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Fair competition in the internal market: Community State aid policy

The ecu and its role in the process towards monetary union

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Abbreviations and symbols used

Countries

B	Belgium
DK	Denmark
D	Federal Republic of Germany
GR	Greece
E	Spain
F	France
IRL	Ireland
I	Italy
L	Luxembourg
NL	The Netherlands
P	Portugal
UK	United Kingdom
EUR 9	European Community excluding Greece, Spain and Portugal
EUR 10	European Community excluding Spain and Portugal
EUR 12	European Community, 12 Member States

Currencies

ECU	European currency unit
BFR	Belgian franc
DKR	Danish krone
DM	Deutschmark
DR	Greek drachma
ESC	Portuguese escudo
FF	French franc
HFL	Dutch guilder
IRL	Irish pound (punt)
LFR	Luxembourg franc
LIT	Italian lira
PTA	Spanish peseta
UKL	Pound sterling
USD	US dollar
SFR	Swiss franc
YEN	Japanese yen
CAD	Canadian dollar
ÖS	Austrian schilling

Other abbreviations

ACP	African, Caribbean and Pacific countries having signed the Lomé Convention
ECSC	European Coal and Steel Community
EDF	European Development Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMS	European Monetary System
ERDF	European Regional Development Fund
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
LDCs	Less-developed countries
Mio	Million
Mrd	1 000 million
NCI	New Community Instrument
OCTs	Overseas countries and territories
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PPS	Purchasing power standard
SMEs	Small and medium-sized enterprises
toe	Tonne of oil equivalent
:	Not available

Part I

Fair competition in the internal market: Community State aid policy

This study was prepared by Stefan Lehner and Roderick Meiklejohn, under the direction of H. Reichenbach. The authors wish to thank C. Lefret, K. Munk, A. Schaefer and R. Walther for information and advice, and V. Barwig for secretarial support.

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Executive summary

The creation and maintenance of a system of free and undistorted competition is one of the basic principles on which the European Communities were built. Subsidies risk threatening the efficient functioning of this system as they often reduce efficiency and distort trade in a similar way to protectionist measures. The founding fathers of the European Communities therefore established a strict Community control of national State aids under the basic principle that aids which may distort competition between firms in different Member States are incompatible with the common market unless derogations are granted. The Commission's second survey on State aids in the Community nevertheless identified ECU 82 billion, or 2,2 % of Community GDP, of average annual national State aids between 1986 and 1988. The full benefits from the completion of the internal market will only materialize if governments do not distort the adjustment process with more national State aids. A profound strengthening of Community State aid policy is therefore required. Today considerable progress has been made : transparency has improved, mandatory repayment of illegal aid has increased discipline, strict rules have been agreed for steel and shipbuilding, clear priorities have been established and major existing aid schemes are under review. But the process has to continue and new challenges have to be addressed : the need to improve convergence in the run-up to economic and monetary union should bring national expenditures on subsidies under additional scrutiny; a commitment to more subsidy discipline would contribute to achieve an even more open international trading system in the Uruguay Round of the GATT negotiations; the long-term efficiency of Community industry requires an effective Community and international control of subsidies. But in general at the beginning of the 1990s Community State aid policy is recovering the bite intended by its founders and necessary for further efficient integration of the Community economies.

There is no generally agreed definition of subsidies. For the purpose of this study subsidies should be understood broadly as all forms of specific transfers from the government sector which directly or indirectly benefit enterprises, for which the government receives no equivalent compensation in return and which are granted with the purpose of changing market outcome.

The particular subset of all subsidies which are subject to Community policy is referred to as 'State aids'. State aids are basically those subsidies which distort intra-Community competition. They are defined in detail by Community law and the decisions of the Commission and the Court of Justice.

Subsidies are a widely used policy instrument. They are granted for example to encourage the use of public transportation, the intensification of research and development, the purchase of catalytic converters, the use of domestic coal or the employment of handicapped workers. But economic theory points out that subsidies and the taxes required to finance them often introduce distortions and reduce domestic and international welfare. The activities of enterprises to obtain subsidies, administrative inefficiencies and international retaliation cause additional welfare losses. Modern welfare and trade theory have, however, stressed the point that in the presence of market distortions, for example externalities or economies of scale, finely tuned subsidies can in theory restore efficiency or capture income from other countries. A rational decision on subsidies therefore requires both a theoretical and an empirical evaluation of the case at hand; for the latter the instruments are far less well developed. The onus of proof lies at any rate heavily on the advocates of subsidization. A policy rule of no subsidies except under particular circumstances remains an appropriate rule of thumb.

The total of the subsidies granted in the Member States is difficult to establish due to the various forms subsidies can take and the lack of a comprehensive national statistical effort in most Member States. But for those subsidies which are subject to Community rules the Commission has made a pioneering effort and has by means of its first and second survey on State aids in the Community, published in 1989 and 1990, established a degree of transparency unmatched by most Member States and its trade partners.

The second survey identifies an alarming ECU 82 billion in annual total national State aids in the Member States on average between 1986 and 1988, which amounts to 2,2 % of Community GDP, 4,5 % of total general government expenditure in the Community or more than twice the Community budget. The differences between Member States are considerable, with Denmark and the United Kingdom spending just 1 % of their GDP, but Belgium, Greece, Italy and Luxembourg spending 3 % and more.

State aids are heavily concentrated: nearly 60 % of the total go to the three sectors: transport — mostly railways — (30 %), the coal industry (16 %) and agriculture/fisheries (13 %). In the coal sector subsidization per employee is extremely high, with Belgium and Germany far above the Community average; in the mean time Belgium has announced the closure of its last coal-mines. The remaining 40 % of total aid mainly goes to manufacturing, of which steel and shipbuilding have come down to only 4 %, but other sectors (for example cars, electronics, aviation) now directly receive about 18 % of total aid with subsidization particularly high in Greece, Spain, France and Portugal. Total State aid to manufacturing is twice as high on average in those countries which are wholly or in large parts lagging behind in their economic development (Greece, Spain, Ireland, Italy and Portugal) than in the other countries but aid per person occupied in manufacturing is also very high in Belgium. Concerning 'horizontal' aids which have no sectoral or regional specificity there is heavy subsidization of trade/export in Greece, Ireland, France, Belgium, of general investment in Portugal, Belgium, the Netherlands, Luxembourg, and of small and medium-sized enterprises in the Netherlands, Belgium, Greece, Italy and Luxembourg.

Surveillance and control of national State aids has from the beginning of the Communities been transferred to the Community level. The ECSC and EEC Treaties established the rather straightforward basic principle that State aids, in so far as they distort trade between Member States, are forbidden unless a derogation is specifically accorded, either in the Treaties themselves or by the Commission or Council acting under powers granted by the Treaties. To allow effective Community control the Member States are obliged to notify the Commission in advance of measures which could constitute State aids. The Commission is the master of the procedure — under the control of the Court of Justice — deciding in each single case whether Community control actually applies and whether a derogation can be granted.

Key elements of the identification of State aids are well established: they are granted by a public body in a Member State, involve some cost to the public purse, benefit enterprises, involve better terms than normal market conditions, are specific to certain sectors, regions or firms and affect competition with other Member States. Some current discussion surrounds the treatment of public enterprises where the Commission, repeatedly supported by the Court of Justice, considers those transactions as State aids which would not be undertaken by a commercial investor under similar circumstances. Another difficult problem is to distinguish between aids and 'general measures', i.e. distortions in intra-Community competition which may arise from changes mainly in the fiscal and social security system of a Member State. For the latter different, far less strict Treaty rules apply. A key criterion is the degree of *de facto* specificity of the measure. In spite of all attempts for precision there is an inevitable grey zone where the Commission has to decide the applicability of the State aid rules case by case.

The main possible reasons for derogations allowed for in the EEC Treaty are regional problems, important projects of Community interest or the development of certain economic activities. In each case the Commission has to assess from the point of view of the Community as a whole the potential harm done, in particular from the potential trade distortion, against the contribution the aid may make towards other Community objectives.

If the Commission considers a measure to constitute a State aid and no derogation to be applicable, it initiates the procedure foreseen in the Treaty inviting the Member State concerned but also all other Member States to submit their positions. Eventually the Commission takes a final decision against which the normal avenue of appeal is to the Court of Justice. Since 1985 the Commission has systematically ordered Member States to recover illegal State aid from the recipient and this has considerably strengthened Community State aid discipline. The Commission has also begun to review existing State aid schemes and to verify whether the reasons for derogation still exist and whether the schemes have been abused.

While the basic principle and procedures are rather straightforward, their application has become highly diversified. To some extent the application has blurred or even put into question the basic principle: for coal, many agricultural and fisheries aids and railways secondary legislation has in fact provided the basis for granting high amounts of national State aids under limited Community control; for coal the relevant Commission decision will, however, expire at the end of 1993. In cases of particular importance to competition in the Community the Commission has defined its rules for decisions on State aid requests in a series of directives, communications, or letters to improve transparency and consistency. There are rules on aids with particular objectives (on regional aid, aid for research and development, environment, rescue and restructuring, general aid and employment and training aid), on different forms of aid (State guarantees, public holdings in company capital) and on specific sectors (coal and steel, agriculture, fisheries, transport, shipbuilding, synthetic fibres, textiles and clothing and motor vehicles).

A common thread running through many of the rules is a negative attitude towards operating aids, which are held to be conservative in their effects and not likely to lead to a lasting solution to the problems which they address.

Another key preoccupation of the application of Community State aid policy is to assure that national State aids are compatible with the improvement of regional cohesion. The Commission therefore permits a higher degree of subsidization for regional purposes in the least developed Community regions. Some leeway is granted for national State aids addressed to national regional imbalances but even then the wider Community context is taken into account. The problem remains that the least developed regions often do not have the financial means to take full advantage of their broader margins and their effective subsidization remains below what wealthier Member States can offer. Furthermore, State aids with other objectives also often have a regional bias which is difficult to establish and to shape in favour of the least developed regions. A stricter discipline on State aids in the wealthier regions is therefore essential to prevent national State aids undermining other Community efforts to improve its economic and social cohesion.

Since the middle of the 1980s the Community has tightened the discipline it imposes on national State aids. This is a necessary concomitant of the drive towards the completion of the internal market and economic and monetary union (EMU). State aids must be prevented from becoming a major obstacle to reaping the full benefits of accelerating economic integration in the Community. Economic integration will intensify competition and induce an acceleration of structural change which will expand the Community's production possibilities, increase its growth and employment prospects and improve its competitiveness in world markets, provided national governments refrain from using national State aids to try to affect the outcome of this process. Furthermore, the importance of convergence in the run-up to final EMU adds additional urgency to the control of State aids as they weigh heavily on those budgets whose deficits or public debt are far above Community average.

Both the Cecchini Report on the 'Economics of 1992' and the report 'One market, one money' on the economic effects of EMU confirm this increased need to restrict State aids. The Commission has reacted not by seeking new legal provisions but by strengthening the effectiveness of Community State aid control and identifying types of aid which merit particularly close attention. It is reviewing existing schemes, seeking better information on the impact of schemes and increasing its efforts to limit the overall volume of aid granted. Categories of aid under particular scrutiny are general investment aid schemes, capital injections into publicly owned enterprises, support for national champions and export aids.

For the Community, as the world's biggest trading bloc, it is also important to assure an open and competitive international trading system. Such a system can be the more beneficial for all participants the more they agree on international surveillance of State aids and counter-measures, even if this reduces national sovereignty. From the negotiations with the EFTA countries on a European economic space emerges a combination of comprehensive self-discipline on the basis of established Community practice, close consultation and a joint court for disputes. In the far wider realms of the GATT the Community is playing an active role in the current Uruguay Round of negotiations, seeking a strengthening of the GATT Codes on subsidies as well as on anti-dumping. The key to success will be to obtain a balanced progress in both the discipline on subsidies and on countervailing measures.

Chapter 2

Introduction

From the foundation of the European Communities it had been understood that trade liberalization has to be accompanied by an adequate cross-border competition policy. It would only be acceptable to sovereign Member States to renounce the use of protectionist instruments for trade among each other if they could be assured that competition with other Member States would be reasonably fair. Furthermore, the founding fathers of the Community shared the conviction that only undistorted competition would provide an efficient division of labour and see the strongest gains emerge from the liberalization of trade.

Therefore the Treaties creating the European Coal and Steel Community (ECSC) and the European Economic Community (EEC) already provided for a Community competition policy. For private enterprises they introduced constraints on cartels (Article 85 EEC) and on the abuse of market power (Article 86 EEC). On granting aid to their enterprises the governments agreed to tie their own hands and to install far-reaching control at Community level. They established the basic principle that State aids, in so far as they distort trade between Member States, are forbidden unless a derogation is specifically accorded, either in the Treaties themselves or by the Commission or Council acting under powers granted by the Treaties. On that basis secondary legislation, rulings by the Court of Justice and, in particular, hundreds of case-by-case decisions of the Commission per year shaped Community State aid policy.

In the mid-1980s the Community set out to take its economic integration one major step forward by completing its internal market by the end of 1992. Many non-tariff barriers to intra-Community trade, for example in public procurement or national technical standards, were tackled. But the benefits of the internal market would be threatened if the adjustment process was distorted by uncompetitive behaviour of enterprises or national governments. A strengthening of Community competition policy was thus from the beginning an essential part of the internal market process.

With regard to the private sector the authority to control mergers between enterprises of Community dimension was transferred to the Commission. Community State aid policy was reinforced not by means of new legislation but by applying existing rules so as to best meet the requirements of the internal market.

Today, well before the end of 1992, Community State aid policy has already developed considerably: transparency of national State aids, a prerequisite for efficient Community State aid policy, has been established for the first time with two surveys on State aids in the Community; the introduction of repayment of those State aids which are found to violate the Treaty enhances the effectiveness of Commission decisions; national aid to the steel sector is dramatically reduced; clear priorities are established aiming at an elimination of aid schemes which do not serve any Community objective; existing aid schemes, which provide the basis for most State aid, are reviewed critically. Overall the effectiveness of Community State aid policy has gained credibility.

But the development of Community State aid policy cannot stop here. Difficult questions still require a more precise answer, for example the identification of State aids for public enterprises, which becomes even more important as the transport sector and public utilities are opened up to broad intra-Community competition. Furthermore, the run-up to economic and monetary union poses new challenges: for example, budgetary convergence requires significant adjustment of budgetary policies in several Member States, and it is often those Member States which spend more than the Community average on national State aids. State aid policy in the Community also has to be seen in a wider context: the growing integration of world markets requires an active contribution by the Community to strengthen the international surveillance of trade-distorting State aids and counter-measures, in particular in the framework of the ongoing Uruguay Round of trade negotiations.

The study takes stock of Community State aid policy at the beginning of the 1990s. Chapter 3 summarizes the economic rationale for subsidy control against the background of both traditional and modern economic analysis and reviews some empirical approaches to measure their impact. Chapter 4 presents the current picture of State aids in the Community mainly on the basis of the Community surveys on State aids. An overview of the legal bases for Community State aid policy is provided by Chapter 5. Compared to the rather straightforward legal bases the application of Community State aid policy has become highly diversified. Chapter 6 therefore tries to introduce some transparency to that domain. Chapter 7 points out aspects of State aid policy currently under review. Chapter 8, last but not least, puts Community State aid policy in the context of international arrangements on State aid policy and countervailing measures, with particular reference to the current round of GATT negotiations.

Chapter 3

Economic rationale for subsidy control

3.1. Introduction

Subsidies are a widely employed instrument of public intervention into the market process. They are granted to encourage for example the use of public transportation, the intensification of research and development efforts, the purchase of catalytic converters, the use of domestic coal or the employment of handicapped workers. Their use is, however, strongly debated as there is no consensus on questions like: will a certain subsidy achieve a specific objective, will the side-effects be beneficial or harmful, what is the impact on the trading partners, why are subsidies used at all? The following provides an overview of typical methods used to analyse these questions and the answers they provide. After an attempt to define subsidies, it will present theoretical approaches in different theoretical contexts and examples of empirical evaluations. At the end some tentative conclusions are suggested.

3.2. Definition

Economic analysis does not dispose of an agreed definition of a subsidy. Prest's observation that 'there is no neat and tidy single all-purpose definition of producer subsidies'[1] is maintained in the more recent literature.[2] For the purpose of an analysis of the economic effects of subsidies it appears appropriate to use a broad definition. Thus this study considers those government interventions into a market economy to be subsidies which meet all the following criteria:

(i) they provide transfers from the government sector which directly or indirectly benefit enterprises and which entail direct budgetary costs either in terms of expenditure or of revenue forgone; this distinguishes them from tariff or non-tariff protection or regulations. Additionally, there are 'regulatory subsidies' in the sense that government regulations impose direct transfers from consumers to producers by fixing prices above market prices, e.g. in agriculture or for electricity;

(ii) the recipients are outside the administrative sector, but transfers to railways, telecommunication services and other economic activities which are often undertaken by public enterprises may well be subsidies;

(iii) the government receives no equivalent compensation in return, thus a public procurement price above market price is a subsidy;

(iv) subsidies contain an element of specificity, i.e. they are destined for a specific group of economic agents (e.g. SMEs or enterprises of a specific region) or for producers or consumers of a particular product (e.g. cars with catalytic converters), service or factor of production which sets them apart from general government taxing or spending activities (e.g. on defence, the judiciary system, the education system); and

(v) they are used as a policy instrument with the purpose of affecting a given or expected outcome of the market process by changing relative prices so as to encourage or discourage certain economic behaviour[3] and/or by changing income distribution.

This broad definition of subsidies exceeds the narrow financial definition of direct transfers to firms, even if the latter is still predominant in empirical studies as it is readily available from national accounts. Instead it encompasses the whole range of forms subsidies can take: grants, credit on preferential terms, tax concessions,[4] equity investments which would not be undertaken by a commercial investor, provision of public goods or services at below market prices as well as public procurement above market prices.

The definition also includes both direct subsidies received directly by the economic actor undertaking the activity to be assisted and indirect subsidies in the form of a higher output price or a lower input price due to subsidies given to other firms or persons in the economy. Subsidies may be paid to the consumer or the producer; their incidence may, however, be quite different from policy intentions depending on demand and supply elasticities in any particular market. Furthermore, subsidies can be linked to gross output, intermediate inputs or primary inputs. They may be directed at traded or at non-traded goods. The economic effect may be quite different in each case.

The broad definition of subsidies will be used for the theoretical analysis. The empirical examples make this definition

1 Prest (1976), p. 65.
2 Bruce (1990), Gerritse (1989), Fritzsche *et al.* (1988).

3 The change in behaviour is the central aspect for example in the subsidy definition of Shoup (1972) for the US Congress.
4 'Tax expenditures' in the American literature.

operational in different ways depending mainly on data availability. Furthermore, competition policy in the Community concerns only a subset of all subsidies which is defined by the Treaties and by a long history of Commission competition policy: details are developed in Chapter 5. To underline the distinction, subsidies which are subject to Community competition policy procedures are called 'State aids'.

