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Phedon Nicolaidides*

The New Frontier in State Aid Control

An Economic Assessment of Measures that Compensate Enterprises

State aid is in principle prohibited in the European Union, with a few exceptions provided for in the Treaty. Recently, a judgement by the European Court of Justice has weakened that prohibition by narrowing the concept of state aid. Criticism of this judgement so far has been based solely on legal grounds. This paper carries out an economic assessment of the judgement and argues that it is based on faulty economic premises. The author proposes an alternative method for dealing with compensatory measures so as to close the loophole opened up by the judgement.

The rules that control state aid granted by member states make up one of the pillars of the common market of the European Union. These rules, i.e. Article 87(1) of the EC Treaty, declare state aid to be in principle incompatible with the common market. This incompatibility is not absolute. Some exceptions are allowed by Article 87(2) & (3) and Article 86(2).

Member states have been very adept at exploiting the exceptions and loopholes in the rules.¹ From the beginning of the Community, they tried to argue that the concept of state aid covered only direct subsidies and not other means of support such as tax exemptions.² Over the years new arguments have been invented by the member states in an attempt to get more of their aid measures through the "sieve" of the EU. The most important of these attempts have until recently been the injections of capital and other investments undertaken by public authorities and public enterprises for the benefit of other enterprises. Public authorities pretended that their investments had commercial logic. As a result, the European Commission had to devise the "private investor principle" with which to assess whether such capital injections and investments conformed to the behaviour of a private investor acting under normal market conditions.³

More than forty years after the establishment of the EC and its system of state aid control, member states still grant aid that has exceeded € 90 billion on average over the past decade. The latest issue of the State Aid Scoreboard (Spring 2002) estimates that in 2000,

member states granted more than € 80 billion of aid to their agriculture, transport and manufacturing.⁴ And this is the aid the Commission knows about.

The Commission deals with about 550 cases of state aid per year (on the basis of the data from the past 10 years). About a fifth of those cases concern aid schemes that are not notified to the Commission, in breach of Article 88(3) of the EC Treaty, which requires member states to inform the Commission and seek its prior authorisation before any aid is disbursed. The exact amount of illegal state aid granted every year is a matter of guesswork.

Even more worrying than the cases which escape the scrutiny of the Commission are two recent court rulings that appear to have widened the loopholes by categorising certain policy measures as not being state aid. Legal and political developments in the EU have always been challenging to the theory of economic integration. It is now rather trite to observe that European law and politics have raced ahead of economic theory and that this theory has struggled to develop new models to assess legal and political innovations. The purpose of this paper is to use simple economic analysis to assess the latter of the two court rulings and propose a method to close the loophole it has created. Most commentary so far on those rulings has been, naturally, legal. Since state aid distorts com-

¹ I consider an "exception" to be an escape clause defined in primary or secondary legislation, while a "loophole" is a subsequent interpretation that effectively widens the escape clause.

² See the case "Steenkolenmijnen Limburg v High Authority", C-30/59.

³ See Commission Directive 80/723 on the transparency of financial relations with public enterprises, OJ L195, 29/7/80; amended by Directives 85/413, 93/84 & 00/52; see also the Commission Communication, OJ C307, 3/11/93.

⁴ COM(2002) 242 final.

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petition in the internal market, it is also natural to consider the economic side of these legal developments.

The first development is the by now famous “Preussen Elektra” judgement of the European Court of Justice [C-379/98]. Under Community rules, a public measure is a form of state aid only when it has an impact on the resources of the state. That is, the state must either lose resources (e.g. a direct grant) or not gain as much as it could (e.g. through lower tax rates or lower interest rates on public loans to enterprises). In the “Preussen Elektra” case, the German government forced large electricity generators and distributors by law to purchase electricity from renewable sources of energy at fixed prices. In other words, instead of granting public money to the producers of green electricity it forced private enterprises to grant private money.

