than this, sale can also be done without unconditional bidding procedure. The valuation of such land is done by special asset values. This person should have a qualified degree taken from one of the recognised learning centres or an equivalent of this and should have experience and should be

competent in valuing land and buildings (Competition Law in the European Communities, 1999, p. 171). If such transactions took place these should be notified to the commission so that the commission would determine whether there was any state aid or not. If the commission decides that the sale should be classified as state aid then the compatibility of the aid with the common market is also tested by the commission.

The different forms of State interventions contributed to understand the State aids concept. Following in the study, the volume of State aids in the EU Member countries will be illustrated to cover the concept better.

2.3. Actual Use of State Aids in the EU

This section is divided into three parts. Several graphs are used in order to illustrate the State aids concept better. The volumes and trends of State aids used by different EU Member States, the different forms of State interventions and the sectoral distributions of State aids are shown in the graphs.

The first section examines the total volume and trends of the state aids and they are shown by the use of graphs. In the second section the sectoral distribution of the State aids are illustrated by the help of graphs as well. The final section focuses on the volume of different forms of State interventions used by the member states.

We will use several figures and graphs in this section of the dissertation. By doing so, we will be able to see the distribution of different measures of State aids which is essential for this study. It is essential to mention that the graphs and figures in this section involve only 15 Member States. The EU Member Countries which are considered are Germany, France, United Kingdom, Italy, Spain, Belgium, Luxembourg, Netherlands, Portugal, Austria, Sweden, Denmark, Finland, Greece and Ireland. The 10 new Member States which entered the EU in May 2004 and the two that followed in January 2007 are not considered in this section.

2.3.1. Total Dimension and Trends of State Aids (Distribution of years)

The first section examines the total volume and trends of the state aids and they are shown and examined by the use of graphs and tables. Total State aid granted by the fifteen Member States was estimated at €49 billion in 2002. In absolute terms, Germany granted the most aid with an amount of €13 billion in 2002 followed by France (€10 billion) and Italy (€6 billion). The amounts of aids granted differ between Member States. There are several reasons for these differences. Germany, France and Italy are the countries that grant the most aids. The Gross Domestic Product (GDP) of these countries is relatively much higher than others. Therefore large amounts of State aids are rational as they are relatively larger economies. Also another reason could be stated as the government policies. Some government's economic policies prefer to aid more State aids than others prefer not to grant much aid. For example the United Kingdom is a relatively rich country and its GDP is very high among Europe. However, when we look at the table below, we can see that the UK government do not grant much State aids. This is because of the government's economic policies and that they pursue liberal policies. They believe that in a free market economy the government intervention to the markets should be lowest amount. They believe that by this way the economic growth will maximise.

Table 2.4.1.
State aid in the Member States, 2002

	EU	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	FIN	S	UK
Total state aid less railways in billion €	48,8	1,3	1,6	13,3	0,7	4,3	9,7	1,0	6,0	0,1	1,9	1,3	1,0	1,7	1,0	3,9
Total state aid less agriculture, fisheries and transport in billion €	34,0	0,9	1,3	11,4	0,4	3,5	6,2	0,5	4,5	0,06	0,8	0,5	0,6	0,2	0,4	2,6
Total aid less railways as % of GDP	0,56	0,53	0,92	0,65	0,52	0,68	0,66	0,85	0,50	0,41	0,46	0,63	0,83	1,28	0,39	0,25
Total aid less agriculture, fisheries and transport as % of GDP	0,39	0,37	0,72	0,56	0,31	0,55	0,42	0,45	0,38	0,26	0,19	0,21	0,55	0,17	0,16	0,17

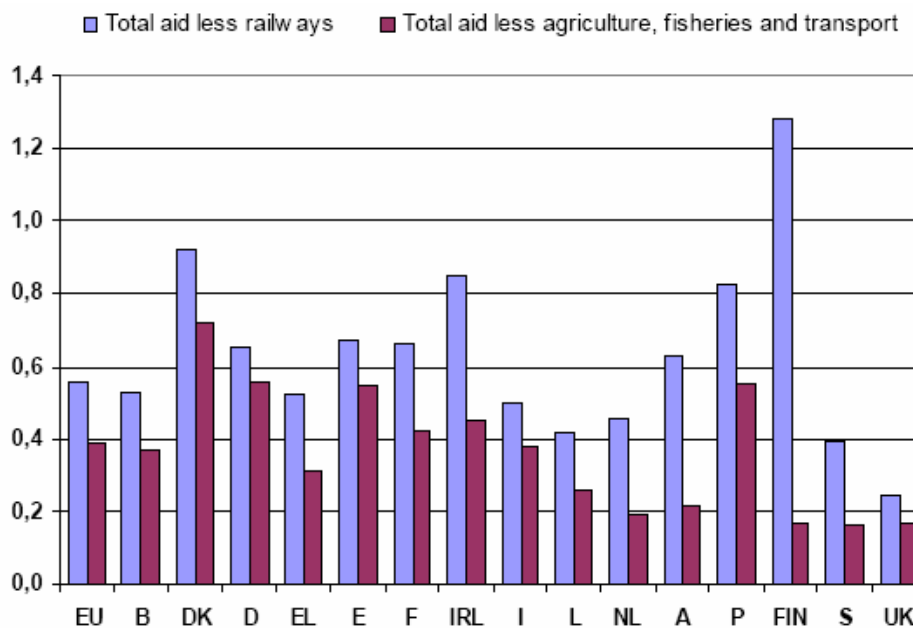
Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

Note that only State aids as defined under Article 87(1) EC Treaty (of more below) that is granted by the fifteen Members States for all sectors except railways has been examined. The total excludes aid to the railway sector. All data are quoted at constant 2000 prices.

In relative terms, State aid amounted to 0.56% of EU Gross Domestic Product (GDP) in 2002. This average marks significant differences between Member States: the share of total aid to GDP varies from 0.25% in the United Kingdom to 1.28% in Finland. The high ratio in Finland can be clarified by the relatively large amount of aid to agriculture which represents approximately 85% of total aid in this country (Table 2.4.1). Indeed, due to the particularities associated with aid to agriculture and fisheries, it is important to look at total aid less these sectors. This new indicator produces a rather different ranking of Member States (Figure 2.4.1). For instance, such aid in Finland represents no more than 0.17% of GDP, one of the lowest rates in the Union and well below the EU average of 0.39%. Germany, Spain and Portugal (each with around 0.55%) and Denmark (0.72%) lie clearly above the average. These percentages represent the different government economic policies.

Figure 2.4.1

State aid as a percentage of GDP, 2002



Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

From the relatively high levels of State aid in the early and mid-nineties, the overall volume of aid fell dramatically from €67 billion in 1997 to €52 billion in 1999 (Table 2.4.2). The three Member States that contributed most to this marked decrease were Germany, Italy and France. In Germany, this can be attributed to the phasing out of the large restructuring programme carried out in the new German Bundesländer. In Italy too, aid to the least developed regions fell sharply while in France, aid levels were especially high in the mid to late 1990s due to the large amounts of rescue and restructuring aid awarded to the banking sector. Between 1999 and 2002, total aid has continued to decline though less sharply than in previous years, falling at approximately €1 billion per year on average.

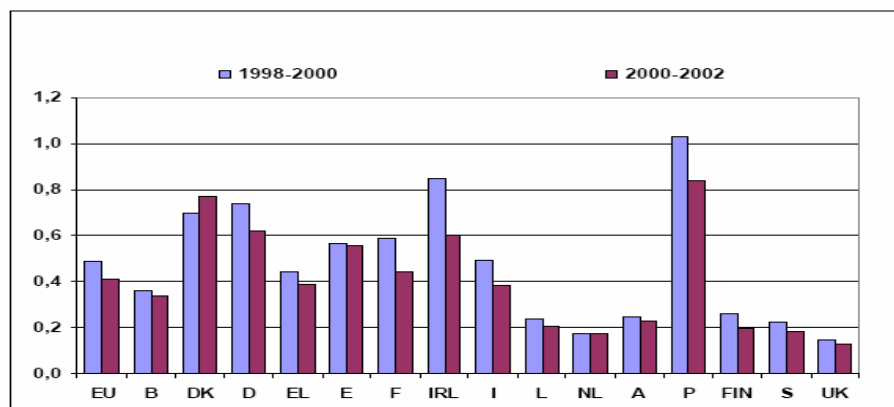
Table 2.4.2
Trend in the level of State aid, EU-15, 1992-2002

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Average 1998- 2000	Average 2000- 2002
Total state aid less railways in billion €	70,4	75,2	72,4	71,0	71,5	67,1	60,5	52,5	50,9	49,5	48,8	54,6	49,7
Total state aid less agriculture, fisheries and transport in billion €	54,4	60,2	55,4	52,6	54,2	50,2	46,4	37,6	36,6	35,4	34,0	40,2	35,4
Total aid less railways as % of GDP	1,09	1,18	1,11	1,00	0,98	0,88	0,77	0,64	0,59	0,57	0,56	0,67	0,57
Total aid less agriculture, fisheries and transport as % of GDP	0,85	0,95	0,85	0,74	0,75	0,66	0,59	0,46	0,43	0,41	0,39	0,49	0,41

Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

In 2001, Member States pledged to show a descending tendency in State aid in relation to GDP by 2003. For the European Union as a whole, total aid less fisheries, transport, and agriculture amounted to 0.41% of GDP overall for the period 2000-2002 compared with 0.49% during the period 1998-2000. The trend is descending in fourteen Member States. Ireland and Portugal experienced the largest falls (approximately 20-25 percentage points) between the two phases. In Ireland, this is mainly the result of a cut in the Irish Corporation Tax coupled with a rise in GDP while the decrease in Portugal was because mostly to a sizeable decrease in a regional aid tax scheme in Madeira that primarily supports financial services. In contrast, aid in relation to GDP increased in Denmark though this increase can be described by a substantial increase in aid for two horizontal objectives, safeguarding the environment and employment creation. While making comparisons between Member States, it is important to understand the effect that the trend in GDP has on this indicator. Member States which have experienced fairly high economic growth over the period could theoretically increase the level of aid and still display a descending trend. (Figure 2.4.2)

Figure 2.4.2
State aid as a percentage of GDP, 1998 – 2002



State aid less agriculture, fisheries and transport

Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

2.3.2. Sectoral Distribution

In the second section the sectoral distribution of the State aids are illustrated by the help of graphs as well. We will analyse the sectoral distribution of State aids in each EU member State. The sectors such as Manufacturing, services (including tourism, financial, media and culture), Agriculture and Fisheries, Coal, Transport and other non-manufacturing sectors will be analysed in detail. We can see a full picture of State aids policy of all EU Member states in each sector and make a comparison of EU member states by different sectors.

Approximately 57% of State aid in the Union was allocated for the service and manufacturing sectors in 2002. An additional 28% was directed towards fisheries and agriculture, 11% for coal and the remainder divided between transport (not including railways) and non-manufacturing not elsewhere classified. There are important disparities between Member States in the sectors to which they direct aid (Table 2.4.3). Aid to the fisheries and agricultural sectors accounted for 20% or less of overall aid in Denmark, Germany, Spain and Italy whereas in Austria the share was 66% and in Finland as high as 84%. Aid to the coal industry accounted around 25 % of overall aid in Germany and Spain.

From the table below, we can see that Finland grants the lowest amount of aids in the manufacturing industry. Whereas Denmark grants the highest amount of State aids. In the Services sector Portugal is well ahead the other EU Member States. In the agriculture and fisheries sector Austria grants the most aids. Germany grants the highest amount of aids in the coal industry.

Overall Germany and Finland grants the highest amount of aids among the European Union Member States. In this respect, it can be argued that as a result of different EU Member State governments have different economic policies; the control of EU State aids becomes harder. Therefore, as the study will argue later, a supranational policy should be followed in the European Union in order to achieve higher rates of economic growth.

Table 2.4.3
Sectoral distribution of aid, 2002

% of Total							Million Euro
	Manufacturing	Services (including tourism,financial, media and culture)	Agriculture & Fisheries	Coal	Transport excluding railways	Other non- manufacturing	Total
EU	51	6	28	11	2	2	48.753
B	67	3	29	-	-	-	1.331
DK	76	2	15	-	6	-	1623
D	57	3	14	26	-	-	13339
EL	59	1	40	-	-	-	686
E	56	2	18	23	1	-	4322
F	37	17	35	10	1	-	9690
IRL	40	12	47	-	-	-	991
I	73	3	19	-	5	-	5690
L	57	5	38	-	-	-	90
NL	39	3	50	-	9	-	1870
A	30	5	66	-	-	-	1324
P	26	40	33	-	-	-	978
FIN	12	1	84	-	2	-	1726
S	30	11	40	-	18	1	969
UK	48	-	28	-	14	20	3855

Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

Between 1998-2000 and 2000-2002, the volume of aid fell in most of the main sectors: manufacturing was down €2.5 billion, services €1.7 billion and coal €1 billion. In agriculture and fisheries, the overall sum of aid remained fairly stable (Table 2.4.4).

Table 2.4.4
State aid by sector in the Community 1998-2002

		€ Billion
	Annual Average 1998-2000	Annual Average 2000- 2002
Overall national aid	54,6	49,7
of which:		
Agriculture	13,4	13,1
Fisheries	0,3	0,4
Manufacturing	27,3	24,8
Coal Mining	7,4	6,5
Transport excl. Railways	0,7	1,0
Services	5,5	3,8
Not elsewhere classified	0,1	0,3

Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

The following section focuses on aid to the manufacturing sector. For some Member States, much of the aid allocated for this sector is of a horizontal nature. However, other Member States could potentially look at the manufacturing sector in order to reduce overall State aid levels. EU-wide, aid granted to manufacturing in 2002 amounted to around €25 billion or, to re-phrase, 1.5% of value added in this sector (Table 2.4.5)

State aid to manufacturing relative to value added continues to fall: from 1.8% over the period 1998-2000 to 1.5% in 2000-2002 (Figure 2.4.3). The sharpest fall occurred in Ireland, primarily the result of a cut in the Irish Corporation Tax. The rise in Denmark can be explained by the increase in aid for horizontal objectives.