3.3. Theoretical economic aspects

Subsidies are an instrument of economic policy to encourage certain behaviour. They change behaviour because they change the relative costs and prices which producers, consumers and suppliers of factors of production face. As the resulting change in the allocation of resources may increase or decrease economic welfare, both domestic and foreign, a thorough understanding of the economic processes set in motion by subsidies is required — but only partially available and only partially uncontested.

The following provides some of the conclusions of economic theory in different analytical contexts: a closed economy under first-best and second-best conditions and the case of an open economy. It also looks at some macroeconomic implications and reviews the political economy of subsidies.

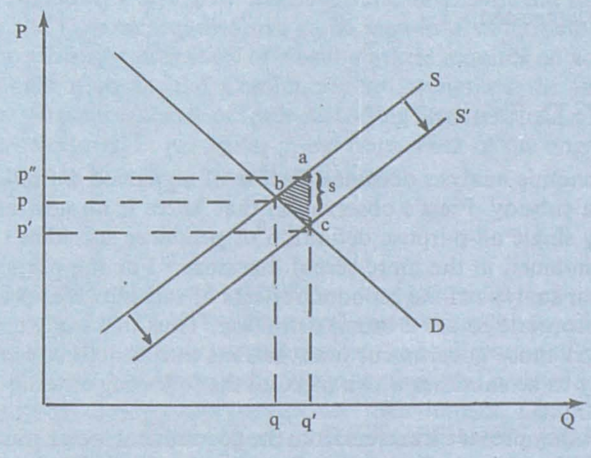
(a) Subsidies in a closed economy under first-best conditions

Traditional microeconomic theory has shown that under a rigorous set of assumptions concerning both consumer preferences and production functions, perfectly competitive markets achieve an allocation of resources which is Pareto efficient and which is only determined by consumer preferences and the production possibilities of an economy. Among the assumptions are that there are no externalities in either consumption or production, no significant increasing returns to scale, large numbers of buyers and sellers in each market and perfect information.[5] In this part it will be assumed that all other markets except possibly the market under consideration are in competitive equilibrium.

There is no mechanism which assures that the resulting income distribution is optimal with regard to a society's values about inter-personal equity. But if, in addition, lump-sum transfers and taxes can be carried out costlessly, then any distributional objective can be obtained without impinging on allocational efficiency. Then distributional effects of a policy instrument can in fact be disregarded. Such a theoretical setting is called first-best (welfare) analysis.

Under the assumptions of first-best analysis and if the market directly affected by subsidies is otherwise undistorted, subsidies can only reduce economic welfare. The competitive markets assure that prices are the monetary measures of the marginal benefits of goods to households and of the marginal costs of production to firms. The equilibrium price and the transacted quantity for each product maximize net social welfare, i.e. total social value minus total social costs. A subsidy for a product lowers the price consumers pay and increases the price producers receive: the transacted quantity increases but the additional utility to consumers is less than the social costs of production: net welfare is reduced.

GRAPH 3.1: **Efficiency loss due to an output subsidy**



Graph 3.1 illustrates this welfare loss for the case of a single market: an output subsidy s shifts the supply curve S to S', the additional social utility is qbcq' whereas the additional social costs are qbaq': the triangle abc represents the ef-

5 For a formal presentation of these assumptions see Debreu (1959), Chapter 6.

ficiency or 'deadweight' loss. Or, from a different angle, both consumers and producers gain: the increase in the consumers' utility — the consumers' surplus — is p'cbp, the producers' surplus is pbap". But together they gain less than the subsidy required, which is p'cap".

This method can also be used to assess the distribution of the costs and benefits of a subsidy: in the example illustrated above both consumers and producers gain, but tax-payers lose. The precise distribution of the gain, i.e. the subsidy incidence, depends on the actual supply and demand elasticities. As these are difficult to determine in practice there is the risk of 'benefit snatching':[6] subsidies mainly intended to benefit consumers may well all end up with producers, if demand elasticities are high and supply elasticities are low. This is why subsidy policy is sometimes considered as 'shooting from the hip'.[7]

While this analysis is simplistic, it illustrates the way subsidies alter market outcome in favour of the subsidized product (for example the consumption of coal by electricity producers), which is one reason why they are widely used as a policy instrument. It also depicts clearly why subsidies may be a threat to economic welfare: subsidized goods are over-produced and over-consumed as compared to an ideally efficient economy. First-best welfare analysis is therefore still widely used as a first approximation for the evaluation of economic policies.[8]

The straightforward conclusion of first-best analysis with competitive markets, that all subsidies are welfare-reducing and thus 'bad' changes when one of its assumptions breaks down and the possibility of market imperfection or 'market failure' has to be considered. The main reasons for market imperfection to be considered in the analysis of subsidies are externalities and public goods, increasing returns to scale and imperfect information. Each factor shall now be discussed in turn. The possibility of imperfect competition *per se*, i.e. the problems of monopolistic or oligopolistic behaviour, are disregarded here as they are mainly addressed by legislation or regulations to enforce competition.[9] The results derived are robust to different market structures as long as market entry is not too restricted. The analysis remains in the realms of first-best, i.e. it still assumes that governments can employ costless lump-sum redistribution and that other markets are not distorted.

(i) *Externalities and public goods*

Externalities are said to be present if an activity undertaken by an individual affects — as an unintended by-product — other individuals without being properly reflected in the competitive market prices.[10] In more formal terms externalities are interpreted as activities of consumers or producers entering the utility functions or production functions of other consumers or producers. There may be consumption externalities, for example the use of a road by one car driver reduces the usefulness of the road to other drivers without a market mechanism to determine pecuniary compensations between them,[11] production externalities, for example the use of river water by one firm as a coolant reduces its value to a similar firm downstream, and production-consumption externalities, for example the pollution of a lake due to a production process reduces its recreational value to consumers. The external effect may be positive ('external economies') or negative ('external diseconomies'). There is also the possibility of intergenerational externalities, for example in the consumption of non-renewable resources.

The ultimate cause of externalities is the absence of markets. This may be due to a lack of enforceable property rights[12] because property rights are difficult to assign (for example for the ownership of the atmosphere)[13] or to enforce as unpaying users ('free riders') are difficult to exclude. If a market could be created the owner would negotiate a market price which would restore efficiency. One approach to the problem of externalities therefore focuses on the creation of missing markets, for example by emission of pollution certificates.

The allocative implication of an externality is that market prices no longer reflect social costs and benefits. A difference arises between the private costs/benefits which determine

6 Wolfson (1990).

7 Gerritse (1989); but he also points out that 'one of the policy-makers in this country ... has contended on several occasions that he'd rather miss six out of ten times than not shoot at all'.

8 See, for example, Ford (1990).

9 For a recent presentation of Community policy to maintain competitive market structures see 'Horizontal mergers and competition policy in the European Community', *European Economy* No 40, May 1989.

10 The externalities considered here are sometimes labelled 'technological externalities' to distinguish them from 'pecuniary externalities' which are reflected in price adjustments.

11 Such cases are typically analysed as public goods problems which will be discussed below as a special case of externalities.

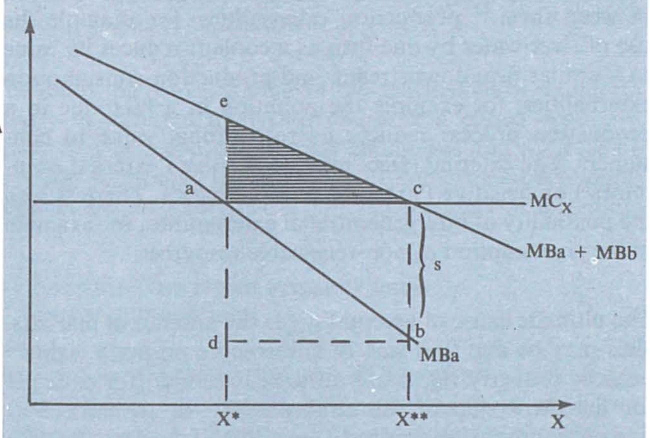
12 Coase (1960).

13 One reason may be the potentially vast distributional implications.

the individual activities and the social costs/benefits which results in an inefficient allocation of resources.

Graph 3.2 illustrates the case of party A emitting a positive externality on party B as a by-product of an activity X (e.g. R&D expenditures of firm A benefit partially firm B). Maximizing his individual net benefits and disregarding the externality A will produce X* which remains below the socially optimal X** where the marginal costs MC_x and total social benefits (MBa + MBb) would be equal. The loss in efficiency is ace.

GRAPH 3.2: **Allocative implications of a positive externality**



If the externalities cannot be remedied by an effective allocation of property rights (for example patent protection in the example mentioned above), Pareto optimal allocation can still be restored by using subsidies to make A profit from the external benefit, i.e. to 'internalize' the externalities. The subsidy s to be paid to A for expanding his activity X beyond X* (a 'marginal' subsidy) is equal to the marginal benefit done to B at the optimum, or bc. The subsidy increases social welfare as the gains to A (adb) and B (aecb) exceed the costs of the subsidy (acbd) by ace. A difficulty is the correct evaluation of the external benefit, and it may in practice also turn out to be elusive to define the reference level of activity (X*) beyond which a subsidy is to be granted.

Subsidies can also be used in the opposite case of external diseconomies: party A, whose river pollution for example reduces the utility of the river for recreational purposes, can be offered a subsidy to reduce this activity. This is done in practice although equity considerations might suggest instead that the 'polluter pays' a tax reflecting the external damage. Both solutions are equal from an efficiency point of view but the distributional outcome differs.[14] Both approaches are confronted with the informational problem of the correct evaluation of the external damage. A subsidy involves the additional difficulty that it encourages additional participation in the damaging activity to cream off the subsidy if entry is not limited.

The case of public goods can be considered similar to the case of external economies: as with an activity causing external economies, public goods jointly benefit third parties, whose number is usually large. Additional users reduce the utility of the existing users only marginally — until congestion starts — and are difficult to exclude. Typical public goods are defence, law enforcement, radio and television. Public goods can in principle be supplied by the State as well as by private enterprises: but private suppliers have to be subsidized for the external economies they cannot capture. A subsidy can restore efficiency analogously to the case illustrated in Graph 3.2 which can be interpreted as, for example, a scholarship granted to a student to internalize the social benefit from his investment in his own human capital or a subsidy to a private firm to run a prison. As the number of recipients of external benefits is large, the problem of correct evaluation of their marginal benefits becomes very difficult to overcome, in particular as individual consumers have no interest in revealing them but try to act as 'free riders'.

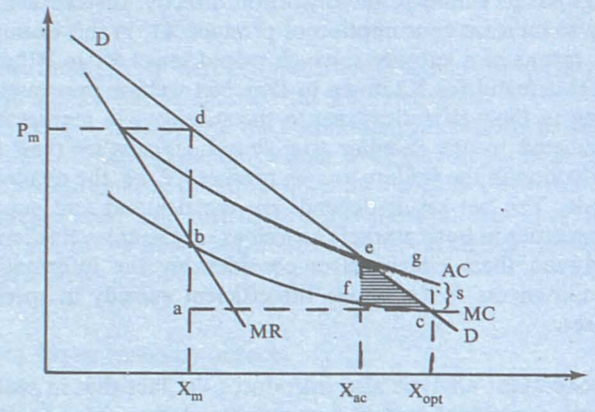
(ii) Increasing returns to scale

Increasing returns to scale in production arise when unit costs fall in the long term along with increasing output. If they cover a large part of output as compared to market demand the entire output is produced by very few firms, in the extreme case by 'natural monopolies'. Examples are activities which require high set-up costs but are then available at relatively low marginal costs: rail services, telephone, electricity, television.

The limited number of efficient suppliers would result in market prices above unit costs and quantities below the social optimum. Government intervention may then improve

[14] This holds only under first-best assumptions; subsidies have to be financed which may introduce other distortions (see below); a tax may on the other hand reduce the number of suppliers.

GRAPH 3.3: Government intervention in the case of increasing returns to scale



efficiency (see Graph 3.3): public regulation to impose price setting at unit costs (X_{ac}) reduces the inefficiency (from cbd to cfe). If the government imposes price setting at marginal costs (X_{opt}) it eliminates the distortion; but in the latter case the enterprise faces unit losses (cg) which would have to be covered by a subsidy s.

The main problem is the correct identification of unit and marginal costs as private firms have an incentive to make exaggerated claims to the regulating authorities. Such activities are therefore sometimes undertaken under public ownership, which may, however, give rise to other efficiency problems.

(iii) Imperfect information

So far perfect information has been assumed about present and future prices of all goods and factors of production. If instead uncertainty is admitted, a number of areas emerge where subsidies may improve efficiency.

To a certain extent risks can be covered by contingency markets such as insurance or futures but no full set of such markets exists.[15] As a result risk-adverse financial markets are biased against activities which involve high risks because they are new or because of long pay-back periods. The actual interest rate for such activities is above the social optimum; as a result such activites are not sufficiently undertaken by the private sector on its own and this could be remedied by subsidization. This argument is often invoked to justify subsidies for 'infant industries'. It requires, however, that governments can make a better assessment of market possibilities than the financial markets and 'pick the winners'.

Information itself can be considered a product whose production creates external economies. It will therefore be insufficiently supplied unless its production is subsidized or publicly provided.

Imperfect information is sometimes invoked in another sense to claim that individuals do not give sufficient preference to certain 'merit goods'[16] whose consumption would 'do them good' in the eyes of decision-makers (e.g. the consumption of Wagner operas). Subsidies are then used to encourage specific consumption. Such reasoning is, however, hard to reconcile with the assumption of consumer sovereignty.

The analysis has so far focused on single markets. Of course the removal of market failure by means of a subsidy has knock-on effects on a whole range of markets: if for example a scholarship internalizes external economies, an individual may spend more on education and less on other consumer goods and this will affect their prices and also the relative prices of factors of production. The methodological apparatus to determine the full new set of prices and quantities is 'general equilibrium analysis'.[17] Under first-best assumptions the reallocation of resources does not introduce new inefficiencies. The arguments presented above therefore do not change.

(b) Second-best analysis

The convenience of first-best analysis, that efficiency aspects of policy instruments can be discussed within the markets affected disregarding the state of the other markets and disregarding distributional issues, evaporates once it is admitted that the government does not dispose of a full set of instruments to assure that the optimality conditions are met in all markets. In other words, if the conditions of optimality are not met in one market due to for example externalities

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[15] Because of high transaction costs and asymmetric information (a principal-agent problem) which creates moral hazards and adverse selection.
[16] Musgrave (1959).
[17] For empirical examples see Chapter 3.4.

or taxes which are not lump-sum and if the government cannot correct for that, the efficiency effects of policies in other markets are no longer unambiguous.

The question then becomes: what are the effects of a certain policy in one market given a specific distortion in another market? As there is potentially an infinite number of such distortions and as the efficiency and distributional effects of a policy instrument are significantly different depending on the form and number of the distortion(s) allowed for, there is no longer a unique normative theory of public policies. The following can therefore only try to highlight some of the implications of the change in the theoretical reference on the conclusions concerning subsidies.

In second-best analysis subsidies offered for a product in an undistorted market may — contrary to first-best analysis above (Graph 3.1) — actually improve total welfare if they help to reduce a distortion in another market. The real world, 'a distorted world of imperfect competition and market failure',[18] may thus be improved by countervailing distortions.

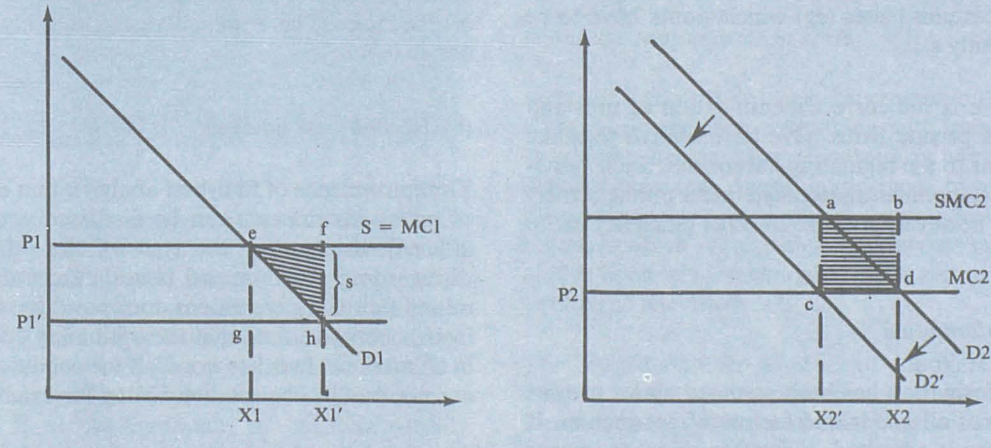
A simple example is shown in Graph 3.4: it depicts two markets for goods X1 (transport by bus) and X2 (individual transport)[19] which are supposedly substitutes. X2 causes external diseconomies and its social marginal costs SMC2 therefore exceed the market price P2. In second-best analysis it is assumed that the government has no instrument at its disposal to eliminate the distortion directly. Instead it may try to increase consumption of product X1, in this example by means of a subsidy s, which would lower P1 to P1' and shift demand for X2 down to D2'. Net welfare improves as long as the welfare loss due to the subsidy s in market X1, indicated by the familiar triangle efh, is smaller than the reduction in the welfare loss on market X2, i.e. the quadrant abdc. The net result depends on the demand and supply elasticities in both markets as well as on the cross elasticities between them which raises considerably the information requirements to determine the efficient subsidy in specific cases.

Second-best analysis also introduces the fact that in reality taxes can rarely be lump-sum. Instead governments must use distorting unit taxes on consumer goods and production

[18] Wolfson (1990), pp. 111 and 112.

[19] All other markets are assumed to be in equilibrium.

GRAPH 3.4: **Effect of subsidies in one market given a distortion in a substitute market**



factors for financing expenditure. An analysis of the welfare effects of subsidies therefore has to take the additional distortions created by their financing into account. The real income costs of raising the tax revenue may, according to some estimates, be twice the revenue due to the distortional and administrative costs associated with raising the tax revenue.[20]

Furthermore, if there is a distortion, income distribution can no longer be disregarded in the determination of welfare effects. A subsidy and the additional tax required to finance it may bring an economy closer to or further away from the distributional optimum defined by a society's distributional preferences. The distributional welfare effects have to be added to the allocational effects to determine the net result of a policy.[21]

(c) Open economy aspects

The analysis presented focused on the domestic economic effects of subsidies. But the high and growing degree of economic integration in the Community and in the world economy requires additional consideration of the effects of subsidies in an international context.

