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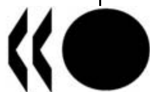

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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

Global Forum on Competition

COMPETITION, STATE AIDS AND SUBSIDIES

Contribution from BIAC

-- Session I --

This contribution is submitted by BIAC under session I of the Global Forum on Competition to be held on 18 and 19 February 2010.

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COMPETITION, STATE AIDS AND SUBSIDIES

-- BIAC --

1. The Business and Advisory Committee (BIAC) to the OECD appreciates the opportunity to submit these comments to the OECD Global Forum on Competition on "Competition, State Aids and Subsidies."

I. Overview

2. State aids and subsidies have played a significant role in the economy over the past 18 months. From bailouts in the banking and insurance sector to investments in the automotive sector to the funding of major infrastructure projects and technology , these aids and subsidies have significantly helped to mitigate the worst adverse effects of the world financial and economic crisis. The problems of the financial sector undoubtedly necessitated some of these measures, without which major global businesses faced potential disaster and economies may have suffered in ways that would have taken many years to cure. It would be easy, therefore, to suggest that subsidies and state aids should be viewed solely in a positive light if only as a "necessary evil". But the remedial benefits of state aids can also present a significant risk to competition that must not be overlooked. Subsidisation, in whatever form, can tilt the competitive playing field, squelch potential innovation and deter investments by rival firms in ways that can impede the competitive process and lead to both short and long-term harm to consumers. These competing concerns must be reconciled through effective governmental oversight, with the unifying theme being the protection and promotion of consumer welfare.

3. Idealistically, subsidies and state aids would not feature prominently as a tool of industrial policy as these mechanisms can have the capacity to create distortions in the competitive landscape. Given the economic realities of the times that have lead to significant market failures, and the promotion of overriding governmental policy objectives to cure these failures, some level of subsidies and State aids can be seen as necessary to ensure that short term distortions in corporate financial stability do not result in long term elimination of efficient firms that happen to be caught up in turmoil created by constriction in the financial markets. For example, in mid-2008 firms typically could gain access to a long-term financing facility (debt or equity) at reasonable rates and thereby secure the capital required to allow the business to grow and invest for a period of 3-5 years. Six months later, by the beginning of 2009, it was extremely difficult for firms to access capital at any rate and doing so often meant sacrificing or putting at risk substantial assets of the firm even to gain short-term operating capital. The ***timing*** of a firms' need for re-negotiating long-term capital had nothing whatever to do with the firms' competitiveness, efficiency, innovation or any other competitive metric; it was purely a question of chance. To punish such firms and allow them to go bankrupt in such blameless circumstances could have resulted in perverse competitive results. At such moments, it is appropriate for governments to make public policy decisions that will help firms get past the period of market illiquidity and regain equal footing with the firms that were more fortunate in securing financing prior to the economic crisis. Thus, in BIAC's view, there is an important role for subsidies and State aids that is consistent with the promotion of competition, efficiency, innovation and net consumer welfare that does not require the sacrifice of sound competition principles.

4. Improperly designed and implemented, however, subsidies and state aids may threaten free competition and consumer welfare. Companies that receive State aids can enjoy some competitive advantage over their rivals that can thwart the competitive process and result in harm to consumers. The McKinsey Global Institute's twelve-year study to determine why some nations remain wealthy and others remain poor despite years of international aid found that "economic progress depends on increasing productivity, which depends on undistorted competition. When government policies limit competition . . . more efficient companies can't replace less efficient ones. Economic growth slows and nations remain poor."[1] To avoid such a result, clear and non-discriminatory rules, and their effective implementation, are necessary to ensure a level-playing field for companies and to limit the potentially harmful effects of subsidies.

5. There are three main parties in the subsidies constellation: the State, the beneficiary and its competitors. All three players have their own motivations and goals. The goals of the state may reflect social policy objectives, for example to attract foreign direct investment, maintain employment, increase tax revenues or stimulate growth in a particular economic sector. At the same time, the objectives of the state decision makers may reflect political objectives that are not as focused on long-term consumer benefits. Indeed, for example, it is a well-known international phenomenon that subsidies increase in election years. Thus, not all State aids should be viewed through the same lens of positive social policy and, accordingly, the impact of State aids on competition should be scrutinised as to each individual case.