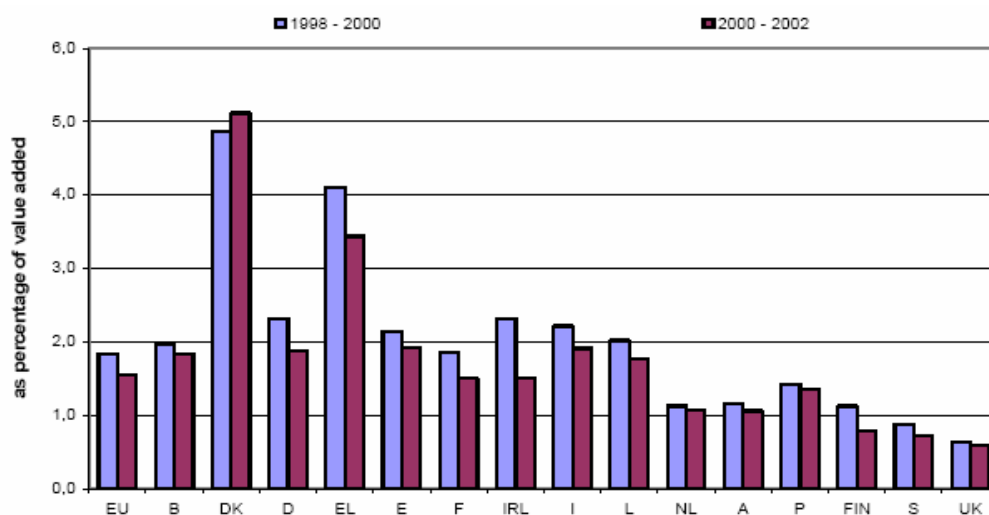
Table 2.4.5
State aid to the manufacturing sector, 2002

	EU	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	FIN	S	UK
State aid to manufacturing sector in million €	24637	887	1237	7559	403	2414	3611	401	4355	52	726	392	253	207	289	1838
State aid to manufacturing sector as % of value added	1.5	2.0	4.7	1.7	2.7	2.2	1.4	1.1	1.9	2.3	1.2	0.9	1.3	0.7	0.7	0.5

Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

Note: Information on manufacturing includes aid for horizontal objectives including general regional development schemes for which the specific sector is not known. Source: DG Competition

Figure 2.4.3
State aid to the manufacturing sector, 1998 – 2002



Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

In the case of coal, €5.6 billion was granted to the sector in 2002. Table 2.4.6 provides a general idea of aid to the coal industry over the period 1998 - 2002. In 2002, around 40% of the aid was not related to current production. Only four Member States still granted aid to this sector in 2002: Germany (€3.5 billion), Spain (€1.1 billion though it was €1.9 billion in 2001), France (€1 billion) and a fairly insignificant amount (€25 million) in the United Kingdom. (State Aids Scoreboard, Spring 2004, p 16)

Due to the increased efforts of the German authorities to restructure its coal industry, the amount of aid to cover the costs arising from the rationalisation and restructuring of the coal industry that are not related to current production has risen. These costs are mainly related to exceptional expenditure on workers who lose their jobs, to administrative, legal or tax provisions and to the rehabilitation of former mining sites. In contrast, production aid has decreased sharply and will continue to follow a downward trend. As a result, the total amount of aid granted by the German authorities has decreased significantly. (State Aids Scoreboard, Spring 2004, p16).

Table 2.4.6
State aid to coal mining 1998-2002

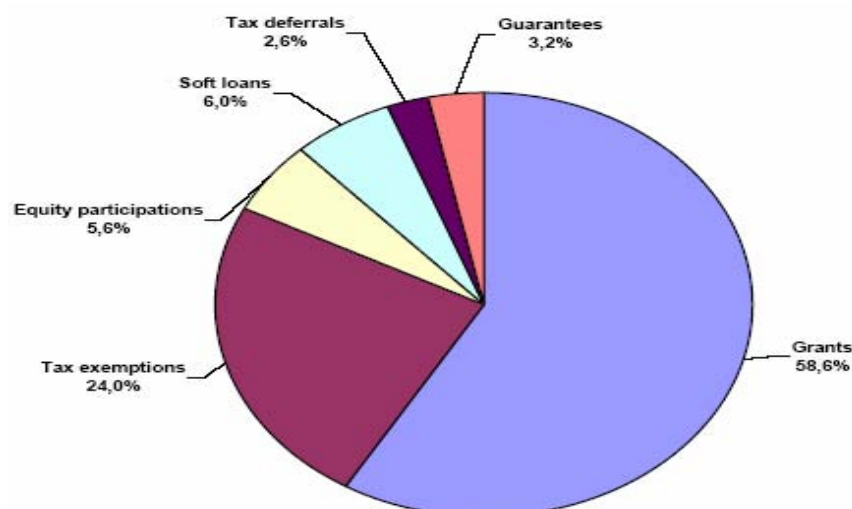
	Yearly Average of aid not destined to current production (in million €)		Yearly Average of aid not destined to current production			
	1998-2000	2000-2002	1998-2000		2000-2002	
			In million €	€ per employee	In million €	€ per employee
EU	2.147	2.513	5247	50.509	3953	45.720
D	663	1196	4064	63.189	2.888	55.002
E	627	640	379	39.475	342	49.785
F	401	695	753	41.705	630	41.939
UK	456	0	51	4.400	92	7.727

Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

2.3.3. Dimension by Different Forms of State Interventions

This part analyses the volume of different forms of State interventions such as grants, guarantees, tax deferrals, soft loans, equity participations and tax exemptions with the help of several graphs. As we can see below from the graph, the most common form of state intervention is grants. The tax exemptions are also commonly used by the Member States. The least common form of state intervention is tax deferrals.

Figure 2.4.4
Share of each aid instrument in total aid for manufacturing and services,
EU, 2000 – 2002



Source: European Commission, State Aids Scoreboard. Spring 2004, Update, Belgium, DG Competition

The whole State aid represents a cost or a loss of revenue to the public authorities and a benefit to recipients. However, the actual aid element may vary from the nominal amount transferred in the case of a subsidised guarantee or loan. (State Aids Scoreboard, Spring 2004, p 37)

Grants made up almost 60% of all State aid in the manufacturing and service sectors during the period 2000-2002. Except the aid awarded through the budget, other aid is paid through the tax or social security system. In the European Union as a whole, tax

exemptions form 24% of the total. While Sweden, Belgium, Denmark, Luxembourg, Austria and Spain provide more than 80% of their aid in the type of grants, other Member States make greater use of tax exemptions, particularly Germany (38%), Ireland (67%) and Portugal (74%). Only six Member States uses a tax deferral. In Italy, tax deferrals make up 14% of all aid compared with an EU-wide average of 3%. There are other forms of aid tools which differ from one Member State to another (Table 2.4.7). One such category covers transfers in which the aid element is the interest saved by the recipient during the period for which the capital transferred is at his disposal. The financial transfer takes the type of a soft loan or tax deferral. The aid elements in this group are much lower than the capital values of the transfers. EU-wide, soft loans represent around 6% of all manufacturing aid. Aid may also be in the form of state equity participation which represents almost 6% of all aid to the manufacturing and service sectors. Finally, aid may be provided in the form of guarantees. Guarantees were awarded in 2002 by most Member States although the aid made up only 3% of total aid in the European Union. (State Aids Scoreboard, Spring 2004 Update, p 37)

Having laid down the necessary information in order to understand the phenomena of State aids in the next chapter we will start examining the policy itself. We do so by looking at its development.

Table 2.4.7
State aid for manufacturing and services by type of aid instrument,
2000 – 2002

percent						
TYPE OF AID						
	Grants	Tax exemptions	Equity participations	Soft loans	Tax Deferrals	Guarantees
EU	58,6	24,0	5,6	6,0	2,6	3,2
B	81,5	10,0	0,0	6,9	0,1	1,6
DK	94,7	5,1	-	0,0	-	0,2
D	49,8	37,7	0,4	3,8	0,4	7,9
EL	74,4	24,9	-	0,7	-	0,1
E	90,1	-	0,3	7,9	-	1,7
F	35,5	24,5	28	9,4	0,1	2,5
IRL	28,7	67,3	2,6	0,1	-	1,3
I	70,0	12,4	0,9	2,9	13,7	0,1
L	94,8	-	-	5,2	-	-
NL	68,4	13,3	0,0	5,4	9,8	3,0
A	85,9	-	-	9,8	-	4,3
P	20,3	73,7	-	4,7	1,0	0,2
FIN	73,3	19,4	-	7,1	-	0,2
S	82,6	8,4	1,0	7,9	-	0,2
UK	72,5	8,7	0,5	18,3	-	-

Source: European Commission, State Aids Scoreboard. Spring 2004,
Update, Belgium, DG Competition

III. THE BASIS OF THE STATE AIDS POLICY

In this chapter we study the basics of the State aids policy. In other words we do not study the details; but we take a general look with the aim of placing the control of subsidies in the larger context of the European integration. The chapter consists of three sections. First the necessity of having such a disciplines in the Rome Treaty is explained. Then the basic provisions contained in the Treaty are laid down. The chapter is completed with a section that reviews the development of the policy over decade.

3.1. The Rationale of State Aids in the EU

In section 2.1 above, first the reason of government subsidies and then the justification of developing disciplines to control them were explained. To remind simply governments should give subsidies in order to correct market failures; but they are tempted to give them in excess amounts and in competition with each other and thus cooperation about this issue is beneficial. This is a general argument. The State aids policy has a more specific function in the context of the EU.

The State aids policy was originally designed to protect the benefits of European economic integration against national measures that can circumvent the elimination of barriers to trade. International economic integration is the institutional combination of separate national economies into larger economic blocs or communities. Its purpose is to promote efficiency in resource allocation in a given region. In order to achieve this, barriers to free movement of goods and factors of production within the integrated area should be eliminated. International economic integration has different steps ranging from free trade areas to monetary unions (Robson, 1998).

Flynn points out to the importance of creating an ‘economic community’ in the EU. He states that the progress of an ‘economic community’ needs a co-ordinated movement from perspectives limited by national interests to a wider idea of common market. (Flynn, 1993, p. 297) Without adequate controls or restricting State aids, an ‘economic community’ target is difficult to achieve.

The initial aim of the Community was to form a customs union that is a free trade area with a common external tariff. This was achieved in 1968 as stated above. Following unsuccessful attempts to form a monetary union, the Community decided to move on to create a common or single market where in principle all types of barriers to free movement factors of production and goods were eliminated in 1986 (Swann, 1996, pp 51-73)

However the simple elimination of barriers to trade is not enough for ensuring the healthy functioning of the economic integration. The Member States also had to harmonize other policies just for enabling integration of their national markets. Common Commercial Policy is the most obvious one among these common policies.

State aids form another such policy field. 'E.U rules governing state aid are an important part of European competition policy. State aids create a threat to the single European programme. Without adequate controls, the entire single market programme would be in danger (Bishop, 1997, p 84).

It is crucial to understand the logic of the State aids policy of the European Union and why the European Union is strict about monitoring State aids.

Baldwin and Wyplosz put it clear;

“EU members’ governments differ over how much they can or want to subsidize loss-making firms. Yet, when only some governments subsidize their firms, the outcome of the restructuring may be ‘unfair’ in the sense that it gets forced upon the firms in nations that do not subsidize, or stop subsidizing before the others. The real problem with this is that it may create the impression that European economic integration gives an unfair advantage to some nations’ firms.” (Baldwin & Wyplosz, 2003, p 165)

State aids pose a threat to the common market. Integration of national markets shifts the allocation of resources at the level of the integrated area. Mobile factors of production move to locations where their productivity is maximized. Even if the location effects are not realized, firms become more efficient since they have unhindered access to a larger

market. However these processes might be politically, socially and technically painful as some firms are closed, others opened, yet others forced to adapt to the new conditions. Therefore governments are inclined to give out State aid to their national undertakings in order to support them. These aids can destroy the incentives created by economic integration to reallocate resources. In other words markets can be distorted.

As Baldwin and Wyplosz state:

“Staying competitive requires industries to change – to adapt to new technologies, to new competitors and to new opportunities. When firms get used to the idea that their governments will keep them in business no matter what, the incentive to innovate and adapt is greatly weakened. Firms with this sort of mindset will soon find themselves far behind their competitors” (Baldwin & Wyplosz, 2003, p 163) .

When the markets are distorted, social welfare is not maximized. Indeed the maximization of social welfare requires coherence between trade policy and industrial policy. (Gatsios, K. and L. Karp. 1992, p 45) Trade and industrial policies should be viewed as two complementary aspects in an increasingly globalized European economy. (Hart and Prakash, 2000, p 180)

Moreover State aids can lead to subsidy wars between Member States that are collectively wasteful even though the individual subsidy commitments are rational. This is a case of what is called Strategic Trade Policy (Besley and Seabright, 2001, p. 21).

Furthermore uncontrolled use of subsidies by Member States can simply erode away the impact of the elimination of tariffs, the basic instrument of protection against trade. Indeed in theory the exact impact of a tariff can also be obtained by a combination of consumption taxes and production subsidies.

Therefore State aids are banned by the Treaty in principle. The derogations that were provided in the original Treaty of Rome are all general, catch-all phrases that did not correspond to specific and actual cases. This means that the original rationale of the State

aids policy was to keep European economic integration intact by limiting the ability of Member States to circumvent elimination of trade barriers.

State aids policy is necessary to prevent Member States from distorting the Single market through subsidies and therefore circumscribe the economic integration, the *raison d'être* of the Community. As a result the policy maximizes social welfare and economic efficiency, the whole of the Union and the Single Market benefit from the State aids policy.

3.2. Basic Provisions on State aids

There are several definitions and descriptions of State aids. State aid from an official source is defined by the following quotation: '*State aid is a form of state intervention used to promote a certain economic activity. It implies that certain economic sectors or activities are treated more favourably than others and thus distorts competition because it discriminates between companies that receive assistance and others that do not*' (State Aids Scoreboard, Spring 2004, p. 8) State aid is also defined as a type of state intervention used to support a certain economic activity (State aid Scoreboard, 2004, p 8). In essence, the Treaty provides that a State aid should be an aid that is granted by a Member State or through State resources, which distorts or threatens to distort competition and affects trade between Member States (Paul, K. and E. Lasok, 2000, p. 20). These are of course generalizations. The exact definition of State aids is contained in the primary source of Community law.

Main provisions on State aids are to be found in Articles 87, 88 and 89 (ex Article 92 to 94) of the Treaty of Rome, or formally the Treaty Establishing the European Community. These Articles are placed under Part Three-Community Policies, Title VI-Common Rules on Competition, Taxation and Approximation of Laws, Chapter 1-Rules on Competition, Section 2-Aids Granted by States.

It is thus clearly understood that the State aid is a branch of Competition policy. Competition policy is among the most important concepts of the EU and to achieve the

Common Market objective, an effective competition is essential. Competition policy plays a crucial role in the European integration process.

It is necessary to understand the concept of 'Competition' and its significance in order to examine the State aids policy. 'Competition' has been defined as the 'struggle or contention for superiority, which in the commercial world...means a striving for the custom and business people in the market place (Whish, 1989, p 3). Competition Policy is a regulatory framework within which governments can maintain or encourage competition. They are negative policies in that they aim to prevent rather than to promote activities. (Cini and McGowan, 1998)

A fair competition in a free market economy is very important for the wealth of the whole society and the achievement of the aims of the Union. Fair competition ensures that the social welfare is maximized; because under those conditions firms produce and innovate more. The consumers have access to cheaper goods with higher quality. From a social point of view unemployment decreases, economic growth increases and the society as a whole benefits from these through the positive externalities unleashed.

With this purpose Article 87 provides that:

“ Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.”

Save otherwise provided is a reference to Article 36 and Article 73 that allow respectively agricultural aids and transport aids under certain conditions. The rest of the Article 87 lays down the legal elements of a State aid. In order to qualify as a State aid a measure must (1) be an aid, (2) be granted by a Member State, (3) distort or threaten to distort

competition and (4) affect intra-Community trade. If these elements are met by a measure, it is a State aid and it is illegal under the Treaty.

There is more than that meets the eye in the definition above; because Article 87 emphasizes favoring certain undertakings. This means that general measures cannot be accepted as State aid. Therefore State aid policy cannot be utilized to prevent competitive devaluations and more relevantly tax competition. Other common policies are needed.

If a State aid (1) has a social character and granted to individual consumers without any conditions on the origin of the products concerned, (2) is granted to make good the damage caused by natural disasters or exceptional occurrences or (3) is granted to certain areas of Germany adversely affected by the division of the country during the Cold War in so far as such aid is required for compensation of the damage it should be allowed.