Environmental benefits notwithstanding, this was a less efficient way of subsidising green electricity because the government introduced two distortions into the economy: one on the production side and one on the consumption side. Nonetheless, legally it was not a form of state aid and, therefore, it was not subject to Community control, i.e. prior notification to the Commission and assessment by the Commission. Although I am not aware of the motives of the German government when it introduced that measure and, therefore, I can only speculate as to its objectives, we see here that avoidance of state aid control has resulted in a measure of inferior economic efficiency.

The repercussions of the “Preussen Elektra” judgement are only now beginning to emerge. For example, in October 2001 the Commission approved a state aid scheme concerning the disposal of car wrecks in the Netherlands on the basis of that judgement.⁵ Perhaps that decision was correct. But the message to the member states is clear. If they want to circumvent Community rules, they should pass legislation forcing the users of a good or service to transfer resources to the producers of that good or service. Public choice literature suggests that this is normally done through consumer protection legislation. The users are many, and therefore less likely to organise effective protest, and the measure can be disguised as a means of protecting those who pay.

The second development is also the result of a case before the European Court of Justice. In the “Ferring” case [C-53/00], the Court found that tax credits granted by France to wholesale distributors of pharmaceuticals to compensate them for public obligations

imposed on them were not state aid. At first sight, this seems very reasonable. If the government forces enterprises to carry out tasks that raise their costs, why should the government not reimburse them for the extra costs they incur in the execution of those tasks? As I explained in more detail in another paper on the economic inefficiencies caused by such measures, the problem is that even if the obligations are defined in law, it is far from obvious that enterprises are “forced” to engage in those activities.⁶ They may have done so irrespective of the requirements of the law. Moreover, when enterprises voluntarily engage in those activities, it is not clear how to measure those “extra” costs.

By contrast, as with the previous ruling, the “lesson” for the member states is crystal clear. As long as the various costs borne by enterprises can be disguised as obligations imposed by the state in the context of some policy of providing services of general interest, then the state will be able to grant aid, say, in the form of tax exemptions and reductions.

One may ask whether that is either a feasible or a likely option. In my view, it is both very feasible and likely. In western economies, there is hardly a company that does not function within a regulatory system. And there is hardly a regulatory system that does not include among its goals the well-being of consumers and the protection of their interests (personal, financial, health, safety, etc.) The weakness of the judgement is not that it allows public authorities to compensate enterprises for extra costs. Its weakness is that it allows public authorities to identify very much whatever they want to subsidise and claim that since it is required by law, then enterprises may be compensated. If the activity in question is not mandated by law, nothing prevents them from making it compulsory.

To understand the magnitude of the problem, consider the following contrived example. A local authority passes a new law that, on the pretext of serving the public, requires all cafes to offer free water to their customers during the summer months. Under the “Ferring” logic, the local authority would be able to compensate them for the cost of that obligation, irrespective of whether the cafes would do it without receiving any state aid because that is the service that customers expect. The “Ferring” judgement does not require that the authority granting the state aid should first establish the necessity of the aid. In the words

⁵ Commission Decision 2002/204, OJ L68/18, 12/3/2002.

⁶ Phedon Nicolaides: The Distortive Effects of Compensatory Aid Measures: The Economics of the “Ferring” Judgement, in: European Competition Law Review, 2002, Vol. 23, No. 6, pp. 313-319.

of Advocate-General Leger, “ ‘Ferring’ effectively removes measures for the financing of public services from the control exercised by the Commission ... If that is the effect of ‘Ferring’, I consider that it will have considerable repercussions for the Commission’s policy on state aid.”⁷ I very much concur with his assessment and I will examine his opinion in more detail in the next section.