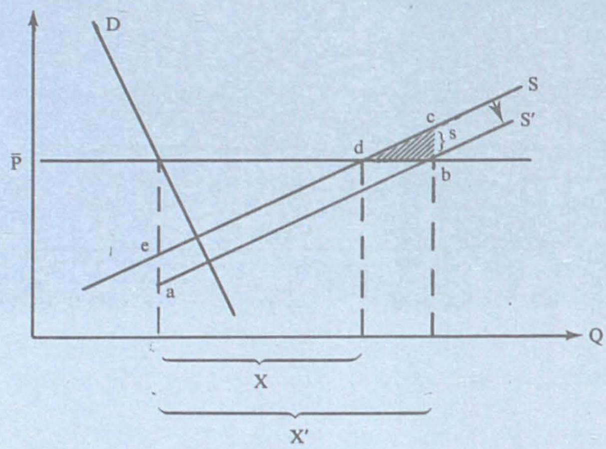
Main questions to be considered here are: what are the effects of a subsidy in an open economy, what are the effects on a trading partner and on the world economy, and what is the efficient reaction if a trading partner introduces a subsidy?

The following presents some theoretical approaches often used for such questions. It cannot aspire to any degree of completeness given the wide variety of cases distinguished by the number of countries and products, the consideration of domestic and/or trade distortions, the degree of factor mobility, the relative sizes of the countries involved, etc.

Traditional normative trade theory concludes that under the assumptions of the first-best welfare framework presented above, free trade will result in an efficient international division of labour determined by comparative advantage. The discussion of subsidies against such a setting first has to consider the existence of market failure: as shown above market failure (e.g. external effects) may actually require a judicious set of distortion-correcting subsidies (or taxes) to achieve efficiency; of course the other factors, i.e. the political costs of subsidies, the distortions introduced by the additional taxation and — in an international context — the threat of retaliation (see below), still have to be taken into account.

In the absence of market failure traditional trade theory concludes that subsidies are an instrument of protectionism equivalent to tariffs distorting the international division of labour. National and global welfare are reduced, but total welfare of the trading partner may well be enhanced.

GRAPH 3.5: **Effect of an export subsidy on domestic welfare**



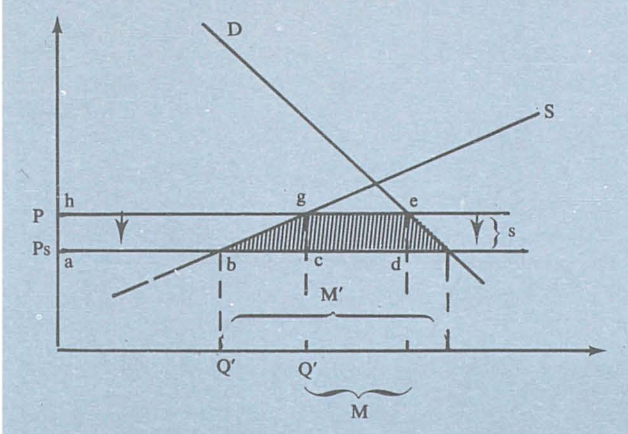
This can be illustrated. Graph 3.5 depicts the partial-equilibrium situation of one exported product in a small country (i.e. the world market price $\bar{P}$ is fixed): given its demand D and supply S it exports the quantity X. If the country decided to stimulate exports by means of an export subsidy s, exports would increase to X′, the producers' surplus would increase by abde but, given the cost of the subsidy of abce, domestic welfare would be reduced by bcd. Choosing a domestic subsidy instead of an export subsidy would cause the same efficiency loss but the transfer to domestic producers would be even higher.

If the additional exports are significant in relation to world demand, the world market price of the exported product

[20] Munk (1989), p. 80.
[21] Munk (1977) for example shows the impact of alternative sources of government revenue on optimal public sector pricing.

falls; this deterioration in the terms of trade further reduces domestic welfare. The case of a reduction of imports by subsidizing domestic production is equivalent. Thus, in the absence of market failure, the use of subsidies to improve the balance of trade is welfare-reducing. In addition the effects on the trading partner have to be taken into account.

GRAPH 3.6: **Effect of an export subsidy on importing country**



These are illustrated in Graph 3.6 for a small importing country: due to the subsidization by the exporting country, the border price of the importing country falls from P to Ps; its domestic production falls from Q to Q′ while imports increase from M to M′. Domestic producers are the losers (producers' surplus falls by abgh) but for the economy overall these losses are more than compensated by the gain for consumers (adeh) which consume more at a lower price; consumers here include downstream producers which use the imported product as an input for their production.

The analysis highlights the potential conflict of interest between producers, consumers and tax-payers: it is producers who benefit from domestic subsidies or suffer from subsidization of foreign production; the impact on consumers, tax-payers and on the economies overall may be quite different. The political theory of protectionism stresses along similar lines as the political theory of subsidization (see below) that commercial policy is often determined by producers' interests rather then by the aggregate national interest. One indication for that is that actual GATT rules on subsidies and countervailing duties (see Chapter 8) indeed focus on material damage to producers rather than to the economy overall.

If then an importing country wants to protect its producers from the effects of a foreign subsidy, it may for example charge a countervailing duty on the subsidized imports. This would not only restore domestic production but also result in a transfer from the foreign to the domestic tax-payer. The consumers would, however, lose the advantage of the cheaper imports and the economy overall would be worse off than with no reaction at all. If countervailing duties are not available (as in the European Community), the importing country may decide to counter-subsidize domestic producers: while that would put domestic producers on an equal footing with their foreign competitors, a counter-subsidy would add a domestic distortion.

In both cases the intention of the export-subsidizing country would be frustrated which is likely to induce additional efforts from that country and probably further counter-measures. Each round in that process of 'bidding up' introduces additional distortions and reduces global welfare. Pressures from domestic producers may not be the only reason for governments to take counter-measures: in the absence of international coordination counter-measures may provide governments with a 'bargaining chip' to persuade other governments to abstain from subsidization. But effective international supervision is a clearly superior approach.

The arguments so far refer to a situation of no market failure. But modern trade theory recognizes that increasing returns to scale and the associated imperfect competition explain an important part of trade between industrialized countries. For such goods a 'strategic trade policy', which exploits the returns of scale in its domestic production through tariffs and subsidies and deters foreign competitors from entering the market, may in fact increase national welfare by shifting profits from abroad to the home industry. Global welfare is still reduced.

This case is often illustrated with the Airbus/Boeing example:[22] assume that Airbus and Boeing have identical cost structures to produce a specific aircraft and that the global market is profitable for either firm if it enters alone, but unprofitable for both if both enter. If Boeing has a head

[22] Krugman (1987), p. 135.

start to commit itself to production before Airbus, it will be the only supplier and reap large profits. Europe's governments can change the outcome if they offer a subsidy to Airbus sufficient to make Airbus enter the market even against the Boeing competition. Boeing will then be deterred from entering,[23] and the Airbus subsidy will shift all of the profits from the USA to Europe.

Thus modern trade theory indeed acknowledges that in some cases 'sophisticated government intervention' in international trade can increase domestic welfare. But it also highlights the economic difficulties of effectively implementing such a policy: the required information is difficult to obtain, new foreign firms may enter the market and dissipate the national gain from intervention and there is the risk — as other domestic sectors always suffer from the subsidization of one sector — that there will still be an overall loss in national welfare, if the government does not pick exactly the right sector.

(d) Macroeconomic aspects

As the aggregate expenditure on subsidies in many countries amounts to a quite significant share of government expenditure and GDP (see Chapter 4), the effects of subsidies also have to be considered from a macroeconomic point of view. In very general terms subsidies can be regarded as an instrument of fiscal supply-side policy which initially reduces inflationary pressures and stimulates economic activity, similar to a reduction in the taxation of enterprises. The longer-term impact then depends on the kind of subsidy granted (output, factor specific, export), the way of financing it (higher deficits and/or increases in taxation), the reaction of the subsidized enterprises (higher profits and/or reduction in prices, increases in output, additional investment and employment), of the employees (higher wage claims), of savings (which may increase to compensate for higher deficits), of monetary policy (accommodating or not, thus influencing the effect on interest rates) and the exchange rate.

To illustrate the different factors determining the macroeconomic effects of subsidies one may sketch a specific example: the introduction of employment subsidies, i.e. transfer payments to enterprises according to their wage bill or the number of persons employed. On the supply side such subsidies directly reduce labour costs and increase profits inducing reduced prices, higher real output and employment; more exports and less imports can also be expected. In addition employment would in the medium term benefit from a substitution effect as it replaces other, now relatively more expensive factors of production. Employment subsidies lower labour costs without directly affecting the remuneration of labour; the reduced unemployment and the possibility of higher taxes to finance the subsidies are, however, likely to increase wage pressures.

The effects on the demand side depend on the financing of the subsidies: their direct budgetary impact is very likely to be negative, even if it is attenuated by additional revenues and reduced expenditures due to higher economic activity and lower unemployment. The budgetary costs can either be allowed to increase the public deficit or have to be covered by higher taxes or cuts in other public expenditures. Higher deficits add an element of deficit spending to the effect of the subsidies; higher private saving, crowding out of private investment and pressures on the exchange rate have to be taken into account. Higher taxes negate much of the stimulating effect of subsidies, although the substitution effect may still favour employment. Another aspect is the development of the trade balance which will initially improve at the expense of the trading partners. The longer-term effects depend on their reaction and on a possible adjustment of the exchange rate.

(e) The political economy of subsidies

It has been shown above that the use of subsidies as a policy instrument may hurt economic welfare and have serious international repercussions. Why then are subsidies so widely used? A positive explanation of actual subsidy decisions is attempted by the theory of public choice or the political economy of protection.[24] It recognizes explicitly that subsidies are granted and administered by a political process in which the actors, politicians and administrators are not neutral but act according to their own preferences and the constraints they face. The non-neutrality of the public sector adds further distortions sometimes labelled 'government failure' in analogy to 'market failure'.

If subsidy decisions are an endogenous result of a political process it becomes part of the profit maximization effort of enterprises to invest resources to obtain subsidies. Politicians may be susceptible to such 'rent-seeking'[25] because selective aid to industry may be an effective tool for maximizing the 'popularity function' of governments[26] if used to support

[23] Unless Boeing in turn obtains subsidies which will make both firms stay in the market at profits below the subsidies with a net loss for both economies.

[24] For an overview of the various theories concerning the political economy of protection see Baldwin (1984).

[25] Krueger (1974).

[26] Burton (1983).

enterprises in marginal constituencies. The costs can be 'hidden' in the complexities of a modern tax system. The asymmetry that subsidies typically raise the welfare of small groups by large amounts, while spreading the costs across larger, more diffuse groups, which are more difficult to organize, provides a steady bias towards excess subsidization.

One implication of rent-seeking is that the budget constraint for enterprises becomes 'soft':[27] it is no longer determined by market forces but by a bargaining process with the government. The resulting pattern of subsidization will depend strongly on the bargaining power of the enterprise or sector concerned: big enterprises, politically strategic regions, powerful industrial organizations are more likely to extract subsidies than small or newly established enterprises.

Furthermore, the information whose essential importance for the evaluation of subsidies has been shown above is to some extent provided by the potential recipient and thus subject to a 'principal-agent' problem : the agent (a potential recipient) may be tempted to inflate its cost estimates to extract a higher subsidy. The principal (a politician or a civil servant) in charge of the policy may have neither the resources nor the incentive to probe into such claims.

Proposals have been made to make the political process more responsive to the preferences of society overall and thus to reduce the risk of built-in excess subsidization: they range from more stringent requirements for parliamentary majorities to grant subsidies (for example two-thirds), a stronger role for the administration as compared to the legislature in determining the details of subsidy policy, to the institution of an international arbiter further removed from national interest groups.

The existence of market failure is thus a necessary but not a sufficient condition for a subsidy to be welfare-improving : the costs of rent-seeking, the administrative costs of implementation and enforcement of government policies, inefficiencies due to imperfect information of government and distortions due to inappropriate incentives for policy-makers and administrators also have to be taken into account.

3.4. Empirical studies

While theoretical analysis is able to identify factors and mechanisms for the evaluation of the economic effects of subsidies, it is for empirical analysis to shed light on the actual costs and benefits of specific subsidies. In spite of the large number and volume of subsidies employed in the European Community (see Chapter 4) and elsewhere there is, however, remarkably little empirical analysis of their effects. This may be due both to the lack of transparency of the various forms of subsidies and to rather limited pressures for justification of subsidies. While the former has been significantly reduced in the European Community with the first and second surveys on State aids (see Chapter 4), the latter is growing with the integration of the Community and the world economy (see Chapter 8).

There are empirical studies which look at the impact of subsidies either by correlating them with sectoral performance, or by means of a partial or a general equilibrium model. General equilibrium models are also used to measure the impact of total subsidization. In addition there are studies on the macroeconomic effects of subsidies on the basis of macroeconometric models.

The most straightforward studies only try to verify whether subsidies at least went along with improvements regarding their primary objectives without looking at efficiency losses. They confront a measure of subsidization with the development of output, employment or observed competitiveness of the recipients.

In one such study Soltwedel *et al.*[28] look at the development of the textile and the shipbuilding sectors in several Member States during the first half of the 1980s. In that period both sectors underwent substantial restructuring which was accompanied by various forms of public intervention. In the textiles industry subsidization reached a significant degree in Belgium (up to 1 % of value-added) and France (up to 2,9 %); nevertheless both countries were unable to expand their share in intra-EC trade. In shipbuilding subsidization was much higher: France and Italy subsidizing up to 50 % of the production costs of ships, Denmark, the Netherlands and the United Kingdom up to 30 %, Belgium and Germany some 20 %.[29] With regard to production or export shares there appears to have been a positive impact of new subsidy measures in the first year; but in the longer term subsidization and production share even appear to have been negatively correlated.

Such an approach can serve as a quick first impression of the performance of subsidized activities : if performance does not improve in spite of the subsidization this may indicate the need for a policy review. Its usefulness is, however, very

[27] Kornai (1979); this argument is often used to explain enterprise behaviour in administered economies.

[28] Soltwedel *et al.* (1988).

[29] Indicative orders of magnitude; actual subsidization varied widely depending on the nationality of the purchaser and the construction year.

limited as it does not permit the isolation of the role of subsidies from other factors nor, as there is no reference solution, any estimation of what would have happened without the subsidy.

A rather recent approach tries to model particular industries to quantify the effects of trade and industrial policies under imperfect competition due to economies of scale.[30] The approach is partial equilibrium, i.e. all other sectors are assumed not to be affected. The model is 'calibrated' to a particular industry using actual performance of a specific year, for example, production, imports, number of domestic firms, domestic market shares in addition to estimates for cost functions and demand elasticities from various industry studies, and choosing the remaining parameter values in such a way that the model reproduces the actual results.[31]

Venables and Smith[32] use this approach to quantify the effects of tariffs, export subsidies and domestic producer subsidies in the cases of the refrigerator and footwear industries in the United Kingdom in 1982. They explicitly allow for the number of brands per firm and the number of firms to vary.

In the case of the refrigerator industry, a 10 % export subsidy is calculated to slightly reduce domestic but to improve foreign welfare, if the number of firms and brands is fixed. If they are allowed to vary, domestic firms increase the number of brands and thus increase domestic sales as well. As a result net domestic welfare actually increases (by 1 % of base consumption), foreign welfare is reduced but global welfare enhanced.

A similar government expenditure for a 1,5 % domestic production subsidy improves domestic welfare already with a fixed number of firms and brands as lower prices induce higher domestic consumption. Again domestic welfare is further enhanced when additional brands are permitted (to 1,4 % of base consumption). Foreign welfare is reduced in any case, but global welfare gains. It may be interesting to note that producers gain relatively more from the export subsidy, whereas consumers would prefer the domestic subsidy. In the footwear industry where economies of scale are smaller the results are equal in principle but the domestic welfare gains from export or producer subsidies are smaller.

Such models are useful illustrations for the quantitative implications of countering a 'distortion' — in this case economies of scale — with a counter-distortion: subsidies. Its main weakness is that it is partial equilibrium, i.e. the secondary effects on other markets, in particular the factor markets, are not taken into account: other, not subsidized, sectors which may also have economies of scale, would be negatively affected, and may in addition have to face the retaliation from the rest of the world. The welfare costs of taxation to finance the subsidies and the general costs of 'government failure' also have to be taken into account.

A model developed to capture the interaction between the different sectors of production and factor supplies is the computable general equilibrium model Orani.[33] This model attempts to capture the efficiency effects of industrial policies and to calculate their macroeconomic impacts on GDP, employment, the trade balance, etc. As in the partial equilibrium studies above, the parameter values of the model are chosen to reflect a specific economy in a reference year. A key element of this model is detailed input-output tables; in addition specific regions and/or categories of labour can be explicitly specified. The analysis is comparative static.

The Centre for International Economics of Australia has applied such a model to estimate the 'Costs of coal industry assistance in West Germany'.[34] They estimate that the German coal industry benefited in 1987 of direct and indirect financial aid and of price support worth DM 10,6 billion ('producer subsidy equivalent'). Removing the price support would result in an increase of German GDP by DM 38 billion and a net employment gain of 157 000. The fall in electricity prices would benefit all sectors of the economy and allow exporting industries to expand their production, in particular iron and steel, electrical engineering and mechanical engineering.

Gerken *et al.*[35] use such a model to compare the costs of different policies to stabilize the employment of unskilled labour in German regions affected by a 10 % decline in world market prices for steel. They find that a subsidy on steel production of 2,1 % could achieve that objective at an annual budgetary cost of DM 2,5 billion. Other sectors and regions profit from the lower steel prices, but if additional taxes are introduced to finance the subsidy, aggregate output declines by 0,12 %. Furthermore, the sectoral subsidy prevents restructuring in the region concerned which makes it likely that the subsidy has to be paid permanently. An alternative measure would be a regional wage subsidy: the

30 Developed by Dixit (1984) and Baldwin and Krugman (1986).
31 Krugman suggests calling this method of quantification 'Industrial policy exercises calibrated to actual cases', Venables (1986), p. 661.
32 Venables (1986).

33 Developed by Dixon *et al.* (1982).
34 Centre for International Economics (1990).
35 Gerken *et al.* (1986).

objective of maintaining the level of unskilled employment could then be achieved at annual budgetary costs of DM 0,7 billion, the lower costs mainly due to directly stimulating employment across all sectors of the region. Furthermore, when capital shifts away from steel production to other sectors, the expenditure on subsidies can be further diminished to DM 0,04 billion.

On one occasion such a model has been used to calculate the effects of abolishing all subsidies in Germany. Weiss *et al.*[36] estimate that a removal of all subsidies combined with an equivalent reduction in taxation would increase German GDP by 0,9 % and provide additional employment for low-skilled as well as for high-skilled labour by 2,2 % and 1,6 % respectively. Behind these aggregate results lies a far-reaching restructuring of German production with dramatic production decline in agriculture, food processing, coal and aerospace and expansion in electrical and mechanical engineering, consumer goods and construction. The overall capital intensity of production, currently artificially elevated due to the subsidies, would decline.