6. A beneficiary of the state aid rarely is concerned about the potential harmful effects on the competitive process. For a recipient company at risk, it can be argued that State aids maintain a competitor that otherwise would not exist and, therefore, competition is enhanced. But in the face of decreasing relative demand (i.e., static demand coupled with increased capacity or declining demand coupled with static capacity), the elimination of one or more competitors from the marketplace may be inevitable. In this case, consumers are best served by witnessing the demise of the least efficient competitor rather than the competitor with the lowest degree of state subsidisation.

7. In general, companies tend to see the short-term advantages of receiving State subsidies: subsidies reduce companies´ costs; they allow investments that would otherwise not have been possible; they can avoid painful restructuring and unrest of their labour force; and they may receive a competitive advantage over their competitors that can be used to achieve a better market position. At the same time, companies often tend to ignore the risks of State subsidies for their future, such as a delay in necessary cost cuts, improvements in efficiency and a focus on innovation.

8. Such a focus can lead to perverse results, with even competitively efficient competitor companies becoming incentivised to employ, invest and spend in ways that are less efficient. To this end, one may question the substantial subsidies doled out nearly all global automotive companies at the height of the economic crisis.

9. In sum subsidies have the ability to distort competition and negatively impact consumer welfare because they can lead to inefficient allocations of taxpayers´ money and company resources and because they reduce incentives to reduce costs and create efficiencies On the other hand, in some cases, subsidies may improve overall welfare, in particular if they correct for market failures unrelated to intrinsic elements of corporate competitiveness or facilitate necessary additional investment in research and development. Given the potential benefits and harms of State aids and subsidies, the consideration and control of such

[1] Deborah Platt Majoras, Chairman, U.S. Federal Trade Comm'n, "National Champions: I Don't Even Think it Sounds Good," Remarks before the International Competition Conference/EU Competition Day, Mar. 26, 2007, available at http://www.ftc.gov/speeches/majoras/070326munich.pdf (citing William Lewis, The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability (2004), at 103).

measures can be viewed as a crucial part of an integrated governmental competition policy. We agree with the EC's fundamental policy that "State aid control is an essential component of competition policy and a necessary safeguard to preserve effective competition and free trade in the single market."[2]

II. Objectives of Subsidy and State Aid Control

10. State aid and subsidies rules should have two main goals. First, they should be implemented in a way that facilitates a level playing field for competition, both on the national and on the international level. Second, they should create a balance between the need to limit the distortion of competition created by subsidies while at the same time preserving legitimate social policy goals of State aids that can help to cure market failures and benefit consumers. We believe that such rules must be based on an economic assessment of the net effect of subsidies.

11. Such rules could have a national, supranational or international basis. In fact, many rules in different countries, in particular budgetary rules, limit the use of subsidies, even though they are not designed to protect competition or markets. These rules often are intended to prevent domestic abuses in doling out subsidies based on sub-optimal government investments. Purely national regimes, however, are not likely to preserve competition particularly when the scope of effective competition transcends national borders, as is the case in an ever-expanding number of relevant product markets. National governments tend to disregard negative spill-over effects on other countries and prioritise national economic interests over international ones.[3]

12. A supranational or international regime is the most effective way to attempt to eliminate the potentially distortive effects of subsidies. Such a supranational State aid regime exists in the European Union. This system relies on an independent regulator and a set of rules that prohibit subsidies that fall outside specified parameters and have not been approved by the regulator. It can be enforced by national and European courts. State aid law has existed in the European Union since the early 1950s. In the last 50 years, the European Commission and the European courts have developed an extensive practice and decision precedent base respect to various questions of State aid law. The Member States of the European Union also developed considerable expertise dealing with these rules and have adapted their behaviour to these rules. The European Commission also has advanced beyond other systems in integrating subsidy and state aid considerations into their competition regime. Yet the impact of the EC system of State aids is limited to the boundaries of the European Union.

13. The international system of the WTO is rather different from the European system. It does not directly regulate or prohibit subsidies and has no regulator that has to approve subsidies. Rather, the system relies on the ability of States to petition for counter measures to neutralise subsidies granted by other States and to restore a level playing field. These counter-measures, however, are often applied as to products or economic sectors other than the one in which the subsidies were granted, so while the net benefits may theoretically be eliminated, the potential distortive effect is not avoided (and arguably is multiplied). Still, the system imposes a beneficial chilling effect on the granting of subsidies.