State aid may also be allowed in other circumstances. These are listed as follows: (1) aid to promote development of underdeveloped areas or areas with serious underemployment, (2) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in a Member State, (3) aid to facilitate the development of certain economic activities or of certain economic areas without contradicting the common interests of the Member States, (4) aid to promote culture and heritage conservation without affecting trading conditions and (5) other categories of aids that may be specified by the Council of Ministers on a proposal from the Commission.

Note that State aids should be allowed in the former case while they might be allowed in the latter one. There is an important difference: The executive authority cannot use discretion in the former case. However this does not mean that the aids in question will not be subject to a review and if necessary investigation process; because the declared and actual objectives of a given State aid decision/scheme might be different.

Article 88 enforces on the Commission the duty of maintaining constant review of State aids. Member States are obliged to inform the Commission of plans to change or grant

aids. The Commission's recommendation must be obeyed by the Member States in these situations. (Swann, 1995, pp 161-162)

Article 88(1) state that the Commission must ensure the monitoring of all systems of aid existing in the member states with their cooperation. The Commission must propose suitable measures in order to maintain, continuous development and functioning of the common market.

Article 88(2) makes it clear that the Commission, in the case of aid granted by a State or through its resources is incompatible with the common market in relation to Article 87 or incorrectly used, may bring to an end or change the related aid, in a certain period decided by the Commission. In the event of that State disobeying such a decision, the Commission or other negatively affected states, have the right to apply to the Court of Justice as stated in Articles 226 and 227.

The procedure, when a member State applies to the Council with an objection, is as follows; The Council may decide that the aid which is being granted by that Member State shall be compatible with the Common market in line with the regulations stated in Article 89 and the provisions of Article 87, in the case of that aid falling within the category of the exceptional circumstances. The Commission shall decide on the case if the Council hasn't made a judgement within three months regarding the aid in question.

Article 88(3) states that while this procedure takes place, the Commission shall be informed in sufficient time, in order to submit its comments. If the Commission concludes that the aid isn't compatible with the common market, the procedure in Article 88(2) will take effect. Until this procedure has concluded, the Member state concerned is unable to enact its proposals.

Member States are required to notify the European Commission of any proposed state aid so that the Commission can determine whether the aid qualifies for exemption. If the aid is not notified the Commission can still investigate its legality based on its own will or a complaint from the interested parties (Cini & McGowan, 1998, p. 139-140).

The Commission decides on the legality of the aid scheme. It can order the Member State to cancel the scheme and even collect the payments that have already been effected plus official interest rate.

These are of course only the main provisions on State aids. Community law also includes secondary legislation, or legislation laid down by regulations, directives and decisions as well as the international obligations of the EU and the case law of the Court of Justice of the European Communities. What is called soft law, i.e. documents (frameworks, guidelines, codes, communications, announcements etc.) that are not legally binding, but explain how specific legal rules are to be interpreted by the executive authorities are also seen very frequently in the State aids policy. However the trend is towards hardening (Cini, 2000). These details will be reviewed to the extent necessary in the following chapter.

3.3. Development of the State Aids Policy

The Community was successful in achieving its objectives in its early years. The customs union was established in 1968, a year before the planned date. The Common Agricultural Policy started to function in 1962 when European Agricultural Guarantee and Guidance Fund and the first common market organisation were established. An embedded economic integration model was built.

This was a special dimension of embedded liberalism as defined in Ruggie. (Ruggie, 1982) Ruggie's concept of 'embedded Liberalism' links the growth of the welfare state to an agreement among the main industrialised nations for the purpose of keeping the global trading system as open as possible. (Frieden and Lake, 2000, p 189) By this way, the growth of European welfare states was integrated in such a way that the common market objective could be achieved.

The economic depression in the late 1970s affected the States negatively and brought increasing pressure on Member States to find ways of overcoming their economic problems. (Mortelmans, 1984, p 405). Thus, beginning from the 1970s, States increasingly

aimed to grant aids as a result of widespread economic depression and the heavy losses of particular industries. The OPEC (Organization of Petroleum Exporting Countries) Countries restricted the oil production and its export to the Western Countries. As a result of this, the world economy experienced a recession and the EU countries suffered an economic crisis.

Therefore, the EU countries started granting State aids to protect particular industries. These State aids resulted in conflict with the Common market objectives. The study examines the evolution of the State aids policy in the 1970s and the policy change from protection of the internal market to a policy of balance. The States increasingly started granting aids and the Commission introduced certain guidelines, frameworks, codes. These covered some exemptions of State aids which increasingly distorted the competition. Exemptions included the State aids which are granted for Research and Development, low economic development and environment purposes.

These State aids resulted in conflicts with the Common market objectives but the new policy areas and the economic depression was also putting great pressure on the Community. The Commission for its part was involved in increasing levels of actions which led to changes or the abandonment of granting aids. (Swann, 1995, p 162)

There were two reasons behind the decay of the initial model that had proved itself to be successful in curbing subsidies in the early days of the European economic integration: (1) the level of economic integration became comparatively shallow and (2) the Community developed new policies.

(1) As the multilateral trade negotiations progressively decreased tariffs and non-tariff barriers, the economic significance of forming a customs union declined. Moreover the overlap of the stagnation of the Community and the financial difficulties in the 1970s created problems in the European economies.

After the 1973 recession caused by the oil crisis, both industry and national governments that were unaccustomed to coping with high inflation, rising unemployment, falling

demand and uncompetitiveness, turned to public expenditure to mitigate the negative effects of recession. (Gros and Thygesen, 1998)

The main answer of the Community to these challenges was to develop its economic integration and form the single market instead of a simple customs union. In 1985 the Commission published a White Study prepared under the guidance of Lord Cockfield that laid down the Europe 1992 program. This program was designed to identify market barriers and progressively eliminate them. The following year the Single European Act was signed and entered into force in 1987. (Swann, 1995, pp.37-75)

The Maastricht Treaty on the European Union was the next major step in European Integration. It focused on the development of co-operation and the EU aid programs, describing new priorities which increase transparency and legal certainty, and which clarify the procedural rules in the field. The main ideas were the ongoing liberalization of certain sectors of the industry, the enlargement of the Union, and increasing involvement of third parties in State aid procedures in relation with the forthcoming economic union.

As the market integration deepened, the State aids policy had to be strengthened; because more integrated markets meant that distortions created by State aids were greater. Besides that, more integrated markets would also create greater pressures for government intervention. Indeed the establishment in 1985 of a task force on State Aids marked the beginning of a new phase in aid control (Cini & McGowan, 1998, p. 144-5)

However the State aids policy was not developed in harmony with the deepening of the economic integration of the Community. Instead its development took into consideration the rise of new Community policies and preferences.

(2) The Community had developed these new policies and priorities because of the will to complement economic integration, enlargement and political demands from the citizenry. There were several examples; therefore only a few examples are taken into consideration below.

One such policy was the regional policy. When the Community was first founded, it had six Member States that were mostly homogeneous. There were regional development problems in some parts of Italy; but they were not huge. However as the Community successively enlarged, it had a larger demand from its heterogeneous regions for help. Moreover the general economic developments accentuated the already existing regional differences. Therefore a stronger regional policy was needed. (Martin, 1999, p 221-224; Tsoukalis, 1997, pp. 187-209)

Another such policy was the environmental policy:

‘Environmental policy was in the 1970s and 1980s a domain of the innovation in the European Union. ‘Green-minded’ governments and advocacy groups were the leaders, pulling the ‘laggards’ towards accepting higher standards of environmental regulation than many could have agreed at the national level. In the 1990s the pattern has changed. A tougher economic climate and recognition of the unanticipated costs of environmentalism have led to a more cautious approach’. (Sbragia, 2000, p. 293)

Certain provisions of the Treaty that had been unusable also revived in this period; Common Transport Policy was the most prominent example. The Treaty stated that the Community should develop this policy. However, the Member States were reluctant to adopt common rules regulating transport. Therefore the Court of Justice stated that the Community had failed to fulfil a constitutional provision. However, as the years passed, it became understood that the success of the intra-Community trade depended on a solid transport infrastructure, both in physical and regulative terms. (Swann, 1995, pp 264-276; Dearden, 1999)

Moreover a previously successful policy, the Common Agricultural Policy started to become a problematic one partially because of its own distortive rules and partially because of international developments. Huge surpluses emerged and budgetary costs rose unexpectedly driving the competitiveness of the European agriculture downwards (Grant, 1997)

It was not only the agricultural sector that lost its competitiveness, but also other community industries declined because of the general macroeconomic problems of the 1970s and the increasing cheaper imports, especially from the New Industrialised Countries (NICs).

As a response to these unfavourable developments, the community also started to develop competitiveness enhancing policies such as industrial policy, entrepreneurial policy and the Research and Technology development policy. The Community was forced to take into consideration its efficiency and competitiveness. One solution was the development of framework programmes to support research and technology development (McDonald&Potton, 1999, pp.168-178):

“The EU has identified help with R&D as an important factor to help develop the competitiveness of European enterprises (...) SEA called for the establishment of a multi-annual Framework programme. The Framework identified the need to enhance the international competitiveness of European Industry as the main objective of the Community’s R&D programmes. ‘To increase the economic spin-offs from Community research, in particular by concentrating on generic technologies which will enable European industry and its subcontractors to go back on the offensive in international competition’ (McDonald&Potton, 1999, pp.168-178)

Finally the citizens of the community came up with demands concerning especially environmental and social issues putting a greater political pressure on the simple project of integration of markets.

Therefore the Community was faced with many new challenges: carrying out new policies, fixing the old ones and keeping up with the international economy. The Globalization period also escalated these challenges to the EU policies.

As a result of the accumulation of these various pressures, the Commission changed its policy of monitoring the compatibility of State aids with the common market. Given the pressures explained above, one would expect the policy to be strengthened.

On the contrary, the policy was watered down. The Commission started to make a cost-benefit analysis between the distortion to the common market created by the aid and the benefits derived from the aid with respect to the new areas of interest for the community. In other words, the Commission was willing to make a trade-off between the competition in the Internal Market and fulfilment of other aims. That means the State aids policy became a policy of balance between the original and the supplementary aims of European integration.

This trend can be followed from the increase in the volume of secondary state aids legislation. Previously only the provisions of the Treaties and some procedural rules were sufficient to carry out state aids investigations. Now there were several primary and secondary law documents including detailed rules designed to assess whether aids were compatible with the common market or not. For example as the regional policy gained importance, secondary legislation and regional state aids also started to emerge. It is not surprising to see that the first official text on national regional aids, a council resolution, is dated 1971, when the regional policy gained importance on the verge of enlargement. Several Commission principles followed in the same decade (Cini & McGowan, 1998, p. 148).

In the 1970s, the state aid set of laws for the transport sector were progressively getting more controversial. With the recent tendency towards liberalization, privatising and restructuring of the state-owned or state-controlled industries, subsidies to airlines, railways and shipping companies have been increasingly more crucial. The national pressures were increasing on Brussels to influence the policy and the Commission was under great pressure. The Commission has been criticised for favouring so many of these aids on the basis of what seems to be like national pressure.

The case of aid to Iberia, the Spanish Carrier, which was granted aid of 87 billion pesetas in total, was important for the reason that the Commission estimated this aid to be a normal Commercial business. However, the competitors and the consumers were the ones who had to bear the cost. New guidelines came forth in a 1994 Communication (Commission,

1995, p 185) in response to the emergence of a political and industrial atmosphere in which the Commission took a tougher position. (Cini& McGowan, 1998, pp. 151-152)

As the European Community's new state aids policy was emerging in the 1970s, the Commission made full use of its ability of using soft law instruments such as codes and frameworks, with the aim of balancing the new policy areas and the common market objectives.

Guidelines, frameworks and codes make up the secondary law of the European Union and they were adopted as a result of the consequences of increasing trade liberalisation and the pressure of globalisation on markets and industries. Guidelines are used in policy areas for aids such as regional, environmental protection, SMEs (Small and Medium Sized Enterprises), employment, undertakings in poor urban areas, and restructuring companies in trouble, agriculture and fisheries. Frameworks consist of aids in relation to research & development, regionally for large investment projects, training, the motor vehicle industry and non-ECSC (European Coal and Steel Community) steel commodities. Codes have been adopted relating to the synthetic fibres industry and for coal and steel. (Quigley & Collins, 2003, pp 100-102)

One of the most important examples of an aid framework was the Community Framework on State Aids for R&D (Research and Development) which was agreed in 1985 (OJ -1985-C83). R&D was a crucial horizontal policy and it was important for the Community to give exemptions from rules for state aids in order to boost its industrial sector and also to prevent R&D subsidy wars between its member states as R&D were the most common tools utilised for Strategic Trade Policy (STP) purposes.(Spencer & Brander,1983) A modified R&D Framework issued in 1995 (OJ -1995-C45) built upon the earlier draft, clarifying the types of support not considered as aid and highlighting exemptions based on the practice of the previous decade (McGowan, 1998, p 153). Following this period, in the 1990s we see that new framework programmes appear. The main aim of these frameworks was to catch up with the United States and Japan in the competitiveness of its industries. (Cini, & McGowan, 1998, pp 151-152)

While during the 1970s the State aids policy became very permissive, in the mid-1980s it returned to the agenda. There were two reasons behind this development: the Single Market Programme and the importance attached to the issue by successive Competition Commissioners.

Single Market Programme was an important step towards the formation of a common market. Deeper market integration also required a stronger State aid policy; because the State aids now had a greater impact on trading conditions and the dynamics of further integration could have spurred a new wave of collusion and protectionism through subsidies like the original integration.

Moreover the Subsidies Code signed at the end of the Tokyo Round of multilateral trade negotiations and the negotiations on the same issue during the Uruguay Round were attracting a greater interest to State aids.

Competition Commissioner Peter Sutherland ordered the formation of Task Force on State Aids in 1985 in this context. This Task Force reviewed all State aid schemes in force and prepared the *First Survey of States Aid in European Community* that was published in 1988. As a result transparency was ensured in the field for the first time. The figures included in the *Survey*-such as the fact that State aids made 10 % of the public expenditure in the period- facilitated the stepping up of the policy. Eight more surveys were published. Today the surveys are replaced by State aid scoreboards.

While Peter Sutherland ensured transparency, his successor Leon Brittan developed three principles that served as the main guidelines of the policy thereafter. These were (1) that the appropriateness of existing aid should not be taken for granted, (2) that the effectiveness of policy should be improved and (3) that aid transparency must become a priority.

Under Karel van Miert and especially Mario Monti the economic dimension of competition policy gained importance. For example Monti, who himself was a professor of economics, appointed a chief competition economist and also formed an advisory group consisting of purely economists. There was already a consultative group on State aids; but it consisted of representative of the Member States being chaired by a member of the Commission. Therefore its input was highly skewed.

At the same time the volume of SA legislation increased and reached approximately a thousand pages. Most of the legislations consisted of soft law documents. These came under various titles: frameworks, guidelines, codes et cetera. They were the result of the experience accumulated by the Commission in the application of State aid rules to certain issues and especially sectors. These documents are reviewed and if necessary updated periodically.

Hard law was also produced in the period. Most importantly Article 89 was used for the first time since 1958 in order to issue a Council regulation on horizontal State aid: Council Regulation (EC) No 994/98 of 7 May 1998 on the application of Articles 92 and 93 of the Treaty establishing the European Community to certain categories of horizontal State aid (*OJ L* 142, 14.05.1998, p. 1). Under this Council regulation the Commission published three block exemption regulations that covered employment, training and small and medium sized enterprises (SMEs).