These models are useful tools in particular to analyse the sectoral interaction and to compare the costs of different forms of government intervention. They still do not capture the administrative costs and the international repercussions of intervention. The results depend strongly on the parameters chosen, some of which can be estimated but which cannot be rigorously tested. Furthermore, they assume that resources can be costlessly re-employed in other activities. The model also makes it difficult to distinguish between the efficiency gains from a reallocation of resources and the macroeconomic effects.

The macroeconomic impact of subsidies may be estimated with macroeconometric models. Such models specify the behavioural equations for both the demand and the supply side to different degrees of detail and estimate behavioural parameters with econometric techniques. A broad range of macroeconomic models is widely used for macroeconomic forecasts and policy analysis.

Whitley and Wilson,[37] for example, use the 'Cambridge growth project multisectoral dynamic model' to estimate the effects of general employment subsidies, i.e. a reduction in the social security contributions, and of marginal employment subsidies, i.e. subsidies granted only for additional jobs created. Marginal employment subsidies have been advocated in the early 1980s to combat rising unemployment.[38] The United States of America, the United Kingdom and Ireland have at some point in time offered such schemes.

Whitley and Wilson find that a marginal employment subsidy of 33 % of average earnings would indeed induce higher employment which would reach 0,3 % after six years. The main gains would be in labour-intensive sectors like distribution and miscellaneous services. The budgetary costs would be an increase in the budget deficit of 0,2 % of GDP, the balance of trade would deteriorate — due to a rather low export price elasticity — by 0,1 % of GDP, but the price level would remain significantly below the reference level (−0,4 %). If instead general employment subsidies were used with the same initial budgetary costs, the improvement of employment would be somewhat smaller (+0,2 % after six years) with a similar deterioration in the balance of payments and a reduction in the price level. Given the high costs of administering and policing a marginal employment subsidy scheme, the authors remain sceptical as to whether a complex marginal scheme would be preferable to a more straightforward cut in employers' national social security contributions.

3.5. Outlook for future research

The economics of subsidies are not a widely researched subject. While the welfare implications in traditional first-best welfare and foreign trade models are well developed, this is far less the case with regard to second-best. More general equilibrium analysis is required therefore to improve the understanding of the effects of subsidies on efficiency and distribution given various distortions both in domestic and in foreign markets. This should facilitate the choice of the most efficient instrument to achieve different policy objectives. Furthermore, the analysis of subsidies is mainly static. The dynamic implications of different kinds of subsidies on innovation and technical progress require further analysis.

With regard to the political economy of subsidies and protectionism, an interesting question concerns the reduction of 'government failure': what political decision-making and administrative structures are best able to implement public preferences and to minimize administrative costs? Concerning the international spill-overs of national subsidy decisions there is also the question of the best division of responsibilities between the national, the Community and the global level.

[36] Weiss *et al.* (1988).
[37] Whitley (1983).
[38] See, for example, Layard (1980).

The prerequisite for empirical research is transparency. With regard to the European Community transparency has greatly improved with the availability of the first and second surveys on State aid in the Community (see Chapter 4). This should now provide a reasonable database for empirical research. Research could still be useful into the different national subsidy statistics to better understand the different definitions and measurement concepts applied. The annual report on government aids in EFTA countries could develop into a similarly comprehensive source of information. For other industrialized and newly industrialized countries transparency still needs considerable improvement.

Empirical research could expand in two directions: on the one hand there is a need for comprehensive cost/benefit-analysis of various forms of subsidies and even individual subsidy cases both to improve the understanding of the relative importance of different factors for the evaluation of subsidies and to improve the rationality of actual decision-making processes. On the other hand, given the data now available on subsidies in the EC, it should be possible to extend the so far mainly national general equilibrium models to explicitly include several Member States. This would make it possible to illustrate the cross-border spill-overs of subsidies and of other instruments of public intervention.

3.6. Conclusions

Economic theory shows how subsidies and the taxes required to finance them often introduce distortions and therefore welfare losses into the domestic and the global economy. Additional distortions are caused by rent-seeking, administrative inefficiencies and international retaliation. It also shows, however, that in the presence of market distortions adequate subsidies can actually restore efficiency. Furthermore, in other cases subsidies may be the instrument with the smallest efficiency losses to realize given distributional preferences.

A rational decision on subsidy policy therefore requires a careful empirical evaluation of the case at hand. The onus of proof still lies heavily on the advocates of subsidization. While there is no consensus on an optimal norm for subsidy policy, a policy rule of no subsidies except under the most convincing circumstances may still be the efficient 'rule of thumb'.[39]

[39] Krugman (1987).

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Chapter 4

Trends and patterns of State aid

4.1. Introduction

In two surveys[1] published in 1989 and 1990, the Commission attempted to quantify the aids granted by Member States between 1981 and 1988. These surveys did not cover the whole range of measures which could come under the definition of subsidies proposed in Chapter 3, but only the subset of measures which constitute State aids and are subject to Community rules in the sphere of competition or transport policy (see Chapter 5). The appendix to the present chapter summarizes the sources and methodology used in the surveys and draws attention to the main limitations of the data. These limitations should be borne in mind when reading this chapter.

The second survey found that in the period 1986-88 State aids to all sectors amounted to ECU 82 billion per year and thus represented 2,2 % of the Community's GDP, ranging from a high of 4,1 % in Luxembourg to a low of 1 % in Denmark and the UK. Aids accounted for 4,5 % of total general government expenditure in this period, again with the highest percentage in Luxembourg (7,6 %) and the lowest in Denmark (1,7 %) (see Graphs 4.1 and 4.2). Clearly, therefore, State aids are of macroeconomic significance in all Member States, even though aid levels vary considerably between them.

A sectoral breakdown of the aids shows that manufacturing took 41 %, transport (mainly railways) 30 %, the coal industry 16 % and agriculture/fisheries 13 %. It should be noted, however, that aid for transport other than by rail is inadequately covered by the surveys and that the coal industry is the only part of the energy sector included in the data.

Graph 4.3 shows the evolution of the amounts of aid granted by Member States (excluding Spain and Portugal) from 1981 to 1988. It shows that, in real terms, both total aid and the amount granted to manufacturing increased up to 1984 and then began to decline, with a particularly sharp fall in 1986, followed by a return in 1988 to nearly the same level as in 1986. Aid to the railways has slowly declined while aid to the coal industry and agriculture was quite stable in real terms over the whole period. The growth in the total volume of aid up to 1984 is perhaps a reflection of the fact that real GDP growth in the Community was sluggish during this period, and the decline from then until 1987 may be largely attributable to faster economic growth. The upturn in State aids in 1988 does not follow this pattern. Indeed, GDP growth, which had been steadily gaining momentum through the 1980s, accelerated sharply in that year and other indicators, such as unemployment rates and gross fixed capital formation, also showed marked improvements.

Although it is not possible to say on the basis of data for one year[2] that the post-1984 trend in State aids has been reversed, there is clearly a continuing need for strict control at the Community level and self-limitation at the national level.

4.2. Manufacturing industry[3]

(a) The volume and evolution of State aid to manufacturing

In the period 1986-88 aids to manufacturing identified by the second survey amounted to ECU 33 714 million per year, or about 1 % of GDP and 4 % of gross value-added in manufacturing.

Table 4.1 relates the aid granted in each Member State to several economic indicators. From this table it can be seen that by most measures aid was highest in the countries which are wholly or in large parts lagging behind the rest of the Community in their economic development (Greece, Spain, Ireland, Italy and Portugal). However, it is also noteworthy that aid per person occupied in manufacturing was very high in Belgium.

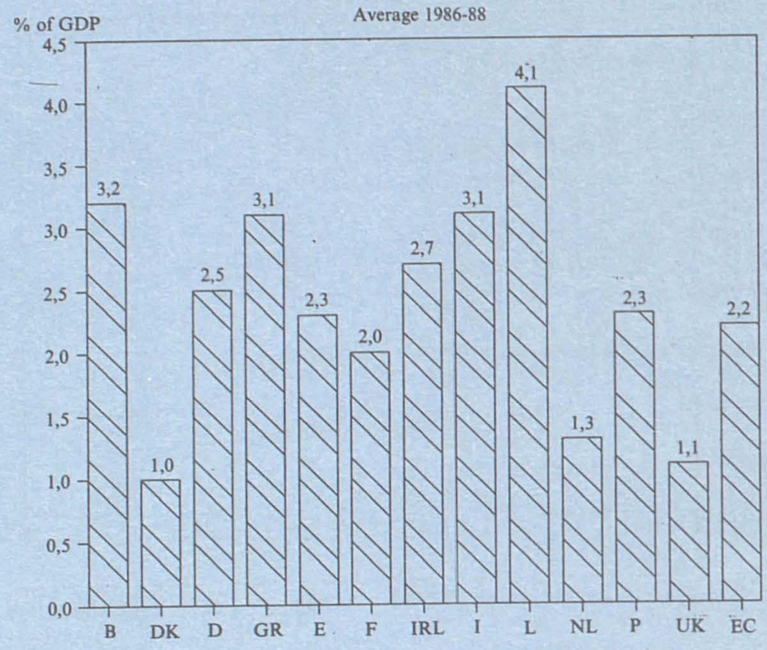
Table 4.2 below compares the average yearly amounts given as State aid to manufacturing in the periods 1981-85 and 1986-88. From this table it can be seen that the volume of aid in EUR 10 has declined in real terms by 25 %. The lowest point was reached in 1987 but the following year saw an increase of almost 14 %. The 1988 level was still well

[1] Commission of the EC (1989) and (1990). These are the main sources of the information contained in this chapter.

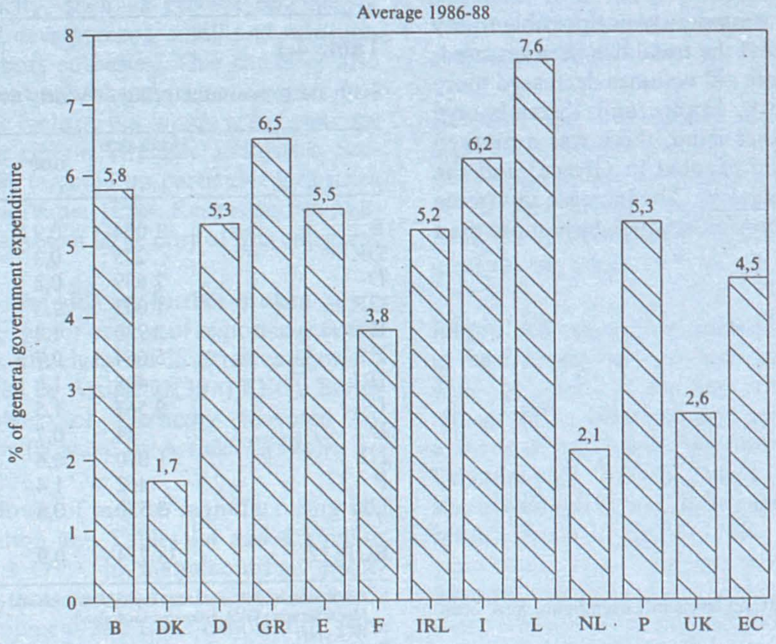
[2] The interpretation of the 1988 data is also made difficult by the fact that some of the figures had to be extrapolated from 1987 because of lack of information on actual expenditure.

[3] A small, but unknown, proportion of the aid considered here as going to manufacturing was in fact granted to the service sector. In what follows it is generally assumed that this proportion is negligible.

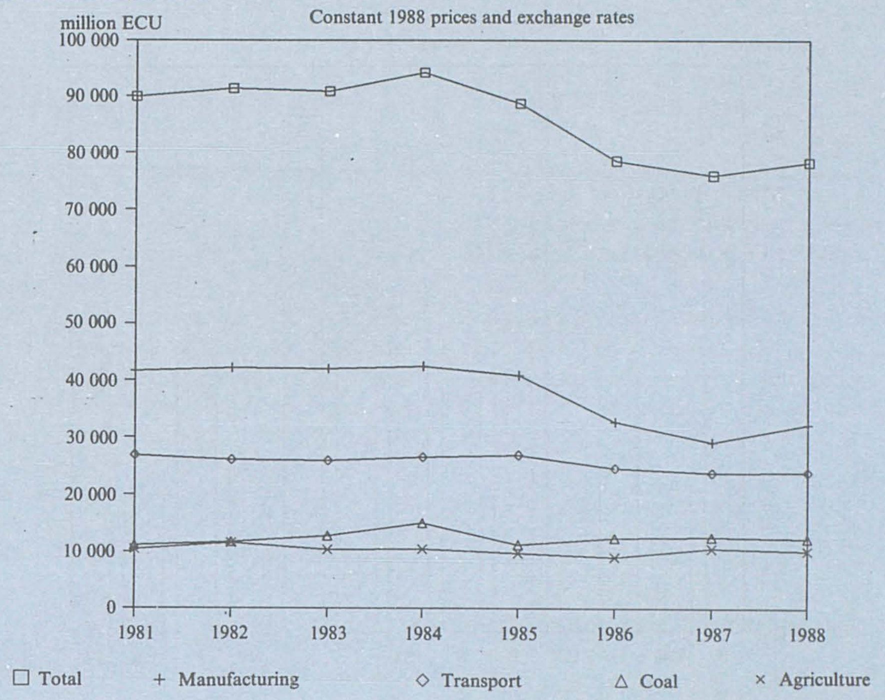
GRAPH 4.1: **Total aid as % of GDP**



GRAPH 4.2: **Total aid as % of government spending**



GRAPH 4.3: **State aids in EUR 10, 1981-88**



below that of 1981-85 and it is obviously not possible to say on the evidence of one year that the trend has been reversed. Table 4.2 also shows that State aid volumes decreased more sharply in Belgium, Denmark, France and Luxembourg[4] than the average. On the other hand, there was a marked increase in the amount of aid granted in Greece[5] and the German level declined by only 5 %. The increase in Greece is mainly attributable to regional aids, which have more than doubled.

[4] It should be noted, however, that aid levels in Luxembourg have been very erratic.

[5] There is, however, some doubt about the accuracy of the data for Greece.

Table 4.1

State aid to manufacturing — yearly averages 1986-88

	Million ECU	% GDP	% of GVA[1]	% GFCF[1]	ECU per person employed[1]
B	1 054	0,9	4,3	19,0	1 437
DK	275	0,3	1,9	5,5[2]	519
D	7 639	0,8	2,7	15,7	963
GR	1 043	2,5	15,8	n.a.	n.a.
E	2 930	1,2	4,9	n.a.	1 207
F	5 664	0,7	3,7	17,5	1 253
IRL	408	1,6	6,1	35,0[3]	1 947
I	9 563	1,5	6,3	27,7	1 900
L	34	0,7	2,5	10,5	892
NL	1 070	0,6	3,2	10,6[2]	1 182
P	462	1,4	5,3	28,4[2]	568
UK	3 570	0,6	2,6	15,2	666
EUR 12	33 714	0,9	3,8	n.a.	1 147[4]

[1] Gross value-added, gross fixed capital formation and occupied population in manufacturing. Manufacturing GVA estimated for Ireland.
[2] 1986 only.
[3] Average of 1986 and 1987.
[4] Excluding Greece.

Table 4.2

Aid to manufacturing — annual averages at constant 1988 prices and exchange rates

(million ECU)

	1981-85	1986-88	% change
B	1 739	1 074	−38
DK	462	286	−38
D	8 219	7 827	−5
GR	802	1 097	+37
E	—	3 154	—
F	8 804	5 743	−35
IRL	18	411	−21
I	14 421	9 898	−31
L	116	35	−70
NL	1 281	1 092	−15
P	—	485	—
UK	5 483	3 880	−29
EUR 10	41 846	31 342	−25
EUR 12	—	34 981	—

(b) Breakdown of aid by objectives or sectors

The first and second surveys classify aids to industry in three main groups: horizontal, particular sectors and regional. Horizontal aids include those schemes which have no sectoral or regional specificity, such as general schemes of support for research and development, small and medium-sized enterprises and export subsidies. This category also includes general investment aid schemes which are not formally targeted on specific sectors, but which are in practice sometimes used to favour certain 'strategic' industries. Sectoral aids include schemes targeted on particular industries and also *ad-hoc* aids for individual firms. Rescue and restructuring aids therefore constitute a large part of this category.

Within each main group, the aids are further broken down according to the objective, sector or type of region concerned by the measure. Regions are classified in three categories: the least favoured (covered by Article 92(3)(a) EEC), Berlin and the 'Zonenrandgebiet' of Germany (covered by Article 92(2)(c) and others (covered by Article 92(3)(c)).

Table 4.3 gives a breakdown of aids to manufacturing according to this classification and Tables 4.4 and 4.5 relate these data to GDP and GVA in manufacturing. From Table 4.3 it can be seen that, among the horizontal objectives, research and development and trade/export aids were the largest sub-categories, closely followed by schemes of support for small and medium-sized enterprises.

In the sub-category 'Other objectives', large amounts of aid were given by Belgium, Germany and Italy. In Germany, environmental protection and energy saving accounted for 60 % of this aid, but in the other two countries most of the aid falls into a miscellaneous class which is not further defined.

It will be noted that sectoral aids accounted for very high proportions of the total in Spain and France. In the case of Spain, 40 % of the sectoral aids went to steel and shipbuilding, since that country was not subject to the full rigour of Community controls on aid to these sectors during the period under consideration. However, the Community rules became fully applicable to the Spanish steel industry after 1988. Exceptional rules continue to apply to Spanish shipbuilding until the end of 1991. Very large reductions in Spanish aid to these sectors can therefore be expected from 1989 onwards. As far as France is concerned, steel and shipbuilding accounted for only 20 % of the sectoral aids and the high volume of aid in this category is mainly attributable to two large rescue operations in other sectors.

Regional aid accounted for 36 % of the Community total, 16 % for the least favoured regions and 20 % for the others.

(c) Horizontal aid schemes

Among the horizontal aid schemes, the most important sub-categories in terms of expenditure are, in order of importance: research and development, export and trade promotion and support for SMEs.

Research and development aid accounted for 10 % of the total aid to manufacturing in 1986-88, an increase of two percentage points by comparison with 1981-86 (the period of the first survey). In addition, Community support for R&D amounted to ECU 505 million per annum in the period 1986-88, about 15 % of the total national aid.