This concern is not his, or my, personal quirk. The funding of services of general economic interest has been discussed for some time at the highest political level in the EU. The Presidency Conclusions of December 2000 indicate that the Nice European Council requested the Commission to draw up a report on that issue because, among other things, “... there is a need here especially for clarification of the relationship between methods of funding services of general interest and the application of the rules on state aid.” This issue was taken up again at the Laeken European Council which considered a special report submitted by the Commission.⁸

It is understood that the Commission is studying, in cooperation with the member states, the possibility of adopting a “group exemption” regulation of certain kinds of state aid for the funding of services of general interest. If and until that regulation is adopted, the law on compensatory measures is as it stands after the “Ferring” judgement.

The purpose of this paper is to consider the main critiques of that judgement, examine the remedies they have proposed and outline a more sound economic way of closing this gaping hole in the dyke that protects the European Union from the sea of state aid. I begin by examining the criticism that has been levied against the judgement by legal experts. Afterwards, I will develop an economic method of dealing with the issue of compensation in a way that, first, fits within the overall logic of the system of state aid control and, second, narrows the loophole.

The Main Critiques of the “Ferring” Judgement

Given the fact that the judgement is fairly recent (November 2001), the critique has been rather limited until now and largely legal in nature. However, two reactions deserve particular mention in the context of this paper.

The first is the reaction of Advocate-General Leger in his opinion on the “Altmark Trans” case [C-280/00] which was delivered in March 2002. The Advocate-General puts forth three criticisms. First, he argues, “Ferring” confuses two distinct issues: whether a

measure can be classified as aid and, if yes, whether it can be exempted. In his view, these are two distinct legal questions concerning, on the one hand, whether a measure falls within Article 87(1) and, on the other hand, whether such a measure can benefit from the exemption in Article 86(2) on the provision of services of general economic interest. If a measure confers a financial advantage to selected enterprises it should be classified as state aid, irrespective of the intentions or motives of the granting authorities and irrespective of whether it may be exempted later on because it satisfies the conditions of Article 87(2) & (3) or Article 86(2).

Second, he believes that the approach adopted in “Ferring”, where compensatory measures are not regarded as state aid, deprives Article 86(2) of its role in the Treaty. This role is to define certain conditions under which otherwise anti-competitive actions that infringe the anti-trust prohibitions in Articles 81 & 82 and state aid measures that fall within the general prohibition of Article 87(1) may be exempted on the grounds that they are indispensable to the provision of services of general economic interest. In fact “Ferring” attenuates Article 86(2) because Article 86(2) defines six conditions which must all hold, while “Ferring” defines only two: that aid has a compensatory nature and that it does not exceed the extra costs of the obligations imposed on enterprises.

Third, he thinks that the principle expounded by “Ferring” undermines the Community system of state aid control because by declaring measures for the funding of services of general interest to be non-aid, it essentially prevents the Commission from assessing them.

Having shown the weaknesses of the “Ferring” judgement, Advocate-General Leger then asks how the funding of public obligations and of services of general economic interest is to be treated under the Community system of state aid control. He proposes that all measures which confer financial advantages to selected enterprises are regarded as state aid, irrespective of their purpose or the intentions of the granting authority. Compensatory measures may then be considered for exemption under Article 86(2).

I very much agree with his first two criticisms. Since they are legal in nature they fall outside the scope of this paper and I will not consider them further. The

⁷ Advocate-General’s Opinion on Case C-280/00, “Altmark Trans”, paragraphs 93-94, delivered on 19 March 2002.

⁸ See the two main Commission Communications on services of general interest, 1996/C 282/3 and 2001/C 17/4 and the report submitted to the Laeken European Council, COM(2001) 598 final.

third argument is a bit puzzling. There are many public measures which are not assessed by the Commission for the simple reason that they are not state aid. For example, regulatory measures, not involving transfers of state resources, are not state aid and, therefore, are not subject to scrutiny by the Commission, even if they skew competition in favour of certain firms. By contrast, assessment by the Commission does not always mean that approved measures are the least costly or distortionary ones. It is a well-established point in the case law on Article 86(2), for example, that funding to compensate the providers of services of general interest may be authorised under Community law irrespective of their internal efficiency. What “Ferring” has done is to widen the category of measures that fall outside the scope of Article 87(1). It has not diluted the control of the Commission over the remaining ones.