Under Prodi Commission, where Mario Monti was the Competition Commissioner for the second time, the SA policy was given a new function as well. This approach was adopted by the following Barroso Commission and its Competition Commissioner Neelie Kroes. Before the Prodi Commission State aid policy was perceived as a negative regulatory policy opposed to positive industrial policy. Moreover the policy was limited with the examination of specific cases of subsidization. In the context of the Lisbon Agenda (renamed as the Partnership for Growth and Jobs by the Barroso Commission) the State aid policy was re-defined as a competitiveness-enhancing positive policy with a focus on the total level and quality of State aid as well as specific cases. The aim is to reduce the total

level of State aid and refocusing aids to horizontal issues, especially those that create economic benefits such as R&D and vocational training. This approach places the State aid policy in an integrated framework for competitiveness. A new action plan titled “State Aid Action Plan: Less and better targeted state aid: a roadmap for state aid reform 2005-2009” was recently published for this purpose

At the same time reduction of the amount of the State aids is a declared political priority in the European Union. The Lisbon, Stockholm and the Barcelona European Councils respectively in 2000, 2001 and 2002 strongly advised the Member States to reduce the State aids and emphasized the importance of the State aids policy in maintaining effective competition.

Taking into consideration the basic provisions and the application State aid policy cannot simply be accepted as a measure basically related with the negative integration phase of international economic integration as the rationale put forward in the first section of the present chapter suggests. The policy actually tries to strike a balance between the negative and positive dimensions of European economic integration. Whether or not this is sensible will be understood in the fifth and sixth chapters.

However before that, in order to understand a more comprehensive understanding of the issue details about the application of the policy should be examined.

IV. THE APPLICATION OF THE STATE AIDS POLICY

In this chapter we first take a deeper look at the State aids policy. Of course it is not possible to cover all existing rules and their actual implementation by the national and Community authorities; but we will underline the most important aspects. For this purpose first the international dimension of the policy is presented. Second, sub-branches of State aid policy, namely horizontal and general, sectoral and are explained. Finally the institutional and procedural issues are studied.

4.1. International Dimension: WTO Rules

International agreements that bind the Community form an integral part of the EU legislation. The agreements forming the multilateral trade regime governed by the World Trade Organization (WTO) are examples. Even though the State aid provisions contained in the Treaty predate the subsidy agreements of multilateral trading system today secondary State aids legislation does have to take into consideration the binding commitments laid down thereto.

The General Agreement on Tariffs and Trade (GATT) agreement was signed in 1947 and it has been a global institution for regulating the international trade. In 1995, GATT was re-established and it became to be known as the World Trade Organization. Its main aim is the liberalisation of the international trade. Another purpose of WTO is to resolve the international trade disputes between the member states. The Agreement on Subsidies and Countervailing Duties has been signed regarding the State aid rules in the WTO.

The Results of the Uruguay Round of Multilateral Trade Negotiations set some rules regarding the State Aids. In the Agreement on Subsidies and Countervailing Measures; in Article 1 the definition of a subsidy is made clear.

A subsidy shall be considered to exist if there is a financial contribution by a government or any public organization within the territory of a member (government), i.e where:

- a government practice involves a direct transfer of funds (e.g grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g loan guarantees);
- government revenue that is otherwise due is foregone or not collected (e.g fiscal incentives for instance tax credits);
- a government supplies goods or services other than general infrastructure, or purchases goods;
- a government makes payments to a funding mechanism, or entrusts or directs a private body to perform one or more of the type of functions illustrated in and I to III above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments

or there is any kind of Income or price support in the sense of Article XVI of General Agreement on Tariffs and Trade (GATT) 1994 (Results of the Uruguay Round of Multilateral Trade Negotiations, 2000, p 264).

The Uruguay Round set some definitions for several terms such as direct taxes, import charges and indirect taxes. The definitions of these terms as set out in the Uruguay Round are as follows: The term ‘direct taxes’ is defined as ‘taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property’. The term ‘import charges’ is defined as ‘ *tariffs, duties and other fiscal charges not elsewhere enumerated in this note that are levied on imports*’. The term ‘indirect taxes’ is defined as ‘sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges’. (Results of the Uruguay Round of Multilateral Trade Negotiations, 2000, p 264)

Export subsidies constitute another important form of State aids. In the Agreement on Subsidies and Countervailing Measures, the export subsidies are considered to be banned and it makes clear that the Member states can not give export subsidies.

The Export Subsidies in the Uruguay Round are defined as follows;

- The provision by governments of direct subsidies to a firm or an industry contingent upon export performance.
- Currency retention schemes or any similar practices which involve a bonus on exports.
- Internal transport and freight charges or export shipments, provided or mandated by governments, on terms more preferred than for domestic shipments.
- The provision by governments or their agencies either directly or indirectly through government-mandated schemes, of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such as terms or conditions are more favourable than those commercially available on world markets to their exporters. (Results of the Uruguay Round of Multilateral Trade Negotiations , 2000 , p 304)

In the WTO regulations, it is stated that non-specific subsidies and aids for R&D, less developed areas and protection of the environment are considered to be exempted by the State aids rules and it states that no legal action can be taken against them.

These provisions are only valid for non-agricultural goods if there are special provisions in the Agreement on Agriculture, probably the most contentious issue in the multilateral trade negotiations.

According to the Agreement on Agriculture agricultural export subsidies are not prohibited, but they were gradually reduced within limits. They can also be subject to counter-vailing duties. Regarding domestic support subsidies the Agreement lays down a three-fold classification unofficially described by using a metaphor of three boxes. Accordingly the amber box includes those subsidies that distort production and trade, such as price support. A *de minimis* level was determined for them and those Members that had higher levels of subsidization had to gradually reduce their subsidies to those levels. Support exceeding reduction commitment levels is currently prohibited. The blue box

covers those subsidies that would normally be included in the former box, but were made less distorting with the imposition of additional conditions in order to limit production. Finally, the green box includes the subsidies that do not distort or minimally distort production and trade. These are either horizontal subsidies or direct income support measures. There are no limits on the blue and green boxes. Agreement on Agriculture also includes special and differential treatment provisions for the developing countries (Josling, 1994).

During the Uruguay Round and later on a number of other sectoral consensus were reached. There are also initiatives outside the WTO framework for the multilateral control of subsidies. However these of no direct interest for our purposes.

4.2. Sub-Branches of the State Aid Policy

It is argued that the State aids policy as implemented by the Commission has three sub-branches: horizontal and general, regional and sectoral (Cini & McGowan, 1998, pp. 146-158). Even though there is no consensus between different official documents (such as the Vademecum and the Surveys on State Aid in the European Union), the State aids scoreboards that are the most recent official publications on the subject somewhat supports this threefold classification.

4.2.1. Horizontal and General Aids Policy

State aid for horizontal objectives, i.e. aid that is not granted to specific sectors, is usually considered as being targeted to market failures and as being less distortive than sectoral. Aid for regional development, the promotion of training, employment creation, research and development, safeguarding the environment, energy saving and support to small and medium-sized enterprises are the most important horizontal objectives pursued with State aid. (State Aids Scoreboard, Spring 2004, p 18)

The Commission has different perspectives in each sub-branch. Horizontal and general State aids (not to be mixed with general non-State aid measures) are seen positively since

these usually target market failures and create less distortion. The horizontal aids acceptability would generally depend whether it can be considered as encouraging a project of common European Interest Article 87(3) (b) E.C (Evans, 1996, p 273). The Stockholm European Council in 2001 called on the Member States to redirect aid toward horizontal objectives of common interest; including cohesion objectives (Presidency Conclusions, Stockholm European Council, 23 and 24 March 2001, p. 6). Horizontal aids include *de minimis*, employment and training, research and technology development, SME and environmental aids. The type of General Aids covers all aids which can not be classified as distinctly sectoral or regional. General aids cover financial aspects (including rescue and restructuring of firms and short-term export credit insurance). (Cini & McGowan, 1998, pp.153) In this section, rescue and restructuring, aids to SMEs, employment aids and aids for environmental protection will be examined.

4.2.1.1. Rescue and Restructuring

Rescue and restructuring aids are usually part of the same aid or the same plan but their terms of applications differ from each other. Rescue aids are provided generally for not more than six months whereas restructuring aids are provided for a long-term which covers a period more than six months. It is stated that the “rescue aid provides a brief respite, generally for not more than six months, from a firm’s financial problems until a long term solution can be worked out” (Competition Law in the European Communities, 1999, p. 211). On the other hand for restructuring aid the following is stated: “Restructuring, is part of a feasible, coherent and far-reaching plan to restore a firm’s long-term viability.” (Competition Law in the European Communities, 1999, p. 211)

The rescue aid in order to be approved by the Commission several conditions must be satisfied and these are as follows:

- Consist of liquidity help in the form of loan guarantees or loan bearing normal commercial interest rates;
- Be restricted to the amount needed to keep a firm in business (for example, covering wage and salary costs and routine supplies);

- Be paid only for the time needed (generally not exceeding six months) to devise the necessary and feasible recovery plan
- Be warranted on the grounds of serious difficulties and have normal no undue adverse affects on the industrial situation in other Member States (Competition Law in the European Communities, 1999, p. 213-214).

A further condition of the rescue aid is that it should be a one-off operation. For the restructuring aid to become acceptable there are five conditions to be satisfied which are listed below:

- Restoration of Viability
- Avoidance of undue distortions of competition through the aid
- Aid in proportion to the restructuring costs and benefits
- Full implementation of restructuring plan and observance of conditions
- Monitoring and annual report

The requirements of the regional development have a priority in the European Union hence when the aid to firms operating in the developed areas are considered this fact is to be taken into account by the Commission (Quigley & Collins, 2003, p. 164). But even when the requirements of the regional development are to be taken into account, the same general criteria for restructuring aids apply also in the underdeveloped areas. In addition to the case of regional development, there is also the case of privatisation considered for the restructuring aids. Quigley and Collins state that the Commission can not impose a condition of privatisation on any undertaking that receives aid for the restructuring purposes (Quigley and Collins, 2003, p.164) But on the other hand if the Member State is to privatise the firm receiving such a restructuring aid than this will be a decisive element in the view of the Commission in evaluating the future viability of the company without the need for further aid (Quigley & Collins, 2003, p. 164). In the case of SMEs, the rescue and restructuring aid conditions are applied less strictly because they do not affect the trading conditions as the large firms do. In the banking sector, the Member States should be aware of the fact that a serious crisis in the financial sector will affect the other sectors

adversely as well as the financial relations between the other Member States therefore the main aim is to avoid such a situation.

4.2.1.2. Research and Development Aid

Research & development and innovation help the communities in several ways. For example research & development and innovation can foster the employment, renew growth and strengthen competitiveness (Competition Law in the European Communities, 1999, p. 186). Therefore supporting research and development has been one of the primary aims of the EU and to achieve this aim, the Research and Technological Development (RTD) framework programmes have been established. These programmes have the following activity areas:

- Implementation of research, technological development and demonstration programmes, by promoting cooperation with and between companies, research centres and universities;
- Promotion of cooperation in the field of Community research technological development and demonstration with third countries and international organisations;
- Dissemination and optimisation of the results of activities in Community research, technological development and demonstrations,
- Stimulation of the training and mobility of research workers throughout the Community (Competition Law in the European Communities, 1999, p. 186).

In order for the aids granted in this field to be accepted as compatible by the Commission, they must comply with the Article 92;(3) of the Competition Policy and the innovation or the research activity must prove that it would enhance the common living conditions within the EU in general. It is stated that the common European interest must be demonstrated in practical terms (Quigley & Collins, 2003, p. 179). For example it must be proved that the project “represents a major advance over specific Community R&D programs or that it enables significant progress to be made towards achieving specific Community objectives.” (Competition Law in the European Communities, 1999, p. 189)

The intensity of the allowable aid is determined by the Commission on a case-by-case basis. In the calculation of the aid intensity, the eligible cost involved in the project are evaluated and these include the costs of personnel, instruments, equipment, land and premises used only for the research activity, also the costs of consultancy and equivalent services (including research, technical knowledge and patents bought from outside sources), additional overheads and expenses as a result of the research activity. (Quigley & Collins, 2003, 181) In addition to this, the aid intensities may exceed in several cases and these are listed as follows by Quigley and Collins (2003):

- Aid SMEs: by 10 percentage points,
- Research projects carried out in Article 87(3)(a) or (c) region: by a 10 or 5 percentage points, respectively,
- Research projects in accordance with the objectives of a specific project programme undertaken as a part of the Community's current framework programme for research and development. By 15 percentage points,
- Research projects not in accordance with the objectives of a specific project or programme undertaken as part of the Community's current framework programme for research and development: up to 10 % provided one of the following conditions apply:
 - The project involves effective cross-border cooperation between at least two independent partners in two Member States, particularly in the context of coordinating national research and technological development policies,
 - The project involves effective cooperation between firms and public research establishments, particularly in the context of coordinating national research and technological development policies, or
 - The result of the project are widely disseminated and published, patent licenses granted, or other appropriate steps taken for the dissemination of Community research and technological development results (Quigley & Collins, 2003, p. 183).

There are also maximum values for aid intensities and they are allowed for a maximum gross intensity of 75% for industrial research and 50% for pre-competitive development activities.

4.2.1.3. Aids to Small and Medium Sized Enterprises (SMEs)

The aids for Small and Medium sized Enterprises are considered in a different way than the aids for large enterprises by the Commission since they perform better than the latter ones on issues such as job creation and innovation (Quigley & Collins, 2003, p. 145).

The small and the medium sized enterprises are strictly defined by the Commission and according to this definition the following condition has to be met by any enterprise in order to be called as a small or a medium sized enterprise: have fewer than 250 employees, and have either an annual turnover not exceeding ECU 40 million or an annual balance sheet not exceeding ECU 27 million (Competition Law in the European Communities, 1999, p. 227). The tangible investment aid must be in fixed assets in the following conditions:

- In the creation of a new investment, the extension of an existing establishment or in engaging in an activity involving a fundamental change in the product or production process of an existing establishment (by means of rationalisation, restructuring or modernisation), or
- By way of take-over of an establishment which has closed or which would have closed, had such a take-over not taken place.

The intensity should not exceed 15% of the eligible costs in the case of small enterprises and 7.5% in the case of medium sized enterprises. In addition to these limits also a maximum value exists. The case of intangible investment is also the same as the tangible ones. Aids up to a 50% of the gross value are also given for the SMEs for the consultancy services that are provided by outside sources. The consultancy service should be for the purposes such as; staff training: management, financial matters, new technology, pollution control, protection of intellectual property rights or like, or for the purpose of assessing the feasibility of new ventures (Competition Law in the European Communities, 1999, p. 235). Other than these aids, the following aids are also granted to the SMEs: aid for the transfer

of SMEs, aid environmental protection, aid for R&D, aid for employment and aid for other purposes.