III. Forms of Subsidies and State Aids

14. The most obvious form of subsidisation is direct government grants. Other less obvious forms of subsidies, however, warrant similar treatment when they have a similar impact to direct grants. Under European law, the concept of "State aids" thus covers all economic advantages granted by the State

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2 Common Principles for an Economic Assessment of the Compatibility of State Aid Under Article 87.3 at 1, available at http://ec.europa.eu/competition/state_aid/reform/economic_assessment_en.pdf.

3 *Id*.

through State resources that grant a specific economic advantage on one or more undertakings or specific industry sectors. Because cash is a fungible good (indeed, that is its sole purpose), subsidies have a direct impact on operational aspects of a firm, regardless of whether those funds are "earmarked" in a particular manner. Subsidy funds can improve a firm's cash flow, enhance the balance sheet, and build assets that allow a firm to raise additional debt financing or equity capital.

15. In those cases where all companies receive the same economic advantage from a State, such as uniform tax treatment, action typically is not warranted. These measures do not threaten the equality between companies within the State and do not confer any competitive advantage on one or more of the undertakings compared to their competitors. While such measures may only benefit those firms operating within the state, the state is presumably pursuing legitimate social policy objectives by imposing taxes uniformly on all businesses within the state and is not attempting to tilt the competitive playing field. Moreover, firms should not be penalised merely for operating within a state that has preferential tax regulations as compared to other states as this is a component of long term cost and therefore impacts efficiency, albeit not in an operational sense.

16. Besides direct grants, governments sometimes rely on industry- or firm-specific tax measures such as tax deferrals, lower tax rates or the decision not to collect taxes from a company, guarantees and loans. Governments often prefer tax measures because they allow them to give companies additional economic benefits without having to finance them out of the State budget. The government may also hand out loans to companies at interest rates or against collaterals or securitisation that would not be acceptable to a normal bank; or it may provide guarantees for a company so that it can receive a bank loan that it would normally not have received. The State can also actively get involved in the economy by investing equity into companies. All of these measures should be considered on a par with direct grants and their impact should be evaluated.

17. At times, this behaviour can resemble or substitute for the actions of a private market participant. For example, the State can grant a loan at market rates against collaterals that are in line with market requirements. Or a State can invest equity in a public undertaking, in particular if the State is already engaged in this undertaking. The State can grant guarantees, for public or private undertakings, if the guarantee would also have been granted on the same conditions, by a private investor. In European Law, the different forms of this behaviour are assessed under a number of closely related tests, the "private investor test", the "private creditor test", and the "private vendor test", each referring to the particular situation in which the State acts like a market participant under unusual conditions.

18. The private investor test raises the question why the State intervenes in the economy if – by definition – a private investor could have done the same. While these actions can be viewed with some scepticism, they do not always imply subsidisation for two reasons. First, the state may be attempting to remedy a market failure that has prevented a private actor from taking the action. Second, the fact that the state, rather than a private party, has taken such action does not imply harmful effects on competition or consumer welfare.

IV. Distortion of Competition

19. Subsidies can result in three types of competitive distortions as outlined by the European Commission in its framework for assessing economic effects of State aids: "First, State aid, by interfering with the allocation of rents through markets, may have long-term dynamic effects on the incentive to invest and compete. Second, at a more specific level, State aids may affect competition in the product market and

trigger different responses by competitors depending on the circumstances. Third, State aid may affect competition in the input markets and in particular the location of investment."[4]

20. Long term incentives can be adversely impacted because firms may conclude that the availability of State aids can supplant the need for their own investments while still ensuring an adequate rate of return. This can reduce innovation and lead to stagnation. Competitive responses might also be muted as rivals conclude that their investments are not likely to result in a competitive advantage. Input markets can also be impacted as the subsidy may favour one form of input (often labour) over others (such as mechanisation).

21. The Commission states that in evaluating the distortive effects of State aids, it will principally consider the effect that the recipient's change of behaviour will have on competitors and input suppliers. It notes that it will also consider the impact on consumers. In our view, that prioritisation is skewed: the impact on consumers should be the principal concern of the Commission in implementing its State aid policies, with impacts on competitors and input suppliers a secondary component of that consideration.