What are we to make of his proposed solution? It is a rather conservative solution that seeks to establish the policy orthodoxy that prevailed before “Ferring”.⁹ If the choice is between the new and the old state of affairs, then the old one is much preferable. However, it is unnecessarily restrictive. The solution that is presented below is both more accommodating and economically more rational. This kind of solution should be preferred because it imposes a lower demand on the Community’s system (i.e. the Commission’s resources) without distorting competition in the internal market.

Another important critique of “Ferring” so far has appeared in the opinion of another Advocate-General, Advocate-General Jacobs. This is indeed important because he proposes a novel method for classifying compensatory measures that is more accommodating without, however, allowing all of them to escape from Article 87(1). I first examine his proposal and then I explain why in economic terms it is defective. The solution I outline following that does not suffer from the same economic defects while it is consistent with the logic of state aid control as a means of preventing distortions to the economy.

Advocate-General Jacobs in his opinion delivered in April 2002 concerning the “GEMO” case begins his analysis by making a distinction.¹⁰ His examination of the landmark cases leads him to the conclusion that the Community Courts have over the years followed two approaches in dealing with state aid. The first ap-

proach (the “state aid” approach in his terminology) regards all measures that involve transfers of state resources and satisfy the other conditions in Article 87(1) as being state aid, irrespective of whether they are intended to fund measures of general economic interest. Under this approach, this kind of state aid is then exempted only if it satisfies the conditions in Article 86(2) (i.e. Advocate-General Leger’s preferred solution). The second approach (the “compensatory” approach in his terminology) regards the funding of services of general interest to be state aid only if the economic advantage it grants exceeds the remuneration of the additional costs of providing such services. He then notes that even though the two approaches grapple with the same issue, they are not equivalent. At minimum, they have different procedural implications. More importantly, the Advocate-General goes on to identify weaknesses in both approaches.

The main problem with a generalised application of the “state aid” approach is that it is too wide and as a consequence catches more measures than it should. The concept of state aid applies only to measures that grant a financial advantage. There is no reason why it should cover measures that do not confer any advantage and which only intend to compensate for the disadvantage they impose. Moreover, public authorities are also market players. They purchase and sell goods and services. These transactions do not involve state aid, provided that enterprises derive no advantage that they would not obtain under normal market conditions. Again there is no reason for the concept of state aid to be so wide as to prevent public authorities from purchasing services which are then provided to the general public.

The problem with a generalised application of the “compensation” approach is that it short-circuits the structure of state aid control devised by the Treaty. Article 87(1) defines the criteria for identifying state aid. Article 86(2) defines the criteria for exempting state aid for funding of services of general economic interest. Not only does the compensation approach convolute the two procedures, it also, as noted earlier, deprives Article 86(2) of any meaning as far as state aid is concerned. A measure that just reimburses extra costs, or does not even fully reimburse them, is not state aid so it cannot be examined under Article 86(2). If it more than reimburses extra costs then it cannot be exempted under Article 86(2) because it fails on the principle of proportionality.

Since the Advocate-General shows that these two approaches do not offer satisfactory solutions on how to deal with the problem of the reimbursement

⁹ It follows the line of reasoning developed by the Court of First Instance in the case of “SIC v. Commission, T-46/97”, concerning the financing of the Portuguese public television channels.

¹⁰ Advocate-General’s Opinion on Case C-126/01, “GEMO”, delivered on 30 April 2002.

of public service obligations imposed by the state on enterprises, he proposes an alternative and very interesting solution. He, again, makes a distinction “which is based (i) on the nature of the link between the financing granted and the general duties imposed and (ii) on how clearly those duties are defined.” (paragraph 118).