Export and trade promotion represented 9,6 % of the total in the same period, a considerable reduction by comparison with the period of the first survey, when it accounted for almost 14 %. However, the level remained rather high for a form of aid which has important implications for the Community's external trade relations. Table 4.6 below shows that the reduction in export subsidies was mainly the result of cuts in France, Italy and the UK but that there were increases, in nominal terms at least, in several other Member States, notably Ireland. The table also indicates that these subsidies represented a significant proportion of the value of the industrial extra-Community exports of Ireland, France, Italy and Greece. In relation to Greece, it

Table 4.3

Aids to manufacturing by objective or sector — yearly averages 1986-88, in million ECU

(% of total in brackets)

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EUR 12
Horizontal objectives	714	200	2 623	429	366	2 629	193	3 051	15	840	299	1 222	12 581
	(68)	(73)	(34)	(41)	(12,5)	(46)	(47)	(32)	(44)	(79)	(65)	(34)	(37)
Innovation/R&D	90	111	1 300	61	162	496	19	486	2	245	8	350	3 330
	(8,5)	(40,4)	(17)	(5,9)	(5,5)	(8,8)	(4,7)	(5,1)	(5,9)	(22,9)	(1,7)	(9,8)	(9,9)
SMEs	258	3	614	39	36	289	24	885	7	371	11	301	2 838
	(24,5)	(1,1)	(8,0)	(3,7)	(1,2)	(5,1)	(5,9)	(9,3)	(20,6)	(34,7)	(2,4)	(8,4)	(8,4)
Trade/export	133	48	132	329	28	1 428	150	645	1	17	8	320	3 239
	(12,6)	(17,5)	(1,7)	(31,6)	(1,0)	(25,2)	(36,8)	(6,7)	(2,9)	(1,6)	(1,7)	(9,0)	(9,6)
General investment	127	0	51	0	97	346	0	278	5	135	262	207	1 508
	(12,0)		(0,7)		(3,3)	(6,1)		(2,9)	(14,7)	(12,6)	(56,7)	(5,8)	(4,5)
Other objectives	106	38	526	0	43	70	0	757	0	72	10	44	1 666
	(10,0)	(13,8)	(6,9)		(1,5)	(1,2)		(7,9)		(6,7)	(2,2)	(1,2)	(4,9)
Particular sectors	125	58	546	207	2 499	2 602	56	1 595	0	69	144	1 201	9 102
	(12)	(21)	(7)	(20)	(85,3)	(46)	(14)	(17)		(6)	(31)	(34)	(27)
Steel	0	0	60	0	891	16	0	357	0	0	21	20	1 365
			(0,8)		(30,4)	(0,3)		(3,7)			(4,5)	(0,6)	(4,0)
Shipbuilding	31	57	166	0	103	476	0	224	0	30	24	452	1 563
	(2,9)	(21)	(2,2)		(3,5)	(8,4)		(2,3)		(2,8)	(5,2)	(12,7)	(4,6)
Other sectors	94	1	320	207	1 505	2 110	56	1 014	0	39	99	729	6 174
	(9,0)	(0)	(4,2)	(20)	(51,4)	(37,2)	(14)	(10,6)		(3,6)	(21,4)	(20,4)	(18,3)
Regional aid	215	17	4 473	406	65	435	159	4 916	19	161	19	1 146	12 031
	(20)	(6)	(59)	(39)	(2,2)	(8)	(39)	(51)	(56)	(15)	(4)	(32)	(36)
Least favoured regions	0	0	0	406	n.a.	161	159	4 261	0	0	19	242	5 313[1]
				(39)		(2,8)	(39)	(44,6)			(4)	(6,8)	(15,8)
Other regions	215	17	4 473	0	n.a.	273	0	655	19	161	0	904	6 717
	(20)	(6)	(59)		n.a.	(4,8)		(6,9)	(56)	(15)		(25,3)	(19,9)
Total	1 054	275	7 642	1 042	2 930	5 666	408	9 562	34	1 070	462	3 569	33 714
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

[1] Including all Spanish regional aid.

Table 4.4

Aids to manufacturing by objective or sector, 1986-88, as % of GDP

	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK	EUR 12
Horizontal objectives	0,59	0,23	0,27	1,04	0,14	0,34	0,73	0,46	0,28	0,45	0,92	0,20	0,33
Innovation/R&D	0,07	0,13	0,13	0,15	0,06	0,06	0,07	0,07	0,04	0,13	0,02	0,06	0,09
SMEs	0,21	0,00	0,06	0,09	0,01	0,04	0,09	0,13	0,13	0,20	0,03	0,05	0,08
Trade/export	0,11	0,05	0,01	0,79	0,01	0,19	0,57	0,10	0,02	0,01	0,02	0,05	0,09
General investment	0,11	0	0,01	0	0,04	0,04	0	0,04	0,09	0,07	0,81	0,03	0,04
Other objectives	0,09	0,04	0,05	0	0,02	0,01	0	0,12	0	0,04	0,03	0,01	0,04
Particular sectors	0,10	0,07	0,06	0,50	0,97	0,34	0,21	0,24	0	0,04	0,44	0,19	0,24
Steel	0	0	0,01	0	0,35	0,00	0	0,05	0	0	0,06	0,00	0,04
Shipbuilding	0,03	0,07	0,02	0	0,04	0,06	0	0,03	0	0,02	0,07	0,07	0,04
Other sectors	0,08	0	0,03	0,50	0,59	0,27	0,21	0,15	0	0,02	0,31	0,12	0,16
Regional aid	0,18	0,02	0,46	0,98	0,03	0,06	0,61	0,75	0,36	0,09	0,06	0,19	0,32
Least favoured regions	0	0	0	0,98	n.a.	0,02	0,61	0,65	0	0	0,06	0,04	0,14[1]
Other regions	0,18	0,02	0,46	0	n.a.	0,04	0	0,10	0,36	0,09	0	0,15	0,18
Total	0,9	0,3	0,8	2,5	1,2	0,7	1,6	1,5	0,7	0,6	1,4	0,6	0,9

[1] Including all Spanish regional aid.

Table 4.5

Aids to manufacturing by objective or sector, 1986-88, as % of gross value-added in manufacturing

	B	DK	D	GR	E	F	IRL[1]	I	L	NL	P	UK	EUR 12
Horizontal objectives	2,91	1,35	0,93	6,45	0,61	1,70	2,89	1,99	1,08	2,47	3,35	0,88	1,43
Innovation/R&D	0,37	0,75	0,46	0,92	0,27	0,32	0,28	0,32	0,14	0,72	0,09	0,25	0,38
SMEs	1,05	0,02	0,22	0,59	0,06	0,19	0,36	0,58	0,50	1,09	0,12	0,22	0,32
Trade/export	0,54	0,32	0,05	4,95	0,05	0,92	2,24	0,42	0,07	0,05	0,09	0,23	0,37
General investment	0,52	0	0,02	0	0,16	0,22	0	0,18	0,36	0,40	2,94	0,15	0,17
Other objectives	0,43	0,26	0,19	0	0,07	0,05	0	0,49	0	0,21	0,11	0,03	0,19
Particular sectors	0,51	0,39	0,19	3,11	4,20	1,68	0,84	1,04	0	0,20	1,61	0,87	1,04
Steel	0	0	0,02	0	1,50	0,01	0	0,23	0	0	0,24	0,01	0,16
Shipbuilding	0,13	0,38	0,06	0	0,17	0,31	0	0,15	0	0,09	0,27	0,33	0,18
Other sectors	0,38	0,01	0,11	3,11	2,53	1,37	0,84	0,66	0	0,11	1,11	0,53	0,70
Regional aid	0,88	0,11	1,59	6,10	0,11	0,28	2,38	3,21	1,37	0,47	0,21	0,83	1,37
Least favoured regions	0	0	0	6,10	n.a.	0,10	2,38	2,78	0	0	0,21	0,18	0,60[2]
Other regions	0,88	0,11	1,59	0	n.a.	0,18	0	0,43	1,37	0,47	0	0,65	0,76
Total	4,3	1,9	2,7	15,7	4,9	3,7	6,1	6,2	2,5	3,2	5,2	2,6	3,8

[1] Manufacturing GVA estimated.
[2] Including all Spanish regional aid.

should be noted that in 1985 and 1986 the Commission, acting under Article 108(3) EEC, authorized the Greek Government as a 'safeguard measure' to grant progressively diminishing aid for intra-Community as well as extra-EC exports until the end of 1989. By now, therefore, Greek export aids should have been reduced to a very much lower level. In the case of Ireland, the main export aid scheme (applicable only to extra-EC exports) was ended in 1990.

Aid to SMEs has grown from 5 % of the total aid to manufacturing in the first survey period to 8 % in 1986-88. It is difficult to assess the significance of this aid with reference to socio-economic indicators specific to SMEs for the following reasons:

(i) statistics by size of enterprise are very inadequate,

(ii) the definition of SMEs differs between countries and even between schemes in the same country,

(iii) much of the aid to SMEs is indirect, e.g. in the form of advisory services,

(iv) it is probable that the service sector receives a significant proportion of the aid,

(v) SMEs can also benefit from aid in most of the other categories; in particular regional aid schemes often give priority and higher rates of aid to smaller firms.

However, Table 4.7 attempts a comparison of aid per employee under SME schemes for those countries where it is possible to make a very rough estimate of the number of employees concerned.

From these partial and tentative results it appears that differences in the size of SME promotion schemes cannot be explained entirely by the relative levels of employment. The Benelux countries clearly attach much more importance to such schemes than do the other Member States. However, as noted above, the data do not allow conclusions to be drawn about the total support given to SMEs from all types of scheme.

(d) Aid for specific sectors

The data on specific sectoral aids only distinguish between steel, shipbuilding and other sectors. It is probably reasonable to assume that the motor vehicle industry figures largely in the last group.

As far as the steel industry is concerned, aid was drastically reduced in the period 1986-88 by comparison with the period

Table 4.6

Trade/export aid (annual average)

	Amounts in million ECU			As % of non-agricultural extra-EC exports
	1981-86	1986-88	% change	1986-88
B/L	98	134	+37	0,8
DK	52	48	−8	0,6
D	99	132	+33	0,1
GR	454	329	−28	(3,3)[1]
E	—	28	—	0,3
F	2 091	1 428	−32	3,1
IRL	83	150	+81	5,6
I	882	645	−27	1,5
NL	34	17	−50	0,1
P	—	8	—	0,4
UK	749	320	− 57	0,6
EUR 10	4 542	3 203	−29	1,0
EUR 12	—	3 239	—	1,0

[1] Percentage of total non-agricultural exports.

Table 4.7

SME schemes — total aid and aid per employee in manufacturing firms with less than 500 employees (annual average 1986-88)

	Total (million ECU)	Per employee (ECU)[1]
B	258	n.a.
DK	3	n.a.
D	614	160
GR	39	n.a.
E	36	20
F	289	100
IRL	24	n.a.
I	885	270
L	7	360
NL	371	470
P	11	n.a.
UK	301	n.a.
EUR 12	2 838	n.a.

[1] Rough estimates.

of the first survey. In Spain and Portugal also a reduction can be expected as Community discipline becomes fully effective (from 1 January 1989 and 1991 respectively). Table 4.8 shows the situation in the periods 1981-86 and 1986-88 for each Member State and compares the levels of aid per employee.

Table 4.8

Aid to the steel industry (annual averages)

	Total in million ECU			ECU per employee	
	1981-86	1986-88	% change	1981-86	1986-88
B	420	0	− 100	10 723	0
DK	7	0	− 100	4 118	0
D	371	60	− 84	2 229	432
GR	0	0	—	0	0
E	—	891	—	—	18 588
F	1 513	16	− 99	17 151	252
IRL	31	0	− 100	50 243	0
I	1 699	357	− 79	20 218	5 598
L	68	0	− 100	5 271	0
NL	35	0	− 100	1 786	0
P	—	21	—	—	3 663
UK	703	20	− 97	9 922	359
EUR 10	4 847	453	− 91	9 938	1 167
EUR 12	—	1 365	—	—	3 088

In the period 1986-88 the ECSC contributed ECU 113 million per annum towards the social costs of restructuring the steel industry (retraining, redundancy payments, etc.) and ECU 33 million per year for research and demonstration projects in the sector.

Aid to shipbuilding was reduced much less dramatically, as Table 4.9 shows, and even increased in terms of ecus (nominal) per employee. However, it should be noted that the sixth Directive with its stricter Community discipline was in force for only the last two of the three years covered by the second survey. Furthermore, this discipline was not extended in full to Portugal until the seventh Directive came into force on 1 January 1991 and special provisions still apply to Spain until the end of 1991. Nevertheless, the intensity of aid per employee is very striking, particularly in France and the UK.

Table 4.10 shows the year-by-year development of aid to shipbuilding in the Community without Spain and Portugal and shows that in the first two years of its operation (1987

Table 4.9

Aid to the shipbuilding industry (annual averages)

	Total in million ECU			ECU per employee	
	1981-86	1986-88	% change	1981-86	1986-88
B	61	31	− 49	14 018	11 903
DK	126	57	− 55	12 223	8 028
D	176	166	− 6	7 399	10 849
GR	4	0	− 100	1 742	0
E	—	103	—	—	6 268
F	507	476	− 6	27 531	48 423[2]
IRL	5	0[1]	− 100	13 127	0
I	237	224	− 5	17 905	19 130
L	0	0	—	0	0
NL	74	30	− 59	9 424	7 200
P	—	24	—	—	4 959
UK	483	452	− 6	25 832	41 091
EUR 10	1 673	1 436	− 14	16 817	22 636
EUR 12	—	1 563	—	—	18 451

[1] No shipyards operating since 1984. The reopening of a shipyard is planned in the near future.
[2] Underestimate: personnel employed in military shipbuilding included in number of employees.

and 1988) the sixth Directive did not have a notable effect on total aid volumes, which were already showing a downward trend in the two previous years.

However, it is probable that the large reductions in the aid ceiling which have taken place since 1988 will have had a more significant impact.

Table 4.10

Aid to shipbuilding in EUR 10, 1983-88

(million ECU)

1983	1984	1985	1986	1987	1988
1 835	1 992	1 670	1 496	1 270	1 336

(e) Regional aid

It is difficult to draw definite conclusions from the data on regional aid schemes. The most striking fact about the figures collected for the first and second surveys is the large proportion of total regional aid which went to West Berlin (27 % of the EUR 10 total in 1981-86 and 28 % of the EUR 12 total in 1986-88). In the period 1986-88 this aid amounted to ECU 1 786 yearly per head of population, a very much higher intensity than in any other regions of the Community, including the most disadvantaged (see Table 4.11). However, the German Government has announced its intention of ending the special aid to West Berlin and the 'Zonenrandgebiet' under the provisions of Article 92(2)(c) EEC. The effect on the total level of German regional aid is, however, likely to be outweighed by the expenditure needed to help the five new *Länder* to adapt their economies.

Aid for the most disadvantaged regions of the Community (those covered by Article 92(3)(a) EEC, about 20 % of the Community's population in 1986 — see box) amounted to about 44 % of the total regional aid granted by Member States in 1986-88. Table 4.11 shows the aid granted per head of population in these regions, indicating a wide variation, with the more prosperous Member States granting larger amounts of aid per head.

Table 4.11

Yearly average regional aid in most disadvantaged regions, 1986-88

(ECU/head)

I	UK	F	IRL	GR	E	P	EC
204	153	124	45	41	4[1]	2	81

[1] All regional aid assumed to go to Article 92(3)(a) regions, as no breakdown available.

However, Greece, Ireland and Portugal qualify in their entirety under Article 92(3)(a) and, consequently, their general investment aid schemes could be regarded as having a regional character from the Community's point of view. No such scheme appears to exist in Greece and Ireland, but if the Portuguese general schemes are taken into account, Portugal's average is increased to ECU 27 per head.

As far as Spain and Portugal are concerned, it is important to bear in mind that the regional aid systems were still in their infancy in the period of the second survey and that the resources devoted to them have probably increased substantially since then.

In the other assisted regions of the Community, regional aid of about ECU 6 700 million per year was granted in the period 1986-88. The average aid per head of population was ECU 65 per year, or ECU 29 if Berlin and the 'Zonenrandgebiet' are excluded. Apart from the latter regions, aid levels per inhabitant were particularly high in Luxembourg and Belgium and low in Denmark and France.

Table 4.12

Yearly average regional aid in Article 92(2)(c) and 92(3)(c) areas, 1986-88

	Totals in million ECU	ECU/head
B	215	57
DK	17	15
D: Berlin	3 340	1 786
'Zonenrandgebiet'	639	94
Other	494	25
E	n.a.	n.a.
F	273	12
I[1]	655	46
L	19	65
NL	161	41
UK	904	46
EUR 12 (excl. Spain)	6 717	65

[1] Most of the Italian regions of the Centre-North were eligible for regional aid only until 31 December 1987.

Aids of a regional character from the Community during 1986-88 totalled about ECU 400 million per year,[6] or about 5 % of the Member States' regional aid, excluding Berlin and the 'Zonenrandgebiet'. One reason for this low volume of aid is that most European Regional Development Fund resources have been devoted to infrastructure (about 90 % in the period in question). This is particularly true in Greece, Spain and Portugal. It is clear that Community regional aid can only have had a modest impact on the overall volume and pattern of regional aids.

[6] Commitments. This figure includes ECU 285 million for ERDF aid to individual projects, ECU 49 million for interest rebates on ECSC reconversion loans and a very rough estimate of the amounts devoted to manufacturing and services in the framework of ERDF programmes and IMPs, for which no breakdown between infrastructure and industry is available.

The Community's most disadvantaged regions: Article 92(3)(a) EEC

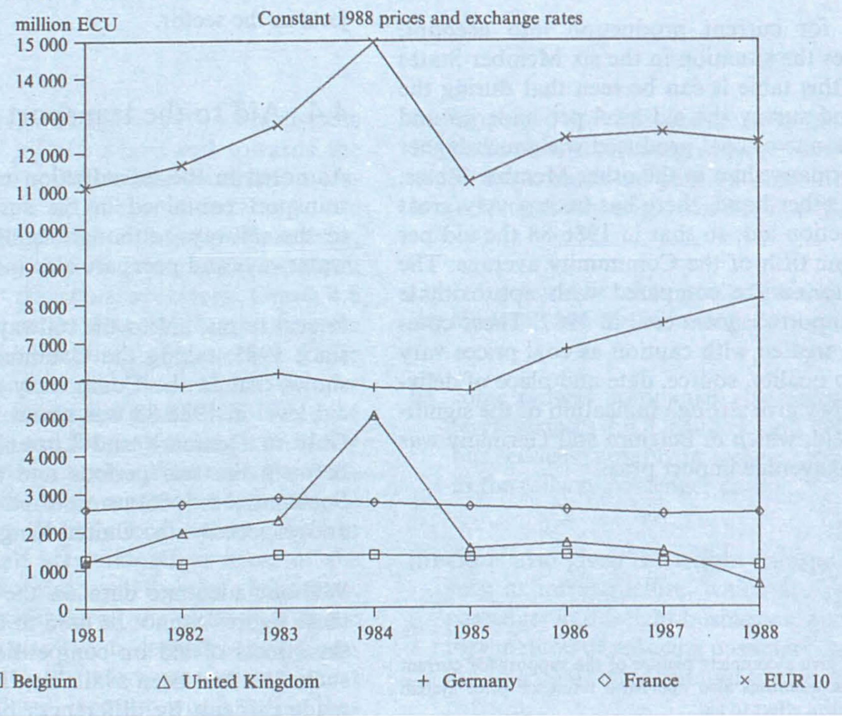
Article 92(3)(a) of the EEC Treaty enables the Commission to grant a derogation in favour of State aids 'to promote the development of areas where the standard of living is abnormally low or where there is serious underemployment'. As a general rule, the Commission has defined these areas as NUTS level II regions which have a per capita GDP of not more than 75 % of the Community average. The Commission has allowed two exceptions to this rule: the Spanish province of Teruel (which is a level III area) and Northern Ireland. The list of regions benefiting from this provision largely coincides with that drawn up for the purpose of Objective 1 of the Community's structural Funds (promoting the development and structural adjustment of the regions whose development is lagging behind).