4.2.1.4. Employment Aid

Creating additional employment opportunities has been one of the most important objectives of the European Union. Five important areas have been identified in coping with unemployment in the Member States and these areas are as follows: boosting investment in education and training, improving internal and external flexibility mechanisms in order to enhance the employment content of growth, reducing indirect labour costs in particular by reducing direct taxation of labour, improving the effectiveness of active policies, notably by redirecting public expenditure on passive income support for the unemployed, and stepping up measures to promote the employment of underprivileged groups in the labour market such as long-term unemployed, young people and older workers (Quigley & Collins, 2003, p. 169). Aids to maintain jobs are granted to firms in order that these firms do not lay off their workers. The subsidy is being calculated on the basis of the number of employees at the time the aid is granted. On the other hand, there is aid granted to create jobs. This aid is calculated on the basis of the number of jobs created. The term 'job creation' is used in its strictest sense and new jobs for additional workers should be created in the firms that the aids are granted. An unusual form of the job creation is job sharing. The same job will be apportioned among a larger number of workers and no additional hours of work will be created. But this is considered as job creation since the number of workers has increased (Competition Law in the European Communities, 1999, p. 241). Also as Quigley and Collins state, employment aids do not cover aids for investment purposes. Because investment is not directly for new job creation and therefore to cure unemployment (Quigley and Collins, 2003, pp.172-173)

4.2.1.5. Aids for Environmental Protection

During the 1970s and the 1980s the main environmental policy of the Union has been setting and implementing the main standards for the main parameters of environment (Competition Law in the European Communities, 1999, p.200) 'The polluter pays

principle' had been accepted in 1973 in which the economic agents bear the full cost of the pollution caused by their activities. Aids are granted as investment aid for environmental protection, operating aid for environmental protection, and aids for horizontal support measures. Investment aids fall into the following categories:

- i) Aids under programmes designed to help existing firms adapt their plant to new standards or encourage them to reach such standards more rapidly (aid available for a limited period to speed up the process of implementing new standards),
- ii) Aid to encourage efforts to improve significantly on mandatory standards through investment that reduces emissions to levels well below those required by current and new standards,
- iii) Aid granted in the absence of mandatory standards on the basis of agreements whereby firms take major steps to combat pollution without being legally required to do so, or before they are legally required to do so,
- iv) Aid for investment in fields in which environmental action is a matter of priority, but benefits the community at large more than the individual investor and is therefore undertaken collectively, this may be the case, for example, with waste disposal and recycling,
- v) Aid to repair past environmental damage, which the firms are not under any legal obligation to remedy (Competition Law in the European Communities, 1999, p. 201).

The activities in aid for horizontal support measures are as follows:

- Research and development of technologies that cause less pollution,
- Provision of technical information, consultancy services and training about new environment technologies and practices,
- Environmental audits in firms,
- Spreading information and increasing awareness of environmental problems among the general public, general promotion of ecological quality labels and of the advantage of environmentally friendly products etc. (Competition Law in the European Communities, 1999, p. 202).

Operating aids take the following form:

- Relief from environmental taxes, introduced in some Member States, where it is necessary to prevent their firms being placed at a disadvantage compared with their competitors, in countries that do not have such measures
- Grants to cover all or part of the operating cost of waste disposal or recycling facilities, water treatment plant, or similar installations, which may be run by semi-public bodies with users being charged for the service (Competition Law in the European Communities, 1999, p. 201-2).

4.2.2. Regional Aids Policy

Regional State aid policy is closely related to horizontal State aids as well as the regional and cohesion policy of the Community. However it does not overlap with them. Regional State aid might be used for horizontal, general or sectoral purposes within a region; but the assessment carried out is related to the level of development of the region concerned. Moreover the assisted regions under Article 87 (3) do not correspond to NUTS II (Nomenclature of territorial units for statistics) levels used for the purposes of the regional and cohesion policy (State Aid Scoreboard, Spring 2003, p. 20-22)

The initial steps toward defining the limits of regional aid policies had been taken in the 1960s and 1970s. The aim of the regional aid policies has been to increase the economic and social cohesion between the more developed and the less developed regions of the community (Quigley & Collins, 2003, p. 127). Regional aids may be granted for initial investment, new job creation, and operating aid. Initial investment is defined as; ‘investment in fixed capital relating to the setting up of a new investment, the extension of an existing establishment, the starting up of an activity involving a fundamental change in the product or the production process of an existing establishment’ (Competition Law in the European Communities, 1999, p. 311). Aid in such cases is calculated on the basis of the investment value. The investment value is determined on the basis of land, buildings, plant and machinery. Certain categories of intangible investment up to a limit of 25% of the standard base for the larger firms can also be included in the eligible expenditure. For the SMEs higher levels are permitted. Such intangible expenditure consists of expenditure

for patents, operating or patented know-how licences and unpatented know-how (Quigley & Collins, 2003, p. 135). Regional aid may also be granted for job creation purposes (Competition Law in the European Communities, 1999, p. 313). The net number of jobs created is taken into account therefore the number of losses is subtracted from the number of job increases. The intensity of the aid should not exceed a certain percentage of the wage cost of the person hired, calculated over a period of two years (Competition Law in the European Communities, 1999, p. 314). Regional aid in the form of operating aid is prohibited under the normal conditions but there are certain exceptions to this rule. The exceptional regions have been defined in the Article 87(3)(a) (Quigley & Collins, 2003, p. 142).

4.2.3. Sectoral Aids Policy

The Commission's sectoral aid policy focuses on specific problematic sectors and individual grants of aid. It has relied largely on a framework approach which involves the drafting of sectoral guidelines to spell out in some detail the type and scope of aid likely to be authorised (Cini & McGowan, 1998, p 150). Since the *Philip Morris* judgment the Commission has taken sectoral aid decisions in five sectors; viz. coal and steel, shipbuilding, agriculture and textile. (Mortelmans, 1984, p 410) Sectoral policy perspective may be expected to be related to the development of specific economic activities under Article 87(3) (c) However; Evan points out that the danger of sectoral interests may create problems. (Evans, 1998, p 444)

There are several Secondary law documents related to different sectors: agriculture, fisheries, broadcasting, coal, electricity, motor vehicles, shipbuilding, steel, synthetic fibres and transport. Some of these rules also concern sectoral policies of the Community: Common Agricultural Policy, Common Fisheries Policy and Common Transport Policy. In the case of aid schemes that are related to these sectors, the investigations are not carried out by the DG Competition and they are carried out by the relevant sectoral DGs (DG Agriculture, DG Fisheries and DG Energy and Transport).

4.2.3.1. Aids to Shipbuilding

The aid granted for shipbuilding, ship repair and ship conversion either directly or indirectly could be considered compatible with the common market only if such aid complies with the provisions of the Council Regulation No 1540/98 (Quigley & Collins, 2003, p. 198). Such aid covers aid granted for the above-mentioned purposes as well as investment aid and aid for restructuring purposes. It is also stated that permissible aid includes aid for innovation, operating aid and closure aid.

In addition to these types of aids development aids are also being granted for the underdeveloped regions. ‘The Competition Law in the European Communities’ states that the following criteria must be applied when granting development aid:

- The aid may not be granted for construction of ships, which will be operated under a flag of convenience.
- In the event that the aid can not be classified as public development, aid in the framework of OECD the donor must confirm that the aid is part of an intergovernmental agreement.
- The donor must give appropriate assurances that the real owner is resident in the beneficiary country and that the beneficiary company is not a non-operational subsidiary of a foreign company.
- The beneficiary must give undertakings no to sell the ship without prior government approval (Competition Law in the European Communities, 1999, p. 410).

But not all countries are considered eligible for granting such development aids and there are certain criteria for being eligible. The regional investment aid is such a development aid that is granted for upgrading or modernizing existing yards. The objective is not the financial restructuring of the mentioned yards but the aim is to improve the productivity of the existing installations (Quigley & Collins, 2003, p. 198). Such aid is considered as compatible with the common market only if the aid is “limited to support eligible expenditure as defined in the guidelines on regional aid and that the intensity of the aid

does not exceed 22.5% for Article 87(3) (a) EC regions and 12.5% or any applicable lower ceiling, for Article 87(3) (c) EC regions” (Quigley & Collins, 2003, p. 198).

Innovative aids may be granted only if the aid is for genuinely innovative projects that will improve the competitiveness (Competition Law in the European Communities, 1999, p. 515). The innovative products should not be currently used commercially by other operators in the sector within the EU and they should carry the risk of technological failure or industrial failure. The aid is considered to be compatible with the common market only up to a maximum aid intensity of 10% gross (Quigley & Collins, 2003, p. 198).

4.2.3.2. Aids for the Steel Industry

Research and development aids related to the steel industry are considered compatible with the rules only if the aids are in compliance with the rules laid down in the Community framework for the State aid for research and development, (as set out in Official Journal of the European Communities C 45 of 17 February 1996) (Competition Law in the European Communities, 1999, p. 529). Aid for environmental protection is to be considered compatible with the common market if the granted aid is in compliance with the rules laid down in the Community guidelines on State aid for environmental protection (as set out in Official Journal of the European Communities C 72 of 10 March 1994) (Competition Law in the European Communities, 1999, p. 529). In addition to these “aid to cover payments to workers of steel undertakings made redundant or accepting early retirement may be deemed compatible with the common market provided that the payments arise from the partial or total closure of steel plants, that they do not exceed those which are customary and that they are limited to 50% of the portion which is payable by the undertaking concerned” (Quigley & Collins, 2003, p. 247). The undertakings granted for firms, which permanently cease to produce steel, products are also considered to be compatible with the common market. These aids should be granted to firms, which have regularly produced steel products and which close and destroy the installation used for the production within six months (Quigley & Collins, 2003, p. 247).

4.2.3.3. Aids for the Motor Vehicles Industry

In establishing a State aid policy for the motor vehicles industry, the aim has been to reduce the distortion of the competition in the EU motor vehicle industry to a minimum (Quigley & Collins, 2003, p. 194). In the booklet of the 'European Union State Aids' prepared by the 'European Policy Directorate' on June 2001 it is stated that; the code for the aids for motor vehicles "covers all aid towards the development, manufacture and assembly of motor vehicles, engines for motor vehicles and "modules or sub-systems" produced by a vehicle/engine manufacturer or a 'first-tier component supplier' (as part of an overall project) (Quigley & Collins, 2003, p.15). If the aid is Euro 50 million or more or if the total aid, including the structural funds is Euro 5 million or more then it should be notified. Also the aid should be granted under an approved scheme (European Community State Aids, 2001, p. 15). Four types of aids, for the motor vehicles industry are examined by Quigley and Collins, which are the regional investment aid, innovation aid, restructuring aid, and operational aid (Quigley and Collins, 2003, p.195-197). Regional aid is to be provided to assist new plants and the extension of the existing plants. There is also a limit for the aid provided. The aid intensity should not "exceed the regional ceiling applicable to the type of undertaking concerned" (Quigley & Collins, 2003, p. 195). The aid should only be provided for changeable geographic regions therefore no aid is provided for the region which is not geographically mobile. Important examples of cases where aid has been permitted are Fiat Punto in Melfi, Daimler Chrysler in Thuringia, and Volkswagen in Dresden (Quigley & Collins, 2003, p. 195). When innovation aid is granted then the innovation should not be done by other firms in the Common market therefore it should be unique and really innovative. An example to innovation aid is the production of the Smart Car. On the other hand the Commission gave a negative decision in the case of the Italia's Iveco SpA case and concluded that the aid was not necessary for IVECO to develop a new range (Quigley & Collins, 2003, p. 197). Those restructuring aids are permitted which are aimed at a net increase in the production capacity. No operating aid is allowed by the Commission in order not to distort the competition in the motor vehicles industry. In addition to this regional aid, aid for modernisation and rationalisation are also not allowed by the Commission (Quigley & Collins, 2003, p. 197).

4.2.3.4. Aids to Synthetic Fibres and Yarn Industries

In the past, there have been several cases that the low production capacity in the synthetic fibres and yarns industry caused to certain problems within the member countries. There have been job losses and unemployment in these industries and for this reason people have faced with certain difficult situations (Competition Law in the European Communities, 1999, p. 357). In such situations, aids had been granted by the government to these industries in order to help the firms and people to solve their problems. Additionally, aids had been granted by the governments without any restrictions. Therefore the European Commission decided to restrict the EU Member States' governments to grant aids so that these aids do not create a distortion in the industry and cause other problems for other firms. At present, specific measures are applied to all categories of aid except for training aid, aid for research & development and aid for environmental protection (Quigley & Collins, 2003, p. 202). The compatibility of the aid is evaluated at three stages which are listed as; the state of the markets for the relevant products, the effect that the aid would have on relevant capacity, and in consideration of the outcomes of the first two stages and the size of the company the innovative character of the products (Quigley & Collins, 2003, p. 203). The aid code covers extrusion, texturisation and polymerisation (including polycondensation) of all generic types of staple fibre and filament based on polyester, polyamide, acrylic or polypropylene, irrespective of the product's end-uses (European Community State Aids, 2001, p. 15). Investment aid is only allowed for the large firms if it would result in a significant reduction of the relevant capacity. Or the aid is allowed if the market for the relevant products was characterised by a structural shortage of supply and the aid would result in a significant increase in the relevant capacity (Quigley & Collins, 2003, p. 204).

4.2.3.5. Aids to the Textiles and the Clothing Industry

The framework for the textile and the clothing industry has been adopted in 1971. Aids were restricted to those areas where there were social problems and serious problems of adjustments (Quigley & Collins, 2003, p. 202). Aids were not allowed in the sectors where there were serious problems of excess capacity and stagnation.

4.2.3.6. Aid to the Transport

Environmental concerns have been one of the major objects of the commission for a long period when considering the transport sector. When thought from an environmental point of view, the rail and inland waterway transport systems have been the two safest, cleanest and the most efficient ways of transport in terms of energy consumption (Quigley & Collins, 2003, p. 229). For this reason, state aids have been supported by the commission particularly in these two sectors. Except the environmental concerns, aid may be granted to these two sectors due to other reasons such as research and development.

The new guidelines for the maritime transport have been issued in July 1997 and these guidelines cover all types of aid to maritime transport. But the guidelines do not cover aid to shipbuilding or aid for fishing vessels (European Community State Aids, 2001, p. 16). It is stated that the aim for the maritime policy is to ensure freedom to access to shipping markets across the world for safe and environmentally friendly ships (Quigley & Collins, 2003, p. 231). The guidelines on State aid to maritime transport were issued for the first time in 1989 and they were revised in 1997. The commission stated that the state aid causes little distortion between the Member States in this sector. Operating aid, investment aid, aid for crew relief, and compensation for public service obligations, regional aid, aid for rescue & restructuring, aid for research & development, and aid for environmental protection have been permitted in this sector. These aids are evaluated in the light of the related guidelines that are issued by the commission.

In the past, there was much state intervention in the air transport sector and for this reason there was much distortion of the competition (Quigley & Collins, 2003, p. 235). Separate guidelines have been issued for this sector in 1994. Aid in this sector is permitted on the same guidelines that are also applied to other sectors. Regional aid, operating aid, and restructuring aid are permitted in this sector.

4.2.3.7. Aids to Postal Sector

The Commission considers the following public funds as compatible in the postal sector:

the setting-off of operating losses, the provision of capital, non-refundable grants or loans, on privileged terms, the granting of financial advantages by forgoing profits or the recovery of the sums due, the forgoing of a normal return on public funds used, compensation for financial burdens imposed by the public authorities (Notice from the Commission, 1998, p.12-13).