On the basis of this distinction he then suggests that compensatory measures can be classified into two categories. The first category would comprise cases where “the financing measures are clearly intended as a quid pro quo for clearly defined general interest obligations or where the link between the financing granted and clearly defined general interest obligations imposed is direct and manifest.” The second category would “consist of cases where it is not clear from the outset that the state funding is intended as a quid pro quo for clearly defined general interest obligations.” The important implication of this distinction is that measures falling into the first category are not state aid, while measures falling into the second category are to be considered as state aid. The latter measures would in general be incompatible with the common market unless they are subsequently found to fulfil the conditions in the exceptions defined by Articles 87(2) & (3) and 86(2).

This proposal is undoubtedly an improvement over both the situation caused by “Ferring” (too broad) and the situation that existed before “Ferring” (too narrow). Yet it suffers from the same two crucial defects as “Ferring”.

First, the fact that public authorities may impose obligations does not necessarily mean that state aid is needed to compensate enterprises for any extra costs. Market players may voluntarily provide such services without any need for state intervention. Consider my example above of the cafes being obliged by law to offer water to their clients.

Second, nothing prevents governments from adjusting the legal definitions of vague public service obligations so as to establish a clear link with the costs they want to subsidise. The Advocate-General’s proposal looks to past cases. He should look to the future and ask how public authorities are likely to react to such a redefinition of what constitutes state aid. Will they be able to escape the net cast by the new definition? I think they will be able to do that with ease.

Having reviewed the main critiques of the “Ferring” judgement and the proposed remedies for repairing the damage to state aid control caused by that judge-

ment, I now turn to an alternative and more economically sound solution.

State-imposed Obligations and the Necessity of State Aid

The EU’s system of state aid control is predicated on two fundamental tenets: that state aid distorts competition and must, therefore, be regulated and that the market does not function perfectly and some state aid may, therefore, be necessary. It follows that where state aid is allowed, not only must it be in the collective Community interest, but it must also be necessary to induce enterprises to do things they would not otherwise do on their own.¹¹

The “Ferring” judgement contradicts those fundamental tenets because it does not seek to establish whether aid is necessary or not. Compensating enterprises for certain obligations begs the question as to why there is no compensation for the many other obligations imposed on them. I conclude that the answer must be that in certain cases public obligations make the activities in question so uneconomical that the affected enterprises reduce the size of those activities or stop them altogether.¹² This may be an unacceptable outcome from the perspective of the public policy that seeks to get businesses to offer certain services to consumers.

Hence, the starting-point of any meaningful analysis must be that enterprises can escape those obligations and that without aid, the services concerned would be reduced to a socially unacceptable level. It follows, perhaps trivially, that the purpose of the aid is to stimulate supply, not just to compensate enterprises. This is indeed what appears to have been the motive of the French authorities in the “Ferring” case. They seem to have wanted to bring about an increase in the wholesale supply of pharmaceuticals. But as I explain elsewhere, there were other inefficiencies in the French system of compensation through tax relief.¹³

I want to pause at this point and highlight an issue that seems to have been neglected in other assessments of the “Ferring” judgement. By and large they have focused on the aspect of compensation. But the crux of the issue is not compensation as such. Gov-

¹¹ See the reasoning in the landmark case “Philip Morris v. Commission”, C-730/79.

¹² Of course, other possible answers may be that public authorities are not concerned about the reduction in the supply of those services or that they cannot afford to grant aid. However, none of these answers is useful for our purposes.

¹³ See Phedon Nicolaidis, *op. cit.*

ernments impose many obligations on enterprises. They do not compensate them for any extra costs because they believe it is the responsibility of business to deliver goods and services of a certain minimum quality and safety. Also, they do not compensate them because there is no adverse effect on supply.