The eligible regions include the whole of Greece, Ireland and Portugal, the French overseas departments, most of the Italian Mezzogiorno and 56 % of Spain's population. Section 2(b) of Chapter 6 gives more detailed information on this subject.

4.3. Aid to the coal industry

The coal industry is the only part of the energy sector covered by the surveys. National aid to the coal industry averaged ECU 10 200 million during the period 1981-85 (EUR 10). In the period 1986-88, the average (EUR 12) was ECU 12 967 million, of which 56 % was granted by Germany, 19 % by France, 9 % each by Belgium and the UK and 7 % by Spain. Graph 4.4 shows the evolution in real terms of the aid granted in Belgium, Germany, France and the UK over the whole period 1981-88. From this it can be seen that in all four countries there was an increase in aid between 1981 and 1983. Thereafter, the volume of aid declined in Belgium and France, so that in 1988 the levels were respectively 13 % and 4 % lower than those of 1981. In Germany, on the other hand, the upward trend was resumed at a faster rate after reductions in 1984 and 1985, so that the amount of aid granted in 1988 was 35 % greater than in 1981. Thus, aid to the German coal industry was second only to Italian aid to the railways as the largest single

GRAPH 4.4: Aid to coal-mining, 1981-88



item identified by the second survey. The UK showed a very sharp increase in 1984 as a consequence of the miners' strike but this was followed by a rapid fall and in 1988 the volume of aid was reduced to 50 % of the 1981 figure.

Aid to current production accounts for about 40 % of the total, while 60 % is spent mainly on costs arising from mine closures and other inherited liabilities (redundancy payments, pensions, etc.). Table 4.13 shows the distribution between the two categories of aid in the period 1986-88.

Table 4.13

Aid to coal-mining (annual averages 1986-88)

(million ECU)

	Aid to current production	Other aid	Total
B	287	893	1 180
D	3 816	3 479	7 295
E	390	531	922
F	400	2 045	2 445
P	2,4	0,2	2,6
UK	539	584	1 123
EC	5 435	7 532	12 968

Taking only aids for current production into account, Table 4.14 compares the situation in the six Member States concerned.[7] From this table it can be seen that during the period of the second survey the aid level per underground employee and per tonne of coal produced was much higher in Belgium and Germany than in the other Member States. In the UK, on the other hand, there has been a very great reduction in production aid, so that in 1986-88 the aid per tonne was about one fifth of the Community average. The aid amounts per tonne are compared with approximate average prices of imported steam coal in 1987. These comparisons should be treated with caution as coal prices vary widely according to quality, source, date and place of delivery. Nevertheless, they give a rough indication of the significance of the State aid, which in Belgium and Germany was well in excess of the average import price.

[7] This table does not give a complete picture of the support for current production, as some countries also operate a reference price system which has an equivalent effect to aid.

In relation to Belgium, however, it should be noted that the planned closure of the last mines in Limburg will bring an end to production aid.

Table 4.14

Current production aid to coal-mines (annual averages)

	ECU per underground employee		ECU per tonne		Average 1987 price of imported steam coal cif ECU/tonne
	1981-85	1986-88	1981-85	1986-88	
B	13 823	31 279	34,1	72,7	36,9
D	14 280	37 551	18,5	46,3	42,3
E	—	10 674	—	21,3	26,8
F	20 813	25 371	32,1	29,3	40,6
P	—	3 083	—	11,0	—
UK	10 332	6 002	22,3	5,3	50,3
EUR 10	12 826	23 603	20,0	24,9	
EUR 12	—	21 637	—	24,6	

In the period 1986-88 the ECSC contributed about ECU 86 million per year towards the social costs of restructuring the industry and ECU 16 million per year for research projects in the sector.

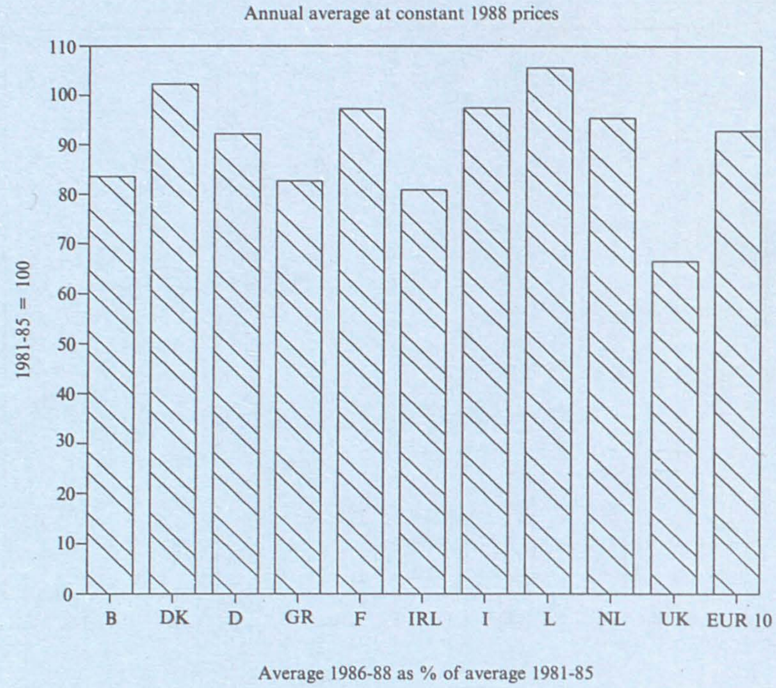
4.4. Aid to the transport sector

As noted in the introduction to this chapter, the data on transport contained in the surveys relate almost entirely to the railways, although small amounts of aid to inland waterways and ports are also included.

In real terms, aid to the railways has shown a slow decline since 1985, taking the Community as a whole. Graph 4.5 shows that in the Community of Ten, the average annual aid level in 1986-88 was about 7 % below that of 1981-85. Only in Denmark and Luxembourg were there increases between the two periods and these were relatively small. Substantial reductions occurred in Belgium, Greece, Ireland and, especially, the United Kingdom.

Without adequate data on the other modes of transport, these figures cannot be used to draw any conclusions about the effects of aid on competition between modes. Even if such data had been available, their interpretation would be made difficult by differences between modes of transport

GRAPH 4.5: **Aid to railways in EUR 10**



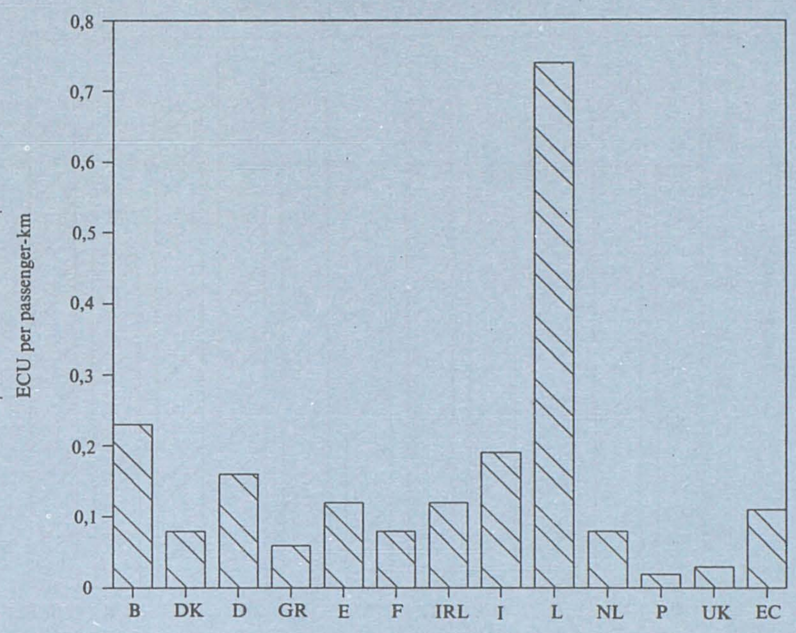
and between countries as regards the extent to which users contribute to the costs of infrastructure and towards the environmental costs of transport. In some countries, moreover, the railway companies, as public undertakings, are subject to special social obligations, in respect of pensions, the employment of staff surplus to requirements etc., which are not imposed on other transport operators. Graph 4.6 makes a comparison between the Member States in terms of the aid granted in 1986-88 per unit of passenger traffic (passenger-kilometre). It shows that the average aid per passenger-kilometre in the Community was ECU 0,11, the aid granted in Luxembourg and Belgium being particularly high (ECU 0,74 and 0,23 respectively). However, these results should be interpreted with caution. Long-distance traffic is usually profitable, whereas local services tend to make large losses. On small networks where most of the traffic is local, the need for subsidies will therefore be greater. On the CFL network (Luxembourg), the average distance travelled by each passenger was 21 km, compared to a Community average of 57 km. It is therefore not surprising that CFL is fairly heavily subsidized. It is also worth noting that in the period 1986-88 about 30 % of the aid to both the Belgian and Luxembourg railways was granted as compensation for exceptional pension obligations. This percentage is much higher than in other Member States.

Other factors to be taken into consideration when comparing the aid levels are the following:

(i) some railway companies also receive aid for operating ferry services (in Denmark and Italy, for example) or bus services (notably in Ireland), which are not included in the railway passenger data;

(ii) aid is also given for freight transport or to cover costs, such as infrastructure, which are common to both the passenger and freight businesses, but there is no satisfactory method of reducing passenger-km and freight tonne-km to a common denominator for the purposes of comparison.

GRAPH 4.6: **Aid to railways 1986-88, in ECU per passenger-kilometre**



4.5. Aid to agriculture and fisheries

State aid to agriculture and fisheries, unlike Community spending on price support measures, remained remarkably stable in real terms over the period 1981-1988, in the region of ECU 10 000 million per year at 1988 prices in the Community of Ten.

Graph 4.7 expresses the aid granted in 1986 in terms of ecus per person employed in agriculture, fisheries and forestry, while Graph 4.8 shows the aid as a percentage of gross value-added in the sector. The single year 1986 has been chosen because there are large gaps in the data for the two subsequent years, which have been filled by extrapolation.

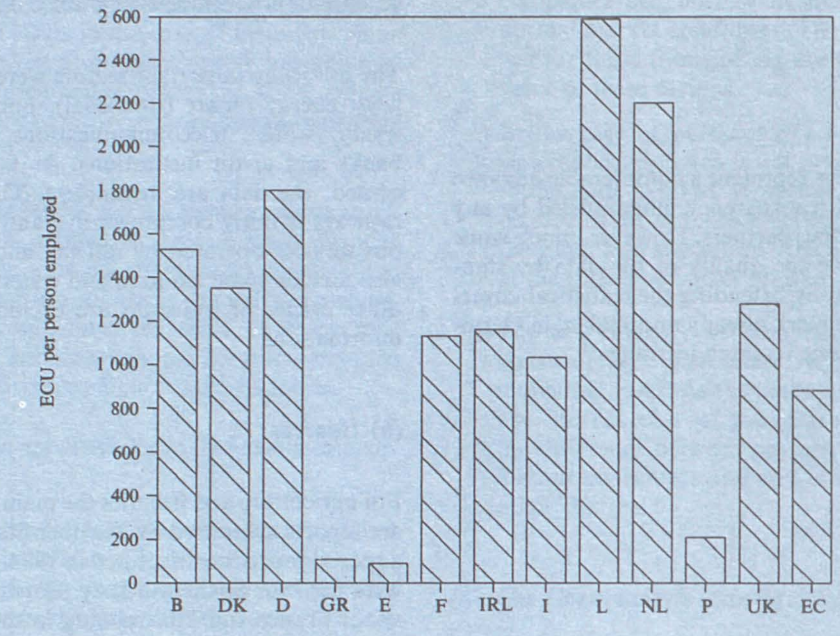
It can be seen that the newer Member States (Greece, Spain and Portugal) give much lower levels of aid than the Community average, although aid as a percentage of GVA is quite high in Portugal, reflecting the low productivity of agriculture in that country.

Germany and Luxembourg stand out as very large aid givers by both measures, while the Netherlands with its high agricultural productivity has a high level of aid per person employed but below-average aid as a percentage of GVA. In Germany about half of the aid consists of compensation through the VAT mechanism to farmers for price falls resulting from changes in the 'green' rate of exchange. This compensation was authorized by the Council but, under Council Regulation (EEC) No 1889/87, it is to be replaced by socio-structural aid not linked to the quantities produced, such as assistance for product diversification, training and research. However, an implementing regulation is required to put this change into effect. The Commission made a proposal for such a regulation in August 1989 but the Council has not yet adopted it.

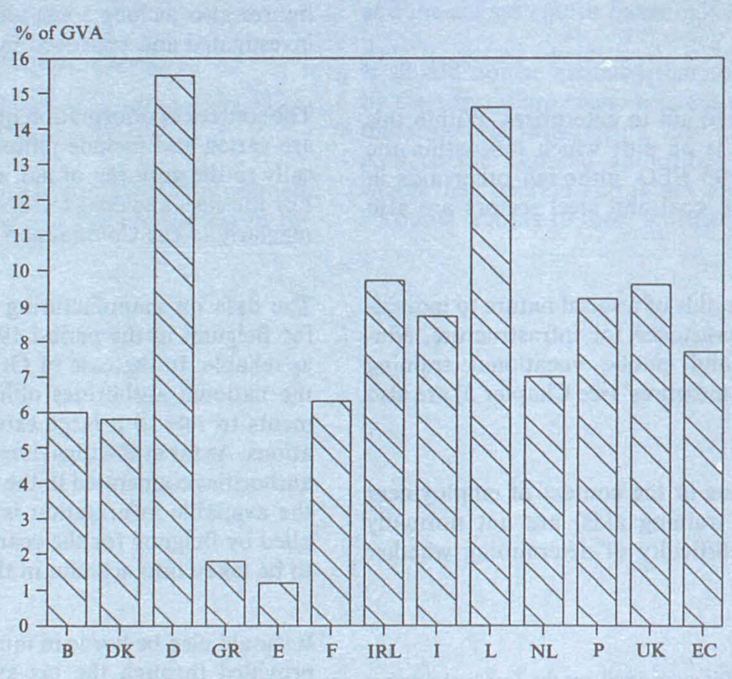
Community expenditure on agriculture in the period 1986-88 averaged ECU 23 635 million per year for price support measures (EAGGF Guarantee Section) and ECU 915 million per year for structural measures, such as investment aid (EAGGF Guidance Section).[8] In addition, the

8 Some of the spending of the Guidance Section is probably included in the national aid data.

GRAPH 4.7: Aid to agriculture 1986, in ECU per person employed



GRAPH 4.8: Aid to agriculture 1986, as % of agricultural GVA



price support mechanism entails considerable transfers from consumers, who are obliged to pay more than world market prices.

4.6. Conclusion

The Commission's surveys represent a considerable advance towards the objective of transparency, unparalleled by any of the Community's trading partners. However, much work is still needed to improve the quality of the data by standardizing definitions and by extending the statistical coverage along the lines of the work already undertaken in Germany by five major economic research institutes.[9]

Appendix

Sources and methodology for the Commission's surveys of State aids[10]

(a) Scope of the surveys

The surveys are restricted to aid to enterprises. Within this category, the main focus is on aids which fall within the scope of Articles 92 and 93 EEC, although other aids in the agricultural, transport, coal and steel sectors are also covered.

The surveys do not include aids of a social nature to individuals and households or assistance for infrastructure, educational establishments and public vocational training centres. So-called 'general measures' (see Chapter 5) are also excluded.

Data on incentives to firms in the context of employment policy (employment and training aids) are not normally included because of the difficulty of determining whether they constitute State aids covered by the Community rules or 'general measures' (see Chapter 6). However, the figures on agriculture include expenditure on training courses.

The following important sectors were omitted from the surveys: energy (apart from coal), public utilities (gas, electricity, water, telecommunications, postal services) and banks and credit institutions. As far as transport is concerned, the data are incomplete. The coverage of aids to railways is fairly comprehensive and includes the ferry and bus services operated by railway undertakings. The figures also include some aid to inland waterways and ports but the other modes of transport are excluded because of lack of information.

(b) Sources

For agriculture and fisheries the main sources of information are reports submitted by Member States in accordance with a special procedure instituted in 1974. Other national sources were used for Spain and Italy. For the Netherlands, as well as for France and Luxembourg in the years 1987 and 1988, the figures are extrapolations.

For transport, the data on railway undertakings and inland waterways were communicated by the Member States to the Commission under the relevant Community legislation. The figures also include some aid to ports where this has been investigated and approved by the Commission.

The sources of information on aid to manufacturing industry are varied and include national documents relating specifically to the granting of aid, national accounts and budgets. For the steel and coal sectors, the figures are communicated regularly to the Commission under the ECSC legislation.

The data on manufacturing for Greece and Portugal, and for Belgium in the period 1986-88, should not be regarded as reliable. In the case of Greece, lack of cooperation from the national authorities obliged the Commission's departments to rely to a large extent on estimates and extrapolations. As far as Portugal is concerned, although the national authorities cooperated in the execution of the second survey, the available information is incomplete. Information supplied by Belgium for the years 1986-88 was received too late to be taken into account in the survey.

It should also be borne in mind that the information on aids provided through the tax system is probably incomplete, since there is a general lack of transparency in this area.

9 See Fritzsche *et al.* (1988).
10 This is only a brief outline. For more detail, see the Technical Annexes to the two surveys.

(c) Methodology

As far as possible, the figures are based on actual expenditure, or actual revenue losses in the case of tax relief. However, in some cases budget appropriations or programmed expenditure had to be used and in others the Commission's departments were obliged to resort to estimates and extrapolations.