4.2.3.8. Audiovisual Sector

The compatibility criteria for the aids in the audiovisual sector are as follows:

- The aid is directed to a cultural product. Each Member State must ensure that the content of the production which the aid granted is cultural according to verifiable national criteria (in compliance with the application of the subsidiary principle).
- The producer must spend at least 20% of the film budget in other Member States without suffering any reduction in the aid provided for under the scheme. In other words, the Commission accepted eligibility criteria for a territory in terms of expenditure of up to 80% of the production budget of an aided film or TV work.
- Aid intensity in principle should be limited to 50% of the production budget with a view of stimulating normal commercial initiatives inherent in a market economy and avoiding a bidding contest between Member States. Difficult and low budget films are excluded from this limit. The Commission considers that, under the subsidiary principle, it is up to each Member State to establish a definition of difficult and low budget film according to national parameters.
- Aid supplements for specific film-making activities (e.g. post-production) are not allowed in order to ensure that the aid has a neutral incentive effect and consequently that the protection/attraction of those specific activities into the Member State granting the aid is avoided (Communication from the Commission 2002, p. 3-4).

4.3. Institutional and Procedural Aspect of State Aids

This section of the study will cover the institutional and procedural aspects of the State aids policy. In the institutional aspect, we will outline the EU Institutions such as the Commission, Council of Ministers and the European Parliament and analyse their roles in the decision making process of the State aids policy. The relationship between the European Court of Justice, National Courts and the Commission will be examined as well in the first part. In the procedural aspects, the legal features will be analysed.

4.3.1. Policy and Decision Making in the European Union

The State aids policy is implemented by the Commission, the member States' national courts, the European Court of Justice and the Court of First Instance. The European Commission holds the main power of the policy backed by the Treaties. The ECJ maintains the legal framework.

Even though the Commission is the main actor in the State aids policy because of the supranational nature of this policy field, other institutions and groups also have an impact on the policy and decision-making procedures.

The Council of Ministers can set rules through regulations (For example Council Regulation (EC) No 994/98 is the framework decision for horizontal State aids). Moreover Article 89 of the Treaty gives broad powers to the Council which however requires an important political consensus. The Court of Justice can oversee the decisions of the Commission or issue opinions when it is asked to do so. The case law produced by the Court can change the application of the policy.

The European Parliament has a consultative role and therefore has not shown a consistent interest in this field. For example it has prepared an own-initiative report on the 2001 scoreboard for State aid (spring 2002 update), but not for the others. Moreover different interest groups, both national and European, try to affect the State aids policy.

However since by its nature the State aids policy is supranational the European Commission assesses the applicability of national measures and therefore it is the Commission that sets most of the secondary legislation in the field of State. Moreover most of these official texts form soft law, that is “those measures which, while not in themselves creating legal obligations, have a bearing on the application of hard law” (Pink Book, 2004, p. 1). State aids soft law consists of texts with different titles such as codes, frameworks, notices etc... Soft law have no legal binding influence however it could have practical effects. The European Commission published several guidelines relating State aids.

DG Competition is the primary department of the Commission in competition policy related matters. However the Commission also has a number of vertical or sectoral DGs. They deal with the sectoral State aids in their own fields of competence. These are DG Agriculture and Rural Development, DG Fisheries and Maritime Affairs and DG Energy and Transport.

It is of course DG Competition where the heart of the State aids policy beats. In other words policy development is carried out there mostly and it has the most dedicated and educated staff on the issue. There is a Deputy Director General responsible of three separate directorates on State aids as seen in the organisation chart of the DG Competition in Figure 4.1.

Considering competition policy and in particular State aids, economic and political environment that led to the common objective on the single market created the chance for the Commission to use its legal forces to more significant matters. The Commission had the opportunity to use its power much more widely after the Single European Act (SEA). (Smith, 1996, p 566)

The proper application of competition policy in the internal market requires effective cooperation between the Commission and national courts. Indeed the Commission states that:

“The Commission is the administrative authority responsible for the implementation and development of competition policy in the Community’s public interest’. National courts are responsible for the protection of rights and the enforcement of duties usually at the behest of private parties. The Commission must examine all aid measures, which fall under Article 92(1) in order to assess their compatibility with the common market. National courts must make sure that Member States comply with their procedural obligations.” (Competition Law in the European Communities, 1999, p. 104)

It is essential to analyze cases which illustrate the relationship between the ECJ and the Commission. An important case to illustrate was the Philip Morris Holland (PMH) case (Case 730/79 <1980> E.C.R 2671). This case illustrated the legal recognition of the Commission’s right to claim the recovery of illegal aid (Cini & McGowan, 1998, p 31). The ECJ has acted in a supportive manner towards Commission decisions in cases such as PMH. In that case PMH Cigarette Company was to receive a funding from the Dutch government as part of PMH’s investment strategy regarding the closing of one factory and the growth of production in another. The Commission decided that the arrangement would be incompatible with the common market and stated that it would distort the competition between member states. The ECJ considered the Commission’s explanation and application of the Article 92(3) exemptions as sufficient. On the other hand, the Court ignored the claim from the Commission itself to examine the applicant company’s request that *de minimis* principles be appropriate to the aid rules. (Ross, 1986, p 883-884)

It is also useful to consider this case which demonstrates the powers of the Commission to implement conditional decisions adopted under Article 88(2) (ex 93). This case illustrates the legal means available to the Commission where a member state does not comply with the conditions under which aid has been authorized in an earlier decision.

In 1986, the Italian Aluminium industry gained approval of the Commission for reorganization but the Italian Government was not allowed to grant any further aid. However in September 1988, the Italian government had been found to have granted aid to two public undertakings in aluminium sector. A decision was made in 1989 that the aid was incompatible with Article 92. The Italian government opened a case against the

Commission (Case C-261/89, *Italy v. Commission*). But the ECJ agreed with the Commission decision because Italy had gone against the previous decision and decided that the Commission had acted correctly.

The Italian Aluminium Case (C-261/89) illustrates that the ECJ had an opportunity to identify the extent of the power of the Commission to enforce conditions which it commonly attaches to a declaration that an aid measure is compatible with the common market. (Winter, 1993, pp 316 & 328)

The Italian Aluminium Case also supports this study's critique of the current State aids policy which will be examined later. The alternative approach of this study argues that it should be prohibited for the Member States to grant aids and aids only in exceptional circumstances should be distributed by the Commission. The Italian Aluminium case illustrates how complicated it gets when dealing with member state aids and evaluating their compatibility with the Common market. To monitor all the aids granted by the Member States is a difficult and an inefficient policy.

The cases for loss due to breaches of the competition rules are not and can not be solved by the Commission and this is what limits the powers of the commission. Such cases are handled by the national courts if the individual or the firm who has experienced such loss is willing to request a compensation for their losses.

Examining the implementation of the State aids policy in the European Union enabled us to analyse the institutional background of the policy field. The institutional background and the implementation of State aids policy will lead us to a critique of the policy later. Next it is essential to overview the procedural aspects of the State aids policy.

4.3.2. Procedural Aspects

In this section the procedural aspects of the State aids policy will be examined. The procedures and the implementations will be covered. First the compatibility of the State aids with the Common market will be investigated. Then the procedural provisions will be

outlined. Following the notification formalities will be studied. The unnotified aids will be analysed and we will outline the situations of what happens when an aid is not notified to the commission.

4.3.2.1. Compatibility of the State Aid with the Common Market

One of the central objectives of the common market is to ensure the free competition of the economic actors. So the competition policy and its many branches mainly deal with this objective. If State aid is permitted in cases where the competition principles of the common market are distorted it would be a mismatch between the EU policies and the practice. For this reason the compatibility of the State aids has been an important subject of the Commission. Hence compatibility has the meaning of properly functioning with the free market rules and free competition and not distorting these rules. Quigley (1988) states the following condition of incompatibility of state aids:

- a) The measure must be aid granted by a Member State or through state resources in any form whatsoever,
- b) It must distort or threaten to distort competition by favouring certain undertakings or the production of certain goods,
- c) It must affect the trade between Member States (Quigley,1988, p. 242)

On the other hand the following types of aids are compatible with the common market:

- a) Aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned,
- b) Aid to make good the damage caused by natural disasters or exceptional occurrences,
- c) Aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division (Quigley & Collins, 2003, p. 76).

There are also other aids, which may be compatible with the common market, and these are as follows:

- a) Aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, (regional policy objective)
- b) Aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State,
- c) Aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common market,
- d) Aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the European Union to an extent that is contrary to the common interest,
- e) Such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission (Quigley & Collins, 2003, p. 81).

4.3.2.2. Notification Formalities

The State aid new and/or altered should be notified to the Commission before they are granted by the Member State. This duty to notify the state aids does not only cover the aids that are introduced by means of laws or regulations but also aids that arise from administrative practice (Luja, 2002, p. 90). The Member State governments see this as a constraint on their decision making and policy implementing process (Cini & McGowan, 1998, p. 139). The only exception to notification of new aid is for that is classed as *de minimis*. This is due to the fact that such aid would not affect the trade between the Member States adversely (Competition Law in the European Communities, 1999, p. 27). The aid that falls within the classification of *de minimis* is not more than EUR 50000 for a three year period.

The notification should be sent to the following departments of the Commission:

- The Secretariat-General if it is proposed to introduce a new aid scheme, alter an existing scheme or to award aid to an individual firm or project outside a scheme or programme,
- The responsible Directorate-General, namely Competition, Agriculture, Transport or Fisheries, in the case of notifiable individual awards of aid under schemes authorised by the Commission subject to notification of all or major awards, or of amendments of existing aid schemes that the Commission has previously authorised which qualify for the accelerated clearance procedure,
- Or the Directorate-General for Competition in the case of a new aid scheme for Small and Medium-sized Enterprises that fulfil the conditions for the accelerated clearance procedure (Competition Law in the European Communities, 1999, p. 28).

4.3.2.3. Unnotified Aid

There are cases where the aid has been notified after the aid has been out to effect but has been admitted by the Commission. But in the cases of suspect that the aid is illegal then Commission has the right to stop the aid. Or in other cases if the Commission decides that aid was not eligible for exemption than the aid may be taken back from the recipient with interest. The cases of illegal aids are usually being informed by the complaints of the third parties (Competition Law in the European Communities, 1999, p. 36). There are three ways used by the Commission in dealing with unnotified aid case and these are: I) Article 169 or other Treaty measures, ii) the direct effect of the last sentence of Article 93(3) and iii) the possibility that the aid will have to be recovered from the beneficiaries (Flynn, 1983, p. 301). According to the last paragraph of Article 93(3) the Member States shall not put the proposed aids into effect until the procedure has resulted in a final decision. But non-notification does not make the aids immediately incompatible with the common market and the Commission still has the duty to examine the aids and test them for compatibility with the common market (Slot, 1990, p. 751).

V. SERVICES OF GENERAL ECONOMIC INTEREST AND THE STATE AIDS POLICY IN THE CASE OF THE TRANSPORT SECTOR: AN ANALYSIS AND A PROPOSAL

After laying down the necessary economic, legal and policy background we can now focus on the research question of the thesis and explore whether or not the State aids policy is working well. SGEI that, by their economic nature, require a balance between government intervention and free competition is the ideal context where such an inquiry can be made. There are several such sectors however. Taking into consideration the subject of the major case laws of the Court of Justice, especially the Altmark case, we choose the transport sector and further narrow our focus in order to refine our arguments. That enables us to criticize the current application of the State aids policy and present proposals for its improvement. However first of all the concept of SGEI should be understood.

5.1. The Concept of SGEI

SGEI is a crucial component in the European model of society and it plays an important role in the overall competitiveness of the European economy. The competitiveness of European Industry was a major goal especially to compete against the Japanese and the United States industries. The globalization and its affect on international trade, the incredible technological change and the internal market targets to be achieved resulted in growing pressure to open new sectors to competition. (Communication from the Commission, p 3, 2000)

The Commission defines the ‘Services of General Economic Interest’ as;

“The term used in Article 86 (ex 90) of the Treaty refers to market services which the Member States 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” (Communication from the Commission, SGEI in Europe, p. 2)

The purpose of the resulting commitment is to ensure that everyone has access to certain essential services of high quality at prices they can afford. The EU's aim, is to support the competitiveness of the European economy in an increasingly competitive world and to give consumers more choice, better quality and lower prices, at the same time as helping, through its policies, to strengthen economic and social cohesion between the Member States and reduce certain inequalities and to prevent certain distortions that affects the trade between Member States.

General interest services have a key role to play here, in view of the fact that they contribute to economic and social cohesion and economic performance. The Community is dedicated to maintaining these services together, while improving their efficiency. The importance of striking this balance was brought out by the Heads of State and Government at their summit in Cannes in June 1995;

“The European Council reiterates its concern that the introduction of greater competition into many sectors in order to complete the internal market should be compatible with the general economic tasks facing Europe.” (Cannes European Council, 26-27 June 1995, Conclusions of the Presidency, SN 211/ 95)

As a result of the Common market's completion, better services will be available for the consumers and this will place European businesses in a stronger situation to face up to rising global competition. (SGEI in Europe, 1996, p 5)

SGEIs are different from ordinary services in that public authorities consider that they need to be provided even where the market is not sufficiently profitable for the supply of such services. The concept of services of general interest is based on the concern to ensure that a quality service is provided at an affordable price everywhere for everyone. Services of general interest contribute to achieving the objectives of solidarity and equality of treatment underlying the European model of society.

Article 16 of the EC Treaty recognises the role which services of general interest play in promoting social and territorial cohesion and calls on the EU and the Member States to

ensure that such services operate on the basis of principles and conditions which enable them to fulfil their role. The role assigned to services of general interest and the special rights which may attach to them stem from general interest considerations such as security of supply, environmental protection, economic and social solidarity, regional planning and the promotion of consumer interests. The guiding principles are continuity, equality of access, universality and transparency of the services.

Services of general economic interest make an important contribution to the overall competitiveness of European industry and to economic, social and territorial cohesion. The concept of services of economic general interest is flexible and adaptable, evolving in line with the characteristics of the relevant sector and technological change. However, this study examines the state aids policy and the SGEI concept only in the transport sector.

5.2. The Interaction of SGEI and the State Aids Policy I: The Problems in the Transport Sector

5.2.1. The Specific Nature of Transport Sector

State aid in the form of public service compensation may prove essential for undertakings entrusted with the operation of SGEIs to operate on the foundation of principles and under conditions which enable them to fulfil their task. Such aid could be compatible with the Treaty under Article 86(2) under certain conditions. Among the types of aid in the type of public service compensation which can be compatible, a distinction should be drawn between, on the one hand, those which, being substantial, might significantly distort competition and, on the other, those that are smaller in amount. In the case of the latter, the risks of competition being distorted are limited where Member States comply with the conditions of compatibility laid down beforehand. With such services, it is also essential to guarantee effective application of the rules on State aid while streamlining administrative procedures. (Commission of the European Communities, The Commission Decision, 2000, p. 3).

For example hospitals and social housing undertakings entrusted with tasks involving SGEIs have specific characteristics that need to be taken into consideration. Particular account should be taken of the fact that their turnover and level of compensation may be very high without there being any particularly large risks of competition being distorted. Accordingly, hospitals and social housing undertakings that carry out activities involving services of general economic interest should benefit from the exemption from notification. (Commission of the European Communities, The Commission Decision, p. 4)

The benchmark case in the SGEIs is the obligation to provide a given service, such as transport, throughout the territory of a country at affordable tariffs and on similar quality conditions, irrespective of the profitability of individual operations. The basic motivation behind creating such an obligation is the opinion that the service in question have properties that make it necessary or desirable to be used in general. This is a merit good argument. However merit good agreements might be sufficient for social services of interest only. For SGEI, that are already provided by the free enterprise, government interventions in the form of regulation and State aids require further justification. Market failures can serve as that source since SGEIs cannot internalize either the positive externalities created by them.