22. The most obvious case of distorted competition concerns the rescue of an inefficient firm in financial difficulties. Keeping such a firm afloat promotes inefficiencies and might harm more efficient competitors, particularly when not linked to a thorough restructuring of the firm. State subsidies can have the effect of reinforcing the very behaviour that the competitive process is designed to discourage. State subsidies risk decreasing pressure on companies to reduce costs, to invest in research, development and innovation and to simply become more efficient. Firms that feel protected may not make the necessary effort to remain competitive without State subsidies. Viable business may become threatened because subsidised and inefficient competitors are able to undercut their prices. Efficient companies may be forced to leave the market or may require State aid themselves to stay in business.

23. At the same moment, one of the least distortive uses of subsidies is to remedy a failure in the financial markets that artificially restricts the availability of investment or operational capital for firms that are efficient and have the potential to enhance consumer welfare. Distinguishing between market failures and favouritism is a challenging task, but a necessary one if consumer welfare is to be maximised.

V. Designing State Aid rules

24. Clear rules and a uniform and non-discriminatory application of these rules are important to maintain or restore a level playing field for businesses around the world. States should not be allowed to provide competitive advantages to companies without clear justification and transparency.

25. Standalone national rules cannot be considered a viable enforcement mechanism to limit subsidies and to ensure that subsidies rules are applied in a non-discriminatory way. Moreover, a national agency cannot be expected to effectively police the actions of the government from which it derives its own authority. Particularly in times of economic crisis when decisions on State aids are being made at the executive level, governmental agencies tasked with monitoring subsidies and competition enforcement have had only a minimal role to play and, at times, have been completely disregarded. Therefore, a supranational authority such as the European Commission or an international organisation such as the WTO is necessary to discipline the incentive to grant subsidies to their own undertakings absent compelling social policy objectives.

26. Rules governing State aids and subsidies should identify legitimate objectives of subsidies including both efficiency, technology and equity objectives, outline the competitive distortions that can

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4 *Id*. at 5.

result from subsidies, and seek to clearly indicate the way in which the positive and negative effects of subsidies will be considered. The rules should provide for transparency and disclosure of State aids and a means for challenging the grant of any economic benefit conferred upon a firm. Adequate investigative and remedial powers should be granted to the responsible authority to ensure that individual abuses can be remedied and to deter abuses from occurring.

VI. Financial and economic crisis

27. During the recent financial and economic crisis many banks and companies could only survive with the help of massive State subsidies in different forms. This was an extraordinary situation: in a normal economy, firms in difficulties should not or only in limited circumstances be rescued through State subsidies. The reasoning behind this is that such firms are usually in difficulties because they are inefficient and it would be beneficial for competition and welfare if inefficient firms that are unable to increase their efficiency have to leave the market. However, this reasoning did not apply in the crisis: banks and companies were in difficulties because of the crisis, not necessarily because of their being inefficient.

28. Refraining from help in this situation would have had serious and unwanted consequences. There was the real danger that the whole financial system would break down, with unknown but certainly disastrous consequences. Furthermore, excluding State subsidies in the crisis would force efficient and inefficient companies alike to exit the market. It would lead to a strong post-crisis concentration in several if not all sectors of the economy, creating oligopolies or monopolies and increasing the likelihood of collusion and cartels. All these consequences would in the medium- and long-run lead to a loss of consumer welfare and a decrease of competition. An aggressive enforcement of subsidies bans would also have put into danger the very existence of State aid rules, given the strong political and economic reasons for granting aid.

29. We therefore welcome the fact that the European Union, have decided to apply the State aid rules in a way that has helped to overcome the banking crisis while maintaining the principles of the law, in particular insofar as the grants have been accompanied by measures designed to limit market distortions.

30. Post-crisis rules should reflect the return to a limitation of State aid and should take into account that the potential distortions of competition entailed by the crisis aid need to be cleaned up post-crisis. In fact, the European Commission is currently closely monitoring the restructuring plans of a number of banks that have received subsidies during the crisis.

VII. Conclusion

31. Subsidies and State aids present a challenge for governments seeking to promote optimal competitive outcomes. Properly utilised, subsidies can preserve and enhance a competitive marketplace by correcting critical market failures and help efficient firms to survive and thrive. Improperly used, they can tip the balance of competition toward inefficient firms in order to promote nationalistic and political objectives at the expense of efficiency and innovation. Maximising consumer welfare demands that these competing objectives be closely scrutinised and that distortive practices be remedied.