The surveys attempt to identify the aid element of the transactions covered. This is defined as 'the ultimate financial benefit contained in the nominal amount transferred' and largely depends on the form in which the aid is provided. Where the aid element could not be identified, as for example in the case of research and development contracts between public authorities and firms, no figures were included.

The various forms of aid are divided into three main categories, as described below.

(i) Where the aid involves straightforward transfers from the State to the beneficiary (or straightforward reductions in the beneficiary's tax or social security liabilities), the aid element is identical with the amount of the transfer (or lost revenue). The following forms of aid are included in this category:

grants,

interest subsidies paid directly to the beneficiary,

tax relief other than tax deferral,

reductions in social security contributions,

equity participation which does not satisfy the 'commercial investor' criterion (see Chapter 5).

(ii) Where the beneficiary receives a 'soft loan' or is granted a tax deferral, the aid element is the interest saved by the beneficiary. The interest saving is estimated using reference rates representing the interest rate at which companies can borrow in each Member State under normal market conditions. The figures given in the survey for these forms of aid are the present (discounted) value of these savings.

In the case of participatory loans and repayable advances this approach is not practicable and the net cost to the State is taken as the aid element. The net cost is defined as the difference between the return received by the State and the return which it would have received at the reference rate of interest.

(iii) The last category covers guarantees. The true aid element of State guarantees varies considerably between individual cases. As the best approximation, the surveys use the net cost of the guarantees to the State, i.e. the difference between payments made by the State to honour guarantees and any revenue from premiums or other charges.

(d) The Community's structural instruments

This chapter gives some information on the aid granted from the Community's structural instruments, in particular the European Regional Development Fund (ERDF), ECSC measures, the Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF Guidance) and the aid system for fisheries.

It should not be assumed that the national aids identified by the surveys are necessarily net of the amounts paid from the structural instruments. The Community aid is usually paid to the national authorities to part-finance schemes which they operate and is not always distinguished in the accounts relating to these schemes.

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Chapter 5

Treaty provisions[1]

5.1. Introduction

Andel (1990) points out that the provisions of the EEC Treaty on State aids are unique in the world:

'They are surprising already in a purely national context if one considers the notorious lack of regulations and transparency. And they are, of course, still more surprising in the context of international agreements, in particular with respect to the wide margin of discretion of the Commission.'

These remarks are also applicable to the control of State aids under the ECSC Treaty. The fact that the founding fathers of the Community gave such wide powers to the Commission is a clear expression of the importance which they attached to limiting State aids as an essential element in the creation and maintenance of a common market.

The main provisions of the EEC Treaty relating to State aids in the context of competition policy are to be found in Articles 92 and 93. Article 92 lays down the general principle that aids which may distort competition between firms in different Member States are forbidden but defines circumstances in which certain aids may be permitted. In exercising its wide discretion under this article, the Commission's primary duty is to consider each case in the context of the Community as a whole: essentially it has to decide whether the harm done to competition in the Community is outweighed by the contribution that the aid may make towards other Community objectives. Article 93 sets out the procedures by which the Commission can exercise its control and imposes specific obligations on the Member States to assist the Commission in its task.

The ECSC Treaty, in its Article 4, appears to impose a much more comprehensive ban on State aid as far as the coal and steel industries are concerned but, as we shall see, this provision now has little practical relevance.

1 Von der Groeben, Thiesing, Ehlermann contains useful commentaries on the relevant Treaty articles.

5.2. Legal bases

The State aids which are subject to Community control are a sub-set of the much wider category of subsidies as defined in Section 2 of Chapter 3, the principal difference being that the Treaties are not in the main concerned with limiting subsidies which have no impact on intra-Community competition.

The basic principle underlying the Treaty provisions on State aids can be expressed as follows: State aids, at least in so far as they distort trade between Member States, are forbidden unless a derogation is specifically accorded, either in the Treaties themselves or by the Commission or Council acting under powers granted by the Treaties.

Article 92(1) of the EEC Treaty reads as follows:

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

Incompatibility with the common market under the terms of the Treaty automatically implies prohibition.

The exceptions referred to at the beginning of the above quotation are defined in Articles 42 and 77, paragraph 2 of Article 90 and paragraphs 2 and 3 of Article 92.

Article 42 relates to the agricultural sector (including fisheries) and empowers the Council to make rules restricting the application to that sector of the normal competition provisions. Article 77 allows aids to transport undertakings if the aids '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'.[2]

Paragraph 2 of Article 90 concerns 'undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly'. It states that such undertakings are subject to the Treaty rules, in particular those on competition, unless the application of these rules would obstruct the performance of the particular tasks assigned to them. The scope of this exception

2 The rules on aid to agriculture and transport are outlined in Chapter 6.

is clearly intended to be very narrow but has never been tested in relation to the State aid rules.[3]

Paragraphs 2 and 3 of Article 92 allow exceptions to be made to the general prohibition in the following cases:

(i) social aid to individual consumers, provided that it is granted without discrimination as to the origin of the products concerned (Article 92(2)(a)),

(ii) 'aid to make good the damage caused by natural disasters or exceptional occurrences' (Article 92(2)(b)),

(iii) regional problems (Article 92(2)(c), 92(3)(a) and 92(3)(c)),

(iv) important projects of Community interest (Article 92(3)(b)),

(v) serious disturbance of a Member State's economy (Article 92(3)(b)),

(vi) 'aid to facilitate the development of certain economic activities' (Article 92(3)(c)),

(vii) other categories of aid specified by decision of the Council (Article 92(3)(d)).

As far as coal and steel are concerned, Article 4 of the ECSC Treaty declares that 'subsidies or aids granted by States .... in any form whatsoever' are incompatible with the common market and are to be abolished and prohibited.

Article 67(2) of the Treaty makes two exceptions to this rule which are of only minor interest since the Commission has never authorized aid on the basis of these provisions.

It should be noted that Article 4 is to be interpreted as referring only to specific subsidies for the coal and steel industries. Measures which are applicable also to other sectors but which confer 'special benefits' on coal and steel undertakings come under Article 67(3) ECSC, which empowers the Commission to make binding recommendations.

However, Article 95 ECSC gives the Commission power to make, with the unanimous consent of the Council, decisions and recommendations 'in all cases not provided for in this Treaty' if such measures are needed to attain the basic objectives of the ECSC. Because of the difficulties facing these industries as a result of profound structural changes in international and Community markets, the Commission has made use of these powers to permit specified aids, firstly to the coal industry (since 1965) and later to the steel industry (since 1980). The provisions of the current Commission decisions concerning these aids are summarized in Chapter 6. These decisions cover all aid, whether specific or general, so that the distinction between subsidies in the sense of Article 4 and 'special benefits' in the sense of Article 67(3) loses its practical significance. The current decision on the coal industry expires at the end of 1993; that concerning the steel industry will expire at the end of 1991.

5.3. The scope of the rules

A comparison of Article 4 ECSC and Article 92(1) EEC shows an apparent difference in the scope of the aid rules, since the latter appears to define the relevant aids more narrowly by specifying that these are aids which distort or threaten to distort intra-Community competition by favouring certain firms or sectors. However, in practice the difference is of little significance.

(a) Effect on trade

The requirement that, to be subject to control, an aid must have an actual or potential effect on trade between Member States is not as severe a limitation as it might seem, given the high and increasing degree of integration of the Community's economy. The Court of Justice has ruled, for example, that Article 92(1) EEC applies even when the firm which receives an aid does not export any of its products, if that firm is in competition on its home market with producers from other Member States.[4] Furthermore, although aids for exports to non-member countries are dealt with in Article 112 EEC, which provides for their progressive harmonization, the Court has stated that this does not preclude the application to such aids of Articles 92 to 94. The Court considered that, given the interdependence of markets, the possibility of distortion of intra-Community competition cannot be ruled out a priori.[5]

(b) The meaning of 'State'

As far as the source of the aid is concerned, it is clear that the Treaty provisions are meant to cover aids from all public

[3] I. F. Hochbaum (in von der Groeben, Thiesing, Ehlermann, December 1984 update) considers that this exception is intended to apply only to provisions relating directly to undertakings, not to those, like Articles 92 to 94, which concern the actions of Member States. However, the Court of Justice judgment in Case 78/76 mentions Article 90(2) in terms which imply that it does exempt some aids from the provisions of Article 92.

[4] Court of Justice, Case 102/87.

[5] Court of Justice, Case 142/87.

bodies, or agencies acting on their behalf, at national and sub-national levels. The Court of Justice has declared, for example, that 'there is no necessity to draw any distinction according to whether the aid is granted directly by the State or by public or private bodies established or appointed by it to administer the aid'.[6] Similarly, in a case concerning aid granted by one of the German *Länder*,[7] the Court ruled that Article 92(1) EEC 'is directed at all aid financed from public resources', including aid granted by regional or local bodies, 'whatever their status and description'. Furthermore, aids are deemed to be financed from public resources even if those resources are obtained by means of a compulsory levy on the sector which benefits from the aid system.[8]

(c) Forms of aid

Aids to enterprises can take many forms, including, for example, outright grants, 'soft' loans, tax concessions, guarantees and the supply of goods or services at less than cost. However, the Treaties make it clear that the form of the aid is irrelevant. The Court of Justice has repeatedly supported the Commission's view that an important test of whether a transaction constitutes aid is the so-called 'commercial investor principle'.[9]

According to this principle, the provision of finance from public resources to an enterprise constitutes aid if that firm would not, in the given circumstances, be able to obtain the sums concerned on the private capital markets, or if it could do so only on terms less favourable to itself. This criterion has been evoked most often in relation to State subscriptions of capital of undertakings but it can also be applied, *mutatis mutandis,* to any other form of aid.

(d) Aids and 'general measures'

Perhaps the most difficult problem in applying the State aid rules is to distinguish between true aids and competitive advantages for firms in one Member State which arise from differences in general economic, fiscal or social policy. In the words of Article 92(1) EEC, the problem is to determine whether a measure favours '*certain* undertakings or the production of *certain* goods'. In considering this question, it is important to bear in mind that Article 92 is concerned with the effects of a measure, not with the Member State's intentions.[10]

Government measures which distort, or threaten to distort, intra-Community competition can be dealt with in two ways, according to the nature of the measure concerned. State aids can be regulated under the powers outlined above; other measures (known as 'general measures') are not subject to the same presumption of incompatibility with the common market and have to be tackled, if necessary, by applying Articles 101 and 102 of the EEC Treaty, which require either the agreement of the Member States concerned or the adoption of Council directives. These articles concern the elimination of distortions in intra-Community competition which arise from differences between legal or administrative provisions.

The provisions which come within the ambit of Articles 101 and 102 have effects which are not specific to certain firms or products and are mainly to be found in the fiscal and social security systems of the Member States. Differences in these systems can give rise to competitive advantages for firms in one Member State by comparison with another. However, to treat such advantages as State aids if they are non-specific would logically require that the national system which places the heaviest burden on enterprises should be taken as the norm. This is clearly neither politically feasible nor economically desirable. Furthermore, harmonization of the systems on the basis of any norm can only take place gradually as the Community becomes more homogeneous. This is why Articles 101 and 102 make it possible, but not mandatory, for the Commission to propose measures in such cases.

In considering the distinction between State aids and 'general measures', it is also important to bear in mind that it is often difficult to adjust one aspect of a country's tax or social security system without disturbing the overall balance of the system. Moreover, the apparent advantage conferred by a 'general measure', which must by definition cover a wide range of firms and products, may be considerably diluted when viewed in the context of the economy as a whole or outweighed by some other national measure. For example, it is difficult to determine where the competitive advantage lies when a country's corporation tax system combines relatively generous depreciation rules with high tax rates. As further illustrations of this point, consider the following cases:

(i) a country where employers pay comparatively small social security contributions but, because the social security system is largely financed from taxation, the tax burden on firms is correspondingly higher;

(ii) a country where a relatively low tax burden on firms is offset by higher costs arising from the poor quality of infrastructure and public services.

6 Court of Justice, Cases 78/76, 290/83 and 57/87.
7 Court of Justice, Case 248/84.
8 Court of Justice, Cases 47/69, 78/76 and 259/85.
9 See, for example, Court of Justice, Cases 234/84, 40/85, 142/87 and 301/87.
10 Court of Justice, Cases 173/73 and 310/85.

In view of the above considerations, an important criterion for deciding whether a measure constitutes State aid in the sense of Article 92(1) EEC is its degree of specificity, i.e. whether it favours 'certain undertakings or the production of certain goods'. As the concept of specificity is relative, not absolute, the application of this criterion is not simple. On one hand, for example, it would not be desirable to treat as aids tax rules which, without other discrimination, benefit firms according to the volume of their investment, even though in a sense, such rules favour 'certain undertakings'. On the other hand, it would be perverse if State aid controls could not be applied to measures, however wide their scope, which are clearly designed to distort competition by favouring exports to other Member States.

(e) Summary: What is a State aid and when is it subject to control?

The following elements of the definition of State aids are well established (see Figure 1 for a simplified presentation).

(i) State aids bestow a competitive advantage on an undertaking or category of undertakings affected by intra-Community competition and involve some cost to the public purse[11] (in terms either of expenditure or of revenue forgone).

(ii) In determining whether there is a cost to the public purse, all public bodies are taken into account, including all levels of government, public enterprises and quasi-governmental agencies. Furthermore, all resources controlled by such bodies are relevant, even those derived solely from compulsory levies on the enterprises which are potential beneficiaries.

(iii) In assessing the degree of specificity of a measure, it is necessary to take into account not only the explicit provisions of the laws or regulations concerned but also their impact in practice. Furthermore, whenever the implementing authorities have discretion in applying the measure so that they can influence the concentration of the benefits, this potential for concentration can justify classifying the measure as a State aid if it meets the criteria in point (i).

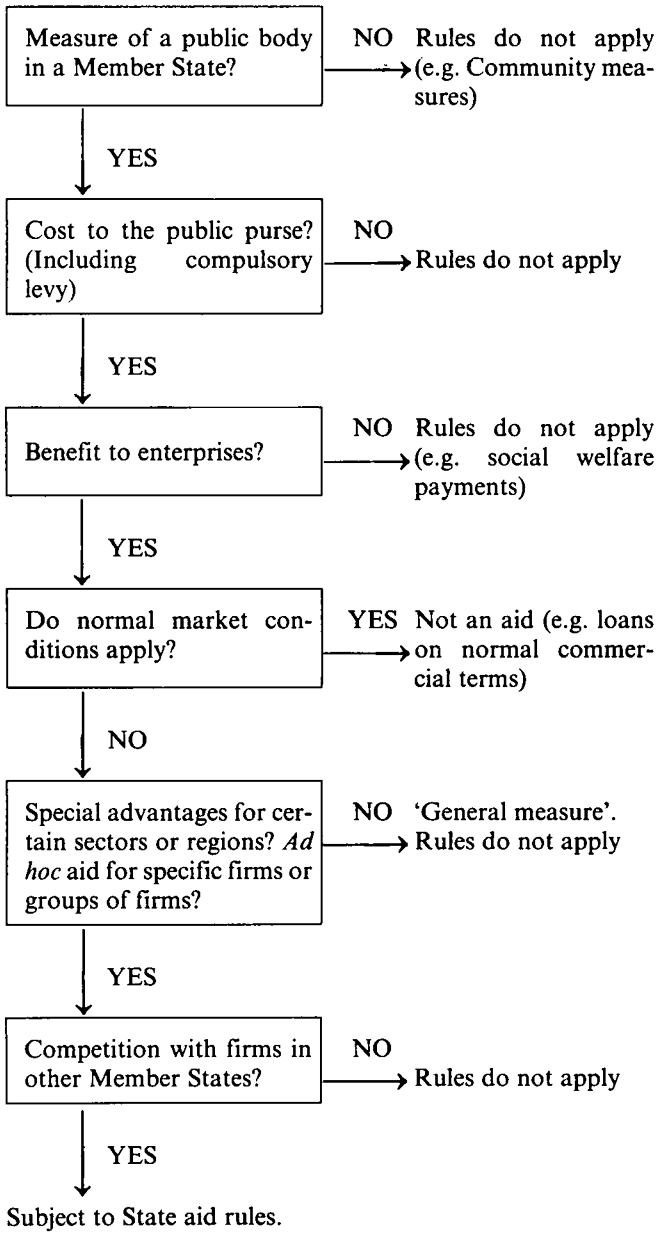
(iv) A transaction does not constitute State aid if, in the given circumstances, the terms of the transaction are no more favourable to the beneficiary than he might have obtained on the open market (the 'commercial investor principle').

(v) Community financial assistance does not fall under the State aid rules.[12]

Figure 1

Do the State aid rules apply?

Simplified presentation of the steps for deciding whether a measure is a State aid covered by Community rules.



[11] Favourable treatment under a regulatory measure (e.g. concerning pollution control) would not normally be considered an aid.

[12] However, care is taken to ensure that the use of Community financial instruments is compatible with these rules, including the limits on aid intensities and sectoral restrictions.

Any measure which can be classified as a State aid using the above criteria should be notified to the Commission under Article 93(3) EEC (see Section 5 of this chapter). Ideally, Member States should also inform the Commission of any borderline cases which may occur. However, under the EEC Treaty, the identification of a measure as a State aid does not automatically imply that it is subject to the competition rules. To be subject to control, the aid must also distort or threaten to distort competition between firms in different Member States.

Obviously, there is still a grey zone where the applicability of the State aid rules can only be decided case by case.

5.4. The derogations

Having decided that a measure constitutes a State aid with an actual or potential distortive effect, the Commission then has to determine whether one of the exceptions referred to in Section 1 of this chapter is applicable.

As far as the ECSC, agriculture and public service obligations in the transport sector are concerned, the relevant legislation defines very precisely the aids which fall outside the basic competition provisions of the Treaties. These rules are discussed in Chapter 6.

Where Article 92(1) EEC applies, the possible derogations are of two sorts. The aids which fall within the three categories listed in Article 92(2) are declared to be compatible with the common market. Therefore, if it can be shown that an aid properly belongs to one of these categories, the Commission has no discretion to disallow it on the ground that it is contrary to the common interest. The aids covered by this paragraph are:

'(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.'

The aid referred to in point (c) is granted to enterprises in the former 'Zonenrandgebiet' (areas bordering on the former German Democratic Republic) and West Berlin. Following the reunification of the country, the German Government announced its intention to cease granting such aid, thus rendering unnecessary the review of the need for the aid which had previously been programmed by the Commission for 1990. The Commission and the German Government are now discussing the timetable for abolition.

The derogations foreseen in Article 92(3) differ from those covered by the previous paragraph in that they are only applied at the Commission's discretion. These derogations concern:

'(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;

(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 interest ...,

(d) 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.'

Very little use has been made of derogation (d). The main instances have been the directives on shipbuilding (see Chapter 6, Section 3(e)) and legislation relating to some agricultural products. None of these measures added significantly to the possibilities for granting aid already foreseen by the Treaty.