Transport is such a sector; because under certain circumstances it is profitable and at other times it is not. Moreover transport is a network industry. In other words there are significant network externalities in transport. Other such industries include telecommunications, postal services, energy and sometimes water and public broadcasting. All of these sectors are subject to SGEI and therefore they are regulated both at the European and the national levels.

It is sufficient to focus on the European level since the principle of supremacy of Community law ensures that national and lower levels of governance of the Member States in the field of transport are in conformity with the European rules. However it should be noted that the EU is far away from having a common transport policy as envisaged by the Treaty.

5.2.2. Transport State Aids Legislation

The importance and the specific nature of the transport sector have been explicitly acknowledged in the Rome Treaty. Article 73 of the Treaty states that “Aids shall be compatible with this Treaty if they meet the needs of coordination of transport or if they represent reimbursement for the discharge of certain obligations inherent in the concept of a public service.” Since Article 87 states that the provisions on State aids in general are valid “Save as otherwise provided in this Treaty” Article 73 provides an exception.

A body of secondary legislation has been built on this Article. Indeed transport forms an important part of the so-called sectoral State aid policy. The first one is Council Regulation (EEC) No 1191/69 of 26 June 1969 on action by Member States concerning the obligations inherent in the concept of a public service in transport by rail, road and inland waterway. Article 2 in this Regulation provides a definition of public service obligation as “obligations which the transport undertaking in question, if it were considering its own commercial interest, would not assume or would not assume to the same extent or under the same conditions”. Therefore the regulation provides a rule for the design of public sector obligations. All obligations not in conformity with the Regulation should be terminated while the Member States can still give State aid for ensuring adequate transport services, especially taking into account social and environmental issues.

Moreover the Regulation also provides an exception for urban, sub-urban and regional passenger transport services. These can be excluded from the scope of the Regulation even completely if the relevant Member State wishes so.

Also transport sector undertakings that face financial distress because of such public sector obligations can ask the competent authorities of Member States to terminate these obligations.

Council Regulation (EEC) No 1192/69 of 26 June 1969 on common rules for the normalization of the accounts of railway undertakings applies these rules to the specific field of railway transport. Normalization of accounts is defined by this Regulation as the

“determination of the financial burdens borne or benefits enjoyed by railway undertakings, by reason of any provision laid down by law, regulation or administrative action, by comparison with their position if they operated under the same conditions as other transport undertakings” and “payment of compensation in respect of the burdens or benefits disclosed by determination”. The Regulation thus aims to create fair competition for train operating companies.

Council Regulation (EEC) No 1107/70 of 4 June 1970 on the granting of aid for transport by rail, road and inland waterway is another important piece of secondary legislation. This Regulation explains when government measures fall within the scope of coordination and are thus exempt from the State aid provisions. Four conditions are laid down: compensation to railway undertakings for extra financial burdens, infrastructure costs, research and development and elimination of excess capacity causing serious structural problems.

Other secondary legislation, namely Council Regulation (EEC) No 1101/89 of 27 April 1989 on structural improvements in inland waterway transport, Council Directive 91/440/EEC of 29 July 1991 on the development of the Community's railways, Council Regulation (EC) No 718/1999 of 29 March 1999 on a Community-fleet capacity policy to promote inland waterway transport and Commission Regulation (EC) No 13/2004 of 8 December 2003 determining the composition of the list of waterways of a maritime character provided for in Article 3(d) of Council Regulation (EEC) No 1108/70 and also soft law documents, Application of Articles 92 and 93 of the EC Treaty and Article 61 of the EEA agreement to State aids in the aviation sector and Commission communication C(2004) 43 — Community guidelines on State aid to maritime transport also lay down rules on the application of State aid rules in the field of transport. However these are either only related to the details or apply the rules of previous regulations to new sectors within the transport services. The previous regulations on the other hand define important concepts and state the basic rules.

5.2.3. Transport State Aid Case Studies

As it can be understood from the secondary legislation transport services are not uniform. We take a look at the sector first from the vertical perspective, i.e. by focusing to a certain mode of transport and then from a regional perspective.

One of the leading sectors where state aids led to serious disputes among the existing companies with the claim of distorting competition is the airlines industry. Regarding the government aids to (regional) airports there are many ambiguities, which cause confusion and unfair competition between various airlines. This is particularly important as a number of test cases have been brought to the attention of the European Commission in which it has been claimed that State aid in one form or another to a particular airport has in fact resulted in unfair competition or an unwarranted level of subsidisation (European Commission, 2002, p.6).

The examples below will give clues on the extent of the problems encountered and the vulnerability of the European Commission regarding its choice between Europeanization and regional development. In the first case there were serious claims that illegal subsidies were paid to Ryanair by Belgium's Charleroi airport when the European Commission decided to postpone its ruling on its investigation into it and the chairman of the AEA (Association of European Airlines) in its annual assembly in November 2003 stated that "financial support by governments distorts competition, and unfairly penalises those airlines who work hard to be competitive through their own efforts," and that "the EU should apply their existing rules on state aids without fear or favour. No-one should receive special treatment no matter how loud they shout" (AEA, 2003). The EU attitude was also openly criticised by ACI (Airport Council International) director since "the Commission failed to guarantee the subsequent guidelines that are essential to serve as a transparent framework for all future government-funded incentives to attract low-fares airlines". This was due to the ambiguities in the conditions set forth for the state aid to the sector regarding the key areas of transparency, duration and exclusivity and this led to the suffering of the consumers. So the inappropriate application of the state aid creates a legal uncertainty and the suffering of the consumers (ACI, 2004).

The second case is a more serious issue for the major airlines in EU. In 1993 summer several airlines, including British Airways, complained seriously on the granting of FFr 20bn in state aid to Air France claiming that the aid granted by the French government exceeded total world-wide industry losses in 1993 and that it would seriously undermine competition in airlines in EU. It was also claimed that the Commissioners, being politicians and viewing themselves as national representatives, tended to side with the home government and that it violated certain articles on state aids. As article 92 prohibits any state aid which "distorts or threatens to distort competition by favouring certain undertakings" it was claimed that the Commission was not properly applying the Treaty since Air France operated too diverse a network, in undistorted markets carriers in distress like Air France reduced capacity, and that excessive service levels harmed the competitor companies. So the airlines as in this case have posed a challenge to the Court where it should require the Commission to improve decision-making on state aid by following the practice in its other areas of competition policy - by requiring factual evidence to support its reasoning (Lexecon Ltd, 1994, pp.1-3).

The infamous Altmark case, which is examined in detail in the next section, is about regional transport, a public transport bus service in the rural district of Stendal in Germany. In 1994, the district council gave the Altmark Company transport franchises with subsidies designed to offset the costs related to its public service mission. A competing firm (NVGA) appealed before the German courts, claiming that the subsidies paid to Altmark conflicted with Community rules on State aids. The Supreme Administrative Court in Germany called upon the European Court of Justice of the European Communities to rule on the nature of these subsidies (Avanzata, 2003, p. 2) The ECJ decided that "a state measure does not constitute aid ... to the extent that the measure may be considered as compensation for services that are provided by undertakings in order to discharge their public service obligations". As the Altmark case indicates the rules are not always sensible, nor they are consistent when applied to state enterprises, and that political considerations affect the decision outcome. Hence, decision by the European Commission for such dossiers will mainly depend on the political colour of its majority and on the position of the deputies from the new Member States since they will be in need of such aids more in order to reach a compatible level of regional economy to the older Member states.

5.3. The Interaction of SGEI and the State Aids Policy II: Major Case Law of the Court of Justice

After reviewing the application of State aid rules in the transport sector with respect to SGEIs we shall now take a look at the important case law of the Court of Justice that shed light on the issue.

5.3.1. Altmark Case

The infamous recent Altmark Case turned out to become the best example for the conflict between ‘economic and legal methodology’ covered below. The Altmark case concerns a public transport bus service in the region of Stendal in Germany. The Altmark Company received transport rights and financial assistance from the local council in 1994 for operating in the public interest. In the German courts a rival firm NVGA insisted the use of State aid as awarded to Altmark was both against the Treaty provisions and the Community interests. The German courts send the case to the European Court of Justice to investigate and make a decision on the Altmark case. (Avanzata, Thomas - The Altmark Case – Public Transport International, 2003)

Public bidding for the ‘SGEI’ had to be in keeping with Common market objectives and not resemble State aid. The Altmark Case’s resolution in the ECJ was waited before ongoing work into Public Service Obligations (PSOs) was able to continue. The Altmark case pointed out inconsistencies in the State aids law and conflicting opinions. (Boyd, Alan & Joanne Teal, 2004, p 3)

In its judgment in the case of Altmark Trans Case, the Court of Justice of the European Communities announced that public service compensation does not constitute State aid within the meaning of Article 87 of the EC Treaty provided that four criteria are met: (Commission of the European Communities, The Commission Decision, 2004, p2)

First, the recipient undertaking must actually have public service obligations to discharge, and the obligations must be clearly defined.

Second, the parameters on the basis of which the compensation is calculated must be established in advance in an objective and transparent manner, to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings. Payment by a Member State of compensation for the loss incurred by an undertaking without the parameters of such compensation having been established beforehand, where it turns out after the event that the operation of certain services in connection with the discharge of public service obligations was not economically viable, therefore constitutes a financial measure which falls within the concept of State aid within the meaning of Article 87(1) of the Treaty.

Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of public service obligations, taking into account the relevant receipts and a reasonable profit.

Fourth, where the undertaking which is to discharge public service obligations, in a specific case, is not chosen pursuant to a public procurement procedure which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

Where these four criteria are met, public service compensation does not constitute State aid, and Articles 87 and 88 of the Treaty do not apply. If the Member States do not respect these criteria and if the general criteria for the applicability of Article 87(1) of the Treaty are met, public service compensation constitutes State aid that is subject to Articles 73, 86, 87 and 88 of the Treaty. (Commission of the European Communities, The Commission Decision, p. 2, 2004)

The judgment in the Altmark case builds on another case, that of Chronopost where it was ruled in another SGEI sector, postal services, that a market for offering the services of a

universal service network did not exist in reality. Therefore the Court argued there was no hypothetical price that would serve as a guide in order to compensate for PSO (Bartosch, 2003). This of course is a judgment that does not take into consideration economic theory at all.

The European Court of Justice built on this previous ruling by deciding that compensation for activities that carry out a SGEI is not State aid, in its ruling in the Altmark case, provided several conditions are satisfied. As a result, subsidies compensating for SGEI will be viewed either as ‘no aid’ or compatible aid. The distinction is based on legal measure and has limited economic basis so that similar measures are now categorized as aid, or non-aid according to whether a bid was offered (State Aid Scoreboard, Spring update, 2004, p. 8).

Altmark has ‘decentralised’ the law regarding PSOs. Provided that the four conditions identified in the judgment are met, PSO payments can be considered to fall outside Article 87(1), i.e. they do not constitute State aid. If they do not constitute State aid then they do not have to be notified. This affords local/national decision makers some discretion over whether or not notification is necessary rather than forcing central decision taking by the European Commission. Each Altmark condition is considered below. (Boyd and Deal, 2004, p 6)

The first condition: the recipient undertaking must actually have PSOs to discharge, and the obligations must be clearly defined (Boyd and Deal, 2004, p 6). This provision seems like a rephrase of the primary and secondary legislation; but it is more than that. It ensures that the public authorities do not “assume” PSOs and lay down the justification of distortion of competition.

The second condition: The parameters for calculating the compensation must be established beforehand in an objective and transparent manner, to avoid it conferring an economic advantage which may favour the recipient undertaking over competing undertakings (Boyd and Deal, 2004, p 6). Here an economic analysis is observed. If a specific methodology is not designed and declared beforehand PSOs can become a tool of

justifying operating aid, the most notorious type of State aid. Every loss of related undertakings would be accepted as PSOs.

The third condition: The compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of PSOs, taking into account the relevant receipts and a reasonable profit for discharging those obligations. (Boyd and Deal, 2004, p. 6). This condition, like the previous ones, is designed to unveil State aids that disguise themselves as compensation. It ensures that the aid is actually given to compensate for the loss and thus correct the market failure. If it exceeds that limit the subsidy becomes harmful for the society. However by taking into consideration the element of profit it is also ensured that the undertaking is not put under a condition of unfair competition. Therefore a double-edged provision that both protect the competition and the competitor is laid down.

The fourth condition: where the undertaking which is to discharge PSOs is not chosen pursuant to a public procurement procedure which would allow for the selection of the tenderer capable of providing those services at the least cost to the community, the level of compensation needed must be determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations (Boyd and Deal, 2004, p. 6). By this condition the Court acknowledges that the best method for giving a PSO is a tender; but since public procurement legislation enables the Member States to use other methods in certain cases of smaller value or urgency sometimes this procedure might not be used. The Court ensures by this condition that the lack of a tender does not cause a justification for subsidization beyond PSO. The rule is so heavy that the public authorities are likely to choose to tender even when they do not have to do so.

The Altmark case illustrates the Commission's failure in the application of the State aids policy. The secondary law in the field is developed by the European Commission. As discussed before, several exemptions of State aids were raised by secondary law after the 1970s.

State aids policy as its nature is an economic policy. However, the State aids policy is governed legally by the European Court of Justice. It is wrong to decide on the cases according to tender without using specific and clear criteria. By this, it is meant that the secondary law is not clear and member states have a wide margin to decide on SGEI cases. Primary law is clear and there are no complex issues in the primary law. As a result of the secondary law that took place after the 1970s, the inequalities between Member States increased and this is against the foundation principles of the Community.

As stated above, the State aids policy is not suitable for a balanced approach on the part of the Commission. This can also be criticized procedurally. The State aids policy is designed as a policy of administrative law. Therefore it has little space for the kind of economic methodology and evaluations required to make cost-benefit analysis on each case. This situation creates a procedural conflict and prevents the Commission from pursuing the kind of policy it desires.

The ‘Services of General Economic Interest’ term is quite complex and there have been inconsistencies between many cases. What constitutes as a SGEI should be made clear and standardization is required for all parties to be treated equally. Altmark case has shown us that the strategically important sectors are important for the society but which sectors are strategic for the society is not clear. Sectors such as energy, communication and transport are important but these sectors should be stated clearly in the official publications so that the SGEI term will be used in such a way that all cases will be consistent and the society will benefit as a whole.

5.3.2. Enirisorse Case

In the *Enirisorse* case, an Italian company challenges a port tax on the grounds that part of the proceeds of the charge went to public undertakings entrusted with dockside loading and unloading of goods at certain ports, despite the fact that it had not made use of the services of these undertakings. One of the arguments put forward is that this constitutes unlawful

State aid, while the Italian authorities argue that the charge was necessary to distribute the costs of the public loading and unloading services provided by the beneficiaries.