For example, airlines are required to use quieter aircraft and investment funds have to explain to their potential customers the risks of investment. Although compliance with such regulations is costly, the costs are absorbed by the companies or passed on to users or both. If airlines stopped flying or investment funds stopped making investments, then the situation would be very different. Then the relevant regulators would be trying hard to determine the right balance between noise and travel and between prudence and investing. Or, they would be thinking of how to offer compensation so as to defray part or all of the costs imposed by their regulations. The important point, therefore, is the impact of the legally mandated obligations on the supply of the relevant services. It follows that compensation is a legitimate option when it can be shown that the obligations cause a reduction in supply.¹⁴

If public authorities could know what companies would do without aid and if they could measure their costs, then it would be relatively easy to calculate the minimum necessary amount of aid that would lead to the desired increase in supply. Unfortunately public authorities do not have that kind of knowledge. Under conditions of imperfect or incomplete information, the only feasible way for public authorities to grant aid without over-compensating is to auction the obligation to provide the relevant services. This statement may seem at first glance surprising. How can you auction an "obligation"? Since the obligation is something that generates extra costs, if there is no corresponding revenue, then no firm would be willing to offer the service in question. Therefore, the purpose of the auction is to identify the firm or firms which would be willing to offer that service with the lowest possible subsidy. These are the firms that have lower operating costs in comparison to their competitors. This means that competition among bidders would bring the required subsidy to the lowest possible level. If some firms would have voluntarily offered the service in a free market without any subsidy because the revenue they earn would exceed any extra costs, then bidding would bring the amount of the required subsidy close to zero. That is how public authorities get to discover whether a subsidy is needed or not.

As is well known, however, auctions provide no panacea.¹⁵ They are good instruments of economic

policy but they are not problem-free. Indeed, there are at least two problems here. First, the correction of one distortion (the under-supply of the desired services) creates another distortion (the subsidy to the successful bidder). If the most efficient firm knows the costs of the second most efficient competitor, the former will bid just below the cost level of the latter and will make extra profits.

Second, the successful bidder in the initial auction may over time develop a better understanding of the market or develop synergies between the supply of the public services and other commercial activities. When the time comes for a second auction, it may outbid other contenders (by requesting a lower subsidy) not because its costs are lower but because of the usefulness of those synergies somewhere else or because potential competitors do not know the market as well. As a result, it can charge a higher price than otherwise and reap extra profits which are not eliminated by the bidding process. Nonetheless, on the whole, properly designed auctions are as close as we can get to avoiding over-compensation.

Now, this approach has two important advantages in relation to the other approaches. First, it does not favour any firm before the auction takes place. Second, it keeps the subsidy to a minimum by introducing competition in the supply of services. If the subsidies are limited geographically, then this approach may have a third advantage. It may be possible for the authorities to compare costs and bids and adjust the conditions of the auction accordingly when the next round comes.

Measures that offer compensation of extra costs through an auctioning procedure would not be state aid. They would fall outside the scope of Article 87(1) not only because they do not, in general, confer an advantage before the rights are granted, but also because they confer no advantage after the rights are granted. They merely remove the cost disadvantage imposed by the public obligation. It is as if public authorities have created a market to obtain the services in question. The price they pay is the subsidy they grant. These measures comprise a much narrower category of measures than those that escape from Article 87(1) either under "Ferring" or under the proposals reviewed above.

¹⁴ For a mathematical exposition of this problem see the analysis in the box.

¹⁵ See P. Klemperer: *Auction Theory: A Guide to the Literature*, in: *Journal of Economic Surveys*, 1999, Vol.13, No. 3, and the references therein.

Compensation for Extra Costs

The problem of compensation, or rather over-compensation, can be shown more easily with the use of some simple mathematics. An unregulated and perfectly competitive market is at equilibrium when demand, given by $P = f(Q)$, equals supply, given by the sum of the supply lines of all the firms $P = \sum g(Q_i)$, where Q_i is the output of firm "i". I assume here and subsequently that all firms are price takers. As is well-known, the market supply is made up of the individual marginal cost curve of each firm, and the price that clears the market, P^* , is equal to the marginal cost of each of the firms in the market, $P^* = MC_i^* = (\partial C_i / \partial Q_i)$.