In the words of the Court of Justice, the exercise of the Commission's discretion under Article 92(3) 'involves economic and social assessments which must be made in a Community context'.[13] The aim of this assessment is to determine, from the point of view of the Community as a whole, whether the benefits to be expected from the granting of aid outweigh the disadvantages, in particular but not exclusively the potential trade distortion. The Court of Justice has ruled, for example, that the Commission may forbid regional aid for an investment which would increase production capacity if there is a general problem of overcapacity in the Community for the product concerned. Such a prohibition can be based both on the seriousness of the potential effect on trade and

[13] Court of Justice, Cases 730/79, 310/85, 142/87 and 301/87.

on the argument that aid in such a case would not be conducive to the economic development of the region concerned.[14] In another case, it was decided that the Commission may refuse a derogation for an aid which would result in diverting an investment from a less prosperous to a more prosperous Member State.[15]

5.5. Notification and review

A prerequisite for the enforcement of any rules is that the enforcing authority should have adequate information. Consequently, Article 93(3) of the EEC Treaty[16] stipulates that 'The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid'. It is significant that this paragraph refers simply to aid and does not mention Article 92(1). This implies that it is for the Commission, not the Member States, to decide whether the aid is within the scope of Article 92(1), since only the Commission is competent to form an opinion on the Community-wide effects of a measure.[17]

Although failure to notify an aid is an infringement of the Treaty, the Commission still considers itself bound to examine such aids to determine whether or not they are compatible with the common market.

In the event of failure to notify an aid in conformity with Article 93(3), the Commission can, if it subsequently decides that Article 92(1) applies and that no derogation can be granted, order that the recipient must repay the aid to the authority which granted it, with interest where appropriate (see Section 6 of this chapter). It is, therefore, in the interests of both the Member State and the aid recipients that prior authorization should be obtained. In cases of non-compliance the Commission's source of information is often a belated notification from the Member State concerned but it may also be, for example, a press report or a complaint from another Member State or from one of the beneficiary's competitors.

Article 93(3) does not, however, require that the Commission should be informed in advance of every individual award of aid. In most cases the grants are made in application of an aid scheme, not *ad hoc*. Provided that the scheme has been approved by the Commission, the individual awards under it are not normally subject to prior notification. However, the Commission may require such notification in special cases, e.g. when the cost of the investment or the aid intensity exceeds a certain level, or when a 'sensitive sector' is concerned.

Under Article 94 EEC, the Council may, on a proposal from the Commission, make regulations determining *inter alia* the conditions in which Article 93(3) is to be applied and exempting certain categories of aid from prior notification. This provision has been used in the case of inland transport to exempt the major categories of aid.[18]

As far as existing systems of aid are concerned, Article 93(1) requires the Commission to keep them under constant review. The Member States have a duty to cooperate with the Commission for this purpose. The aim of this review is to identify aid schemes which, in their existing form, are no longer justified in the light of social and economic changes, are proving obstructive to the proper functioning of the common market or are being misused. Therefore, it should not be assumed that a scheme, once authorized by the Commission, can continue indefinitely, even when the grounds for a derogation have ceased to exist or the balance of costs and benefits to the Community has changed.

Finally, no discussion of the Member States' obligations to inform the Commission about their aids would be complete without a mention of Article 5 of the EEC Treaty and Article 86 of the ECSC Treaty. These articles place a general obligation on Member States 'to facilitate the achievement/performance of the Community's tasks'. The implementation of competition policy being a major task of the Community and the Commission being the institution responsible for that task, the duty of the Member States to provide all necessary information, even beyond the specific requirements of Article 93, is clear.

5.6. Procedural provisions[19]

After its initial examination under the EEC Treaty of a new aid or an alteration to an existing aid, the Commission may

[14] Court of Justice, Case 310/85.
[15] Court of Justice, Case 730/79.
[16] For the ECSC and agricultural aids not subject to Articles 92 and 93, the derived legislation contains detailed provisions on notification.
[17] See Commission of the EC (1983), which states that 'Member States cannot evade (the obligation to notify an aid), even if they consider that the measures they plan do not have all the characteristics described in Article 92(1)'.

[18] Council Regulations (EEC) Nos 1191/69, 1192/69 and 1107/70.
[19] Slot (1990) provides a critical review of some of the procedral aspects of State aid control.

decide that the aid is compatible with the common market or that it is not covered by Article 92(1). In such cases it notifies the Member State concerned that it has no objection and the State is then free to put the aid into effect. If, on the other hand, it finds that Article 92(1) applies but cannot find adequate reason for applying one of the derogations foreseen by Article 92, it initiates the procedure foreseen in Article 93(2). This second stage of the examination involves inviting all interested parties, and in particular all Member States, to submit their comments within a prescribed time-limit. It also gives the Member State concerned an opportunity to present further arguments in favour of the aid. Indeed, the procedure is sometimes initiated simply because the Member State has been dilatory in providing all the information necessary for the Commission's assessment.

If the Commission still considers, after taking account of the comments received, that the aid is incompatible with the common market, it takes a final decision forbidding the aid. The Member State concerned has the right under Article 93(2) to appeal to the Council in exceptional circumstances for a decision permitting the aid. However, since such a decision requires unanimous support in the Council, this right is of little practical importance and the normal avenue of appeal is to the Court of Justice.

With the exception of the right to refer the matter to the Council, similar provisions are included in Commission Decision 322/89/ECSC governing aid to the steel industry.

As far as existing aid schemes are concerned, Article 93(1) EEC, which requires the Commission to keep such schemes under constant review, also empowers it to propose 'any appropriate measures required by the progressive development or by the functioning of the common market'. If the Member State does not agree to implement the Commission's proposals, the Article 93(2) procedure described above is initiated. If the comments received cause the Commission to conclude that the scheme remains compatible with the common market, the procedure is closed without further action; otherwise, the Commission makes a final decision requiring the Member State to abolish or amend the aid scheme. Such a decision can be based not only on the grounds stated in Article 93(1), quoted above, but also on evidence that the aid is being misused.

In many cases, concerning both new and existing schemes, where there is an initial disagreement between the Commission and a Member State it is not necessary to follow all the steps outlined above. It is often possible during either the first or the second stage of its examination for the Commission to negotiate an agreement which removes the features of the aid which are objectionable from the Community's point of view.

5.7. Enforcement

In 1973, the Court of Justice stated that the Commission had a right to order that a Member State must recover an illegal State aid from the recipient.[20] The Court remarked that, in order to have a useful effect, Commission decisions requiring the abolition or modification of an aid could include the obligation to repay any amounts granted in violation of the Treaty. In this way the past and future consequences of the violation could be effectively eradicated.[21]

However, it was not until 1983 that the Commission announced its intention of making use of this possibility.[22] The practice of ordering recovery was introduced gradually and was only generalized in 1985.

In the agricultural sector, the Commission also makes use of another sanction: witholding payments from the European Agricultural Guidance and Guarantee Fund. This practice was recognized as legitimate by the Court of Justice in a judgment made in 1979.[23]

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[20] Court of Justice, Case 70/72.

[21] It can, of course, be argued that simple repayment, even with interest, especially if it occurs at a much later date, would not be sufficient to rectify the damage done to intra-Community competition.

[22] Commission of the EC (1983).

[23] Court of Justice, Cases 15 and 16/76.

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* Council Regulation (EEC) No 1192/69 of 26 June 1969 on common rules for the normalization of the accounts of railway undertakings, OJ L 156, 28.6.1969.

* Council Regulation (EEC) No 1107/70 of 4 June 1970 on the granting of aids for transport by rail, road and inland waterway, OJ L 130, 15.6.1970.

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Chapter 6

Application of the Treaty provisions

6.1. Introduction

The application of the principles laid down in the EEC Treaty, as well as the definition of the special rules on agriculture, coal and steel, has required a large body of derived legislation and Commission guidelines.

In relation to many agricultural and fisheries aids and to aids for coal and steel, the derived legislation in effect substitutes new rules for those contained in the Treaties. In other sectors, the Council and the Commission have no power to make such a substitution and the derived legislation and guidelines serve mainly to clarify the ways in which the Commission will exercise its discretion under the EEC Treaty and to ensure that the Member States provide adequate information for the enforcement of the competition provisions. In the transport sector, the legislation also serves to specify the circumstances in which Member States can grant aid under Article 77 EEC to 'meet the needs of coordination of transport' or to compensate for public service obligations. As has been noted in Section 4 of Chapter 5, the derived legislation under Article 92(3)(d) EEC does not add significantly to the possibilities of derogation.

The legislative provisions and guidelines can be divided into two main categories: horizontal and sectoral. The horizontal rules are especially concerned with ensuring that the Commission has adequate information and with regulating particular forms of aid or types of aid scheme. The category of sectoral rules includes the special provisions under the ECSC Treaty and those concerning agriculture and transport which have been mentioned above, as well as regulations and guidelines on some other sectors which are particularly sensitive from the point of view of competition policy.

In cases where both sectoral and horizontal rules apply, the more restrictive of the two will generally be decisive. A common thread running through many of the rules is a negative attitude towards operating aids, which are held to be conservative in their effects and not likely to lead to a lasting solution to the problems which they address. In so far as they can be deemed to be State aids, employment and training subsidies are an exception to this principle.

The final section of this chapter deals with financial support granted to enterprises by the Community. Although such support is not itself subject to the State aid rules, the Commission has an obvious duty to ensure compatibility between State aid policies and the operation of the Community's own financial instruments.

6.2. Horizontal rules

(a) Financial relations between states and public undertakings

Article 90 of the EEC Treaty states that public enterprises are subject to the competition rules. The second paragraph of that article makes an exception to this general principle where the application of the rules would 'obstruct the performance, in law or in fact, of the particular tasks assigned' to certain types of undertaking. However, as noted in Section 1 of Chapter 5, the practical significance of this exception is unclear as far as State aids are concerned.

Article 222 EEC stipulates that 'This Treaty shall in no way prejudice the rules in Member States governing the system of property ownership' and thus establishes the principle of equal treatment of public and private enterprises. However, the financial dealings between States and public enterprises are particularly complex and the Commission found that they tended to be less transparent than transactions involving private firms. In order to obtain the information needed to ensure that the State aid rules were enforced with the same rigour in both public and private sectors, the Commission therefore adopted a directive[1] 'on the transparency of financial relations between Member States and public undertakings'.

This directive applies to most public enterprises with a turnover of ECU 40 million or more. It requires that accounts should be kept in such a way as to show clearly all direct or indirect transfers of funds from public authorities[2] to these enterprises[3] and the use made of the funds. Member States must ensure that this information is kept at the disposal of the Commission for five years from the end of the financial year when the transfer of funds occurred or when the last of the funds were used by the firm concerned.

[1] Commission Directive 80/723/EEC, amended by Commission Directive 85/413/EEC.
[2] Defined as the State and regional or local authorities.
[3] Except deposits on normal commercial terms with public financial institutions.

The directive does not imply that such transfers are automatically to be considered as aids falling under Article 92(1) EEC or in any way attempt to define the scope of the State aid provisions of the Treaty. It enables the Commission to check whether such aids have been granted without notification by examining the transactions recorded in this way and applying, in particular, the 'commercial investor principle' referred to in Chapter 5.

(b) Rules concerning aids with particular objectives

In this category, the Commission has issued guidelines on aids aimed at promoting regional development, research and development, the protection and improvement of the environment and the rescue and restructuring of ailing firms. It will shortly be publishing guidelines for schemes directed at small and medium-sized enterprises. In addition, in order to prevent the granting of excessive amounts of aid for individual projects by the use of more than one type of aid scheme, the Commission has laid down rules on the cumulation of aids for different purposes.

Regional aid

The EEC Treaty provides for three types of regional derogation, relating respectively to areas of the Federal Republic of Germany adversely affected by the division of Germany[4] (Article 92(2)(c)), areas with an abnormally low standard of living or serious underemployment (Article 92(3)(a)) and other areas (Article 92(3)(c)).

The regions which can benefit from the last two derogations are the subject of precise criteria.[5] The analysis is normally conducted on the basis of the standard NUTS[6] geographical units. GDP data are always expressed in terms of purchasing power standards (PPS) in order to allow for differences in the cost of living between Member States.

Regions for which the Commission grants a derogation under Article 92(3)(a) (the least favoured regions) are defined as NUTS II regions with a per capita GDP, averaged over at least the last three years for which statistics are available, at least 25% below the Community average. Per capita GDP can be regarded as a composite measure of three factors: productivity, the rate of participation in the labour force and unemployment. It therefore constitutes a measure both of the standard of living and of underemployment as required by Article 92(3)(a). Of course, underemployment also exists in regions where high unemployment or a low participation rate is combined with high productivity. In these cases, it can be argued that the GDP per capita data do not fully reflect the extent of underemployment. However, the application of this derogation is clearly intended to be reserved for the most extreme cases of regional disadvantage and it is reasonable to conclude that such extreme cases can only be identified by examining the combined working of the three contributory factors, not by considering each one separately.

The Commission makes two exceptions to the above rule. One of these is the Spanish province of Teruel, a NUTS level III area in the region of Aragon, a region which does not itself qualify under the rule. However, Teruel borders on other Article 92(3)(a) regions and is considered to be extremely underdeveloped with a sparse population and a high degree of dependence on agriculture. The other exception is Northern Ireland, included in the list because of its exceptional problems.

At present, pending a decision on the new German *Länder*, the Article 92(3)(a) derogation is applied to regions comprising about one fifth of the Community's population, including the whole of Greece, Ireland and Portugal (see Table 6.1). These regions lie mainly on the southern and western periphery of the Community. In these regions investment aid up to 75% NGE[7] of the investment cost can be granted. However, the Commission requires a differentiation of aid rates within this limit to reflect the relative socio-economic situation of different areas. Temporary operating subsidies may, as an exception from the normal rule, also be permitted in these regions on certain conditions.

Article 92(3)(c) opens up wider possibilities of derogation in favour of regional aids and allows the Commission to authorize aid intended to further the development of areas in a Member State which are disadvantaged in relation to the national average. However, the Commission still has to consider the wider Community context when examining such aids. Consequently, the Commission's method for applying Article 92(3)(c)[8] takes account of a region's situation in relation to both the national and the Community averages.

4 Aid for the 'Zonenrandgebiet' and West Berlin, which is to be phased out (see Chapter 5).
5 See Commission of the EC (1988a and 1990).
6 Nomenclature of statistical territorial units. Level II corresponds to German 'Regierungsbezirke', Spanish 'Comunidades autonomas', French and Italian 'regions', etc. Level III comprises smaller units such as German 'Kreise', 'provinces' in Spain and Italy, 'départements' in France, counties and Scottish regions in the United Kingdom.

7 Net grant equivalent, which takes account of the effect of taxation (see point c, 'Measuring aid intensity').
8 Commission of the EC (1988a).

Table 6.1

List of regions to which Article 92(3)(a) EEC applies

Member State	Region	Population (1.1.1990) in million
Greece	Whole country	10,046
Ireland	Whole country	3,499
Portugal	Whole country	10,337
France	French overseas departments[1]	1,270 (est.)
Italy	Campania	5,809
	Abruzzi	1,266
	Molise	0,335
	Puglia	4,069
	Basilicata	0,623
	Calabria	2,153
	Sicilia	5,173
	Sardegna	1,658
Spain	Galicia	2,807
	Castilla y Leon	2,629
	Castilla-La Mancha	1,713
	Extremadura	1,128
	Andalucía	6,903
	Murcia	1,024
	Ceuta y Melilla	0,124
	Canarias	1,478
	Teruel	0,156 (1986)
	Comunidad Valenciana	3,781
United Kingdom	Northern Ireland	1,584
Total		69,565

[1] Guadeloupe, Guiana, Martinique and Réunion.

To qualify for a derogation under this provision a region must normally show the following minimum disparity in the national context:

(i) per capita GDP at least 15% below the national average, or

(ii) an unemployment rate at least 10% higher than the national average.

Because regional development policies deal with long-term problems and long-term measures, the indices used are five-year averages.

In order to take the Community context into account, the above thresholds are adjusted so that, if the Member State is better off than the Community average, a greater deviation from the national average is needed in order to qualify. The adjustment formula is as follows:

$$\text{modified threshold} = \left(\text{basic threshold} + \frac{\text{basic threshold x 100}}{\text{European index}}\right) \div 2$$

The thresholds are expressed as indices, where the national average equals 100. Thus the basic threshold for GDP/capita is 85 and that for unemployment is 110. The European index refers to the situation of the Member State in relation to the Community average (= 100). An example of the application of the formula is given in the box.

Because disparities in unemployment rates are extremely wide, the Commission decided not to impose a modified threshold value of more than 145.

When an area does not satisfy the above conditions the Commission proceeds to a second stage of analysis. In this stage, the Commission takes other economic indicators into account. These indicators may, amongst others, include forecasts of impending job losses, net migration, population density and dependence on declining sectors. Especially when an area is very close to the threshold values required in the first stage, this second stage may reveal an adequate justification for authorizing regional aid.

Once it has decided on a derogation under Article 92(3)(c), the Commission fixes the investment aid ceiling for each area individually. This ceiling is not normally higher than 30% NGE. Parts of Madrid and Asturias provinces in Spain are exceptional cases where a limit of 45% has been fixed; however, the Commission has recently proposed withdrawing this concession as far as Madrid province is concerned.

Research and development[9]

As the Community has set itself the objective of improving its international competitiveness by strengthening the scientific and technological basis of its industry,[10] and in view of the important externalities involved, there is a generally favourable attitude towards aid for R&D.

[9] See Commission of the EC (1986).
[10] Article 130f of the EEC Treaty.

Threshold formula for regional aid (Article 92(3)(c) EEC) — Example of application to the province of Twente, Netherlands

The province of Twente is a NUTS level III area, and is thus at the appropriate level for the application of the Commission's method for deciding whether regional aid should be permitted.

Averaged over the last five years for which statistics are available, the Netherlands had a GDP per capita index of 107 and an unemployment index of 97 (EC = 100). Consequently, for Dutch areas the threshold values to qualify under the first stage of the Commission's method are:

GDP/head

$$\left[85 + \frac{8\,500}{107}\right] \div 2 = 82$$

Unemployment

$$\left[110 + \frac{11\,000}{97}\right] \div 2 = 112$$

In other words, a Dutch region qualifies if, on average over the last five years, either its per capita GDP is not more than 82% of the Dutch average *or* its unemployment rate is at least 12% above the national level.

For Twente, Eurostat data on GDP per head are available only for 1986-88, not the last five years, but they indicate a level slightly above 82% of the national average. On this test, Twente does not appear to qualify. However, the province's unemployment rates over the period 1985-89 yield an index of 114,9 (NL = 100). This is higher than the threshold of 112 and regional aid can therefore be authorized.

Support for fundamental research not directed towards commercial objectives does not