5.3.3. Gemo Case

In the *Gemo* case, a French supermarket opposes a meat purchase tax imposed on supermarkets but not on small meat retailers. Revenue from the tax is meant to finance a public service for the collection and disposal of animal carcasses and dangerous slaughterhouse waste, provided free of charge to farmers and slaughterhouses by private carcass disposal undertakings remunerated by the state under contracts awarded after public procurement procedures. The supermarket's argument is that this system constitutes state aid for the farmers and slaughterhouses (and the small meat retailers), which is unlawful since the Commission has not been notified. For that reason it asks the French courts to set aside its obligation to pay the tax. The French authorities claim that the system compensates the disposal operators for their public service obligations and therefore does not constitute state aid.

In all these cases, there is an additional matter – whether article 86(2) may not provide a solution to a finding that the financing system for public service obligations forms unlawful state aid. As mentioned above, article 86(2) contains an escape section for undertakings assigned with a service of general economic interest not to be subject to the Treaty rules where this would block the performance of their tasks. Nevertheless, it is not clear that article 86(2) could be relied on by national courts as a reason not to set aside aid measures granted in violation of the notification and standstill obligations imposed by article 88(3). In a previous judgment, the Court has in fact already decided that member states could not rely on article 86(2) to avoid the notification and standstill obligations.

5.3.4. Ferring Case

In the *Ferring* case, a pharmaceutical company argued that it should not have to pay a tax levied on direct suppliers to retailers, which had been introduced in France to offset the disadvantage that wholesalers in pharmaceutical products suffered as a result of the public

service obligations imposed on them by the French state. These obligations were not imposed on pharmaceutical companies' direct deliveries to retailers. The pharmaceutical company argued that the scheme constituted state aid in favour of the wholesalers. Since the scheme had not been notified to the Commission, it argued that the French courts should refuse to apply it and hence that it should not be made to pay the tax. The French State argued that the Scheme did not constitute aid since it merely offset the costs supported by the wholesalers as a result of their public service obligation.

5.4. Analyzing and Proposing an Alternative Approach for the State Aids Policy

After examining the application of the State aids policy in the existence of SGEI in the case of the transport sector it is time to analyze the State aids policy by merging and completing the criticisms some of which were already stated above. It should be noted that the case study enabled us to see field where competition concerns meet sectoral and regional needs of a social nature. Therefore it has been a fertile field for analysis.

We can state our analysis of the State aids policy of the EU in three points: (1) It is not in harmony with the aim of the creation of a Single European Market; (2) the current application creates unfair competition between the Member States of the EU; and (3) there is an inherent conflict of law versus economics in the policy.

Taking into consideration the first issue it should be underlined that one of the aims of competition policy is to prevent distortions of competition and trade within the EU by means of State aid. The focus of regional aid and sectoral control is, on the other hand, on the precise description of the assisted area maps and on containing assisted area coverage. Therefore, such regional and national-level state aids create both negative and positive impacts on the creation of a single European market. The link between the fundamental objectives of both policy areas and the activity of area designation has little substance; there is a dislocation between the underlying objectives of policy and the hows and whys of the spatial targeting of policy. This in turn has significant implications for whether the objectives of policy have been in consistent of the EU common market. On the other hand, "within the parameters of the Guidelines, aids that cause potentially serious distortions can

be granted without prior scrutiny by the Commission; similarly, the design of innocuous measures may be compromised quite needlessly” (Wishlade, 2003, p 248).

The cases analysed in the previous section make it quite clear that the State aids policy in the transport industry led to distortions in competition due to ambiguities in the rules, the rules being inconsistently applied, decisions in authorizing or disapproving various cases were influenced by political considerations and problems arising due to differences in the level of economic development between various states and regions. The founders of Treaty of Rome were aware that state aids were like a double-edged knife bearing the seeds of destruction of an economic union and were therefore sensitive to limit the scope for Member States to distort competition by granting state aids.

EU competition policy can work harmoniously only if winners are allowed to win and losers obliged to lose. If unproductive companies – whatever the reasons are - can convince the governments to set up barriers to trade or to provide unlimited subsidies then competition and economic integration will not bring benefits. On the other hand, the European Court of Justice has been reluctant in enforcing the free competition/market integration policy, and therefore is somewhat blind to the dangers of state aids. Subsidy, if not appropriately applied, bring in counter-subsidy and if not stopped, will one day endanger the whole single market structure.

While the competition policy aims to develop the single European market the regional policy aims to reduce disparities between the levels of development of the various regions and the backwardness of the least-favoured regions. So the problem of reconciling the State aids with the competition policy of EU leads to two distinct tendencies. On the one hand, State aids is encouraged to enhance competition and create a Euro-wide competitive basis, on the other hand it leads to unfair competition. In this matter, the Director-General of DG Competition has even acknowledged that: “there is the impression that we are simply applying rules which aim to curtail state aid as such rather than concentrating on controlling aid which really distorts the European single market” (Lowe, 2003, p. 5). This seems to be due to the differences in national policies on regional aid and the differences in

the complexity and variability of policy evolution (bottom-up) and implementation (top-down), which create significant challenges for policy formulation.

The second weakness of the new state aids policy is the following; Even though the approved aid schemes also serve the purposes of European Integration such as regional development, they do this on a national basis therefore; these aims create unfairness between different member states in addressing common objectives. This is certainly against the principle of solidarity between member states and the Community method.

In anti-trust, another branch of competition policy, block exemptions can serve the social welfare even though they restrict the competition in the relevant market. However in the case of State aids policy, a national subsidy is almost always harmful. Because even if the distortive cost of the national subsidy is less than the expected benefit, the fact that the subsidy is national, creates an injustice between different Member States. For example, only one of the two or more Member States that face the same environmental problem might give an environmental State aid to its enterprises, therefore harming the competition between them and the foreign ones.

The following statement by Bishop points out to another danger of State aids. Bishop states that the “Community’s goals of economic and social cohesion between national economies and living standards would be greatly undermined if the richer nations of the Community were able to use their greater wealth to give their companies unfair advantage”(Bishop, 1997, p 84). This means that more wealthy EU Member States like Germany, France and Belgium firms will have an advantage over poorer EU Member States’ firms like Greece and Portugal. Bishop also justifies our critique and he expresses that the inequalities of Member States would cause the poorer States to suffer.

Moreover, the national state aids have two more defects which rationalize our argument. The first one is the fact that these aids might lead to subsidy wars between the member states. Another problem is that the national decisions regarding aid schemes are more open to the influence of local and national interest groups. This is likely to lead to politicisation of the subsidisation schemes leading to government failure in the context of the

international economic integration such as the European Union (EU). This means that funds are allocated sub-optimally at the European level. This politicisation even leads to interference in the independent administration of the state aids policy by the institutions in certain politically important cases such as the Alstom and the Volkswagen events.

Bishop demonstrates this by stating;

“The Treaty of Rome pits the Commission directly against governments. However, the Commission’s own practice does little to limit the degree to which politics affects decisions. While the current process remains, the chances of diminishing the role of politics in decisions of state aids remain slim.” (Bishop, 1997, p 84)

Below, as Bishop argues, the danger of the Commissioners viewing themselves as the national representatives of member States, distorts the Common market objective and this is an obstacle towards the aim of deeper economic integration. Political intervention is a sensitive area in which strict monitoring is essential for the benefit of the EU as a whole.

The Court’s role in ensuring that the Commissioners have to act as Eurocrats but not as national representatives is crucial if the Court wants to maintain its impartiality. The EU can never achieve the aim of being a single State with full economic integration if the problem of the high degree of political intervention continues.

As Bishop puts it:

“The Court, notoriously, has a long history of allowing the Commission to wave through state aids. The results have been entirely predictable: most Commissioners, being career politicians and viewing themselves as national representatives, tend to side with the home government. In state aids matters, the Commissioners can be expected to prostitute themselves to political interests unless and until the court requires otherwise.” (Bishop, 1995, p 331)

It is interesting to note that the Court of Justice has in fact limited the ability of Member States to give harmful State aids by exempting those subsidies that fulfil the four conditions laid down in its Altmark judgment from the obligation of notification to the European Commission; because in order to fulfil those four conditions Member States have to ensure that the State aid does not exceed the amount needed to compensate for the externality. Otherwise it should be notified to the Commission. Such notification would clearly point to the fact that the State aid does not fall within the scope of SGEIs and therefore it should be banned if there is no other justification. This is, what is called an unintended consequence at work.

There is of course a wide margin of uncertainty in the Altmark judgment of the Court and therefore the Commission has felt the necessity to prepare guidelines explaining which small scale public services do not constitute State aid accordingly. The legislation in question has not entered into force yet.

However whether or not the Commission is able to prepare rules that clarify the Altmark judgment our third criticism to the State aids policy would remain intact: There is an inherent conflict of law versus economics in the policy. The Commission pursues policies based on economic rationality whereas the courts decide on the basis of legal background. The secondary legislation which took place after the 1970s allowed several exemptions for state aids. Therefore the main goal of banning State aids set by the Rome Treaty was changed. The courts decided on the legal basis based on the days of 1950s whereas the Commission pursued policies including the secondary legislation and the changing economic conditions. As a result of this situation, a divergence occurred between the policies pursued by the European Commission and the decisions taken by the European Court of Justice.

Taking into consideration these three criticisms one can propose an alternative approach to the State aids policy. This approach can best be described as orthodox; because the proposal rests on the position that the State aids policy should not only return to its original form, but be even more restrictive.

As it is explained the State aids policy is not suitable for striking a balance between the costs and benefits of subsidies from the perspective of Single European Market. It is a negative policy that had been designed for the protection of competition only. The wider interpretations of the exemptions and exceptions provided in the second and third paragraphs of Article 87 as a result of the economic and policy-related developments in the EU and the resulting utilization of economic techniques did not fit into the original design. The policy became too permissive on the one hand and unable to control subsidies in the field of SGEI on the other. Since this situation creates distortion and unfair competition time should be reversed back to 1960s, that is before the economic problems and the policy developments of 1970s took place, and the policy should become simple again. Most of the secondary legislation and numerous soft law documents can be annulled and replaced by simpler texts laying down general principles and general *de minimis* thresholds.

However what is more important that whether or not the latent policy objectives of the EU are taken into consideration the current application of the State aids policy creates unfairness between the Member States; because most types of externalities are observed in all Member States and they have reciprocal impacts. Only exceptional circumstances such as natural disasters, prolonged periods of strikes, terrorism etc. cause economic problems unique to certain Member States.

Therefore the Member States should follow a method they have already used extensively in policy areas such as the Common Agricultural Policy and regional policy: utilization of EU funds. In other words the central budget of the EU should be increased and special funds should be created in order to address the externalities and public sector obligations currently corrected or financed by the means of State aids.

The EU budget should be appropriated so that the State aids are governed and distributed not by member States but via Brussels. Public funds ought to be distributed to the companies, who have to bear the cost financially as a result of unfair competition and market failure while considering their economic size. As a result of the distribution of these public aids, the trade between member states will not be distorted and the effect of free competition on social welfare will be minimised. This is because the Strategic Trade

Policy and the political economy considerations do not take place with this new distribution of aids from Community budget.

Concerning EU Treaty; both Articles 5 and 102(a) state that Member States have to assist Community objectives by carrying out their economic policies. Furthermore, in Article 103a it is stated clearly how Member States should conduct their economic policies in order to achieve their objectives. Besides, Article 130B, states that Member states are encouraged to achieve a co-ordinated social and economic cohesion. (Frazer, 1995, pp 17-18)

These Treaty Articles provide the legal basis for the argument of creating a central budget for State aids in the European Commission by transferring some proportions of the budgets from Member states to the EU budget.

Furthermore, the high degree of political intervention towards national governments will be prevented, by this alternative policy of state aids. Any aid that has been granted for specific interests not compatible with the law should be penalised very heavily so that it will be discouraged.

The European bureaucrats (also known as Eurocrats) in Brussels should work for the interests of the EU as a whole and should not act in their own national interest. While the current policy does not ensure that since Member States can lobby for their own State aids, other Member States might not be willing to challenge them for diplomatic reasons and national biases would be at work under our policy proposal since there will be competition for common funds the Member States would have incentive to ensure their fair distribution and lobbying activities would be offset by others.

It should be noted that when exclusive EU funds exists for a specific area the Member States cannot give additional subsidies. For example under the Common Agricultural Policy when a product or the corresponding agricultural are is financed from the European Agricultural Guidance and Guarantee Fund, additional national subsidies are prohibited by the means of Article 36 of the Treaty which lays down the sectoral provisions.

In this context the Altmark judgment in the field SGEI gains a much larger importance; because the four conditions laid down by the Court of Justice in this case can also serve as guidance for seeking to understand whether or not a subsidy should be given in any case when there are externalities at work. Common financing of these subsidies would then ensure that unfair conditions of competition do not arise between the Member States.

The European Globalisation Adjustment Fund is a recent initiative of the EU in this direction. It was proposed by a Commission report that expressed the benefits of globalisation and also stated that there was a need to help the workers who are adversely affected from this process to find new jobs. The Fund was accepted by the European Council in late 2005 and it was debated between the institutions during 2006 in order to create a necessary legislation. It has become operational as of 2007. Under this Fund Member States can apply to the European Commission in order to receive funding for active labor market policies for the workers who have lost their jobs as a result of globalisation to foreign competitors. Member States would otherwise apply to State aids which would be questionable under Article 87. The European Globalisation Adjustment Fund replaces the State aids by community subsidies. This example clearly demonstrates the benefits and the feasibility of our alternative policy proposal.

How about the remaining State aids? As stated above when there are exceptional circumstances Member States should be able to give State aids on their own. However the basic rules of Article 87 should be observed and the aid should not be greater than the amount needed to correct or compensate the enterprises in question. This can be ensured by means of a simple secondary legislation laying down general principles.

Application of these policy proposals would ensure unarmful subsidisation and higher growth in the EU.

VI. CONCLUSION

The aim of the present study was to analyze the State aids policy by placing it in the context of Single European Market. For this purpose in the second chapter the economics of State aid was studied. That chapter covered a theoretical analysis of government intervention in the markets, actual forms of State aids and detailed information about State aids given by the Member States of the EU. In the third chapter the historical development of the State aids policy was examined. The following chapter presented more detailed information on the branches of the State aids policy and institutional and procedural matters.

While chapters two, three and four laid down the necessary background information the fifth chapter was the one where the study made its analysis based on a case study. The case study was that of SGEI in the transport sector. After explaining the concept of SGEI we studied the problems of transport sector, State aid legislation in the sector, important cases and important judgments as so far as they were necessary to evaluate. The infamous Altmark judgment was given a special importance and the four conditions laid down by the Court of Justice were analyzed.

Based on this case study we stated three criticisms for the State aids policy: (1) It is not in harmony with the aim of the creation of a Single European Market; (2) the current application creates unfair competition between the Member States of the EU; and (3) there is an inherent conflict of law versus economics in the policy.

The alternative proposed has three components: (1) The State aid policy should be simplified to return to its original stage and seek only the protection of competition in the Single European Market. (2) Member States should be able to give subsidies only in exceptional circumstances. (3) Instead of State aids Member States should form new funds for common subsidization.

The proposal further stresses two points: (1) The four conditions laid down in the Altmark judgment in the case of SGEI in the transport sector should be generalized to provide

standards for subsidization of externalities and public service obligations at the European level. (2) For the remaining State aids simple and general rules should be laid down.

The analysis and the resulting proposal provide a comprehensive evaluation of the State aids policy and the need for its reform. Adaptation of these proposals would enable the EU to reach a more competitive and fair Single European Market and therefore higher levels of growth and employment.

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