Suppose now that a public obligation requirement is imposed on these firms. We can think of this obligation as a regulation that makes it more costly for firms to produce. There are two possibilities here. The first possibility is that the obligation or regulation applies to the whole range of output (a "quality" regulation). The second possibility is that it applies to additional amounts of output (a "quantity" regulation).

With respect to the first possibility, if the cost function of each firm is $g(C_i)$, the obligation can be modelled as $g(C_i(R_i))$, both components of which are functions of Q_i and where $(\partial C_i / \partial R_i) > 0$ and $(\partial R_i / \partial Q_i) > 0$. At the new equilibrium, the market-clearing price, P^{**} , is equal to the new marginal cost, MC_i^{**} , which is given by $((\partial C_i / \partial Q_i) + (\partial C_i / \partial R_i)(\partial R_i / \partial Q_i))$. Since the last two components are positive, it follows that $MC_i^{**} > MC_i^*$. The new equilibrium price will also be higher as $P^{**} > P^*$. Given that there is an inverse relationship between price and quantity demanded, it follows that $Q^{**} < Q^*$.

With respect to the second possibility, the cost function is amended to $g(C_i + C_i(R_i)_{Q_i > n})$. That is, the added costs are experienced after a certain level of output denoted by "n". Above that level, marginal cost is $MC_i^{**} = ((\partial C_i / \partial Q_i) + (\partial C_i / \partial R_i)(\partial R_i / \partial Q_i))$. So again we get the same expression as with the first possibility and the same results, namely $P^{**} > P^*$ and $Q^{**} < Q^*$.

And this is precisely the public obligation problem. When public authorities, in the name of serving the public, try to get enterprises to offer a certain service to consumers, the fact that the obligation raises operating costs leads to exactly the opposite! Supply contracts. Therefore, a subsidy is needed.

One can of course question the wisdom of the public policy itself. Why should public authorities want to force firms to offer more than the market can pay for? But the purpose of the analysis here is not to examine the motives of such policies. Rather, it asks what is the least distortionary means of achieving that policy objective.

Therefore, given this public policy objective, the best response or the optimum intervention is to offer a subsidy that offsets the extra costs. At the margin, these extra costs are not the whole cost of the last unit of output. They are only a smaller portion. The problem with compensation à la "Ferring" is that it covers the whole cost of each unit of output at the margin, i.e. $((\partial C_i / \partial Q_i) + (\partial C_i / \partial R_i)(\partial R_i / \partial Q_i))$. An optimum subsidy should cover only the real extra cost, i.e. $(\partial C_i / \partial R_i)(\partial R_i / \partial Q_i)$. I emphasise that this is the "real" extra cost because when lawyers or judges refer to extra costs they do not make the necessary distinction between the whole cost of an additional unit of output and the extra component of the cost of the additional unit of output. As I explain in the main body of the paper, the reason is that firms would be willing to offer some of the regulated output at market prices.

What happens when public authorities do not organise auctions before granting compensation? As already pointed out, the decisive factor is not the obligation which is imposed by public authorities but the consequent reduction in supply and the necessity of raising it through aid. Is compensation granted for this purpose a form of state aid? The answer is yes for the following reason.

The authorities cannot know what amount of aid would be sufficient to restore supply. This depends on the internal costs of each market player. A firm that exits the market after public service obligations are imposed does not necessarily need to be reimbursed for all the costs associated with that service in order

to re-enter the market (the reason being that the firm can earn some revenue by selling that service). Naturally, the situation would be different if public authorities reimbursed only the portion of the costs which is needed to induce re-entry. That portion is that which lies above the market price of the service. But this is not what authorities do when they compensate for extra costs. They cover the full extra cost of the service.¹⁶ At least this is what the facts of the "Ferring", "Altmark Trans" and "GEMO" cases reveal.

¹⁶ In other words, they compensate for the "incremental cost", IC, of the service. They should compensate, instead, for the difference between IC and price, P, so that the subsidy, S, should be $S = IC - P$ (assuming that $IC > P$).

Compensatory measures that reimburse the full costs of each enterprise of providing the service in question must be state aid in the meaning of Article 87(1). Economically, they offer unnecessary aid and legally they treat firms differently. The least efficient firms, i.e. the ones with higher costs, receive proportionally larger subsidies. This does not mean that they may not be subsequently authorised by the Commission under the exceptions of Article 87(2) & (3) or Article 86(2).

Only when public authorities can show that they adjust the reimbursement they offer to reflect the internal cost structure of each beneficiary firm should their compensatory measures be regarded as falling outside Article 87(1). This, however, is neither an easy nor an advisable course of action for public authorities. Not only do they not have the necessary information to do that, but even worse, they would fall prey to the misleading information provided by firms eager to obtain subsidies.

We must conclude, therefore, that compensation granted after an auctioning process is not state aid, while compensation granted on the same conditions to all enterprises delivering services linked to public obligations must be state aid. The decisive factor is neither the *quid pro quo* link between compensation and the obligation, nor the clarity of the obligations imposed. The decisive factor is the necessity of compensation or rather the absence of any proof of it.

Before closing this section I would like to address two questions. First, how can aid that is not necessary for some firms be exempted? Second, what would be the role of Article 86(2) in this alternative approach to analysing compensatory measures for state aid purposes?

With regard to the first question, it was mentioned above that one of the weaknesses of existing compensatory measures is that they may offer aid when it is not necessary. But aid that is not necessary would normally not be exempted by the Commission under Article 87(2) or (3). In reality, however, the guidelines and notices of the Commission define criteria for exempting state aid schemes. By definition, schemes include many awards of individual amounts of similar aid or aid for similar purposes that is granted to different firms. When the Commission or the member states apply the guidelines and the notices they do not examine whether each individual recipient truly needs the aid in order to do what the aid scheme requires them to do (e.g. train workers, invest in underdeveloped regions, etc.) This is because the necessity of aid is defined in terms of the conditions facing the “aver-

age” enterprise. So in general, for example, the average firm would under-train its workers. But this does not mean that every firm would under-train. Nonetheless, all firms that undertake training are eligible for aid that is exempted under the relevant guidelines.

In relation to the second question, it seems to me that the approach presented above restores Article 86(2) to its traditional role of providing one of several exceptions. It is, nonetheless, a special exception because it applies only to services of general economic interest and only when the obligation is explicitly imposed by law on specific enterprises which cannot escape from that obligation by simply exiting the market in question. After all, the explicitness of the legally imposed obligation is one of the conditions defined in the case law for applying Article 86(2). By contrast, this is not the case with other instances of public obligations imposed on classes of enterprises or which apply to any firm that enters a particular market. These entrants always have the option of not providing those services by leaving that market and by engaging instead in different commercial activities. Providers of services of general interest that may benefit from Article 86(2) do not have this option. In this sense they deserve to have the benefit of the exception in Article 86(2), while other undertakings should have only the options for exception available under Article 87(2) & (3).

Conclusion

Community policy on state aid is at a crossroads. While member states at the highest political level profess a desire to reduce state aid, they keep stretching the interpretation of the rules. Even though the European Court of Justice has traditionally been viewed as a champion of integration, ironically in this connection, two of its recent judgements may have had the opposite effect. They may have helped member states to circumvent the rules.

I have argued in this paper that measures that compensate for public service obligations imposed on enterprises pose a considerable threat to the integrity of the Community system of state aid control. For this reason, and bearing in mind their economic effects, these measures should normally be viewed as state aid unless compensation is granted after an auctioning procedure.

This approach does not necessarily exclude the possibility that compensatory measures may consequently be exempted on the grounds that they satisfy the conditions defined in Article 87(2) & (3). This approach would also restore the traditional role of Article 86(2) as an exception for services of general economic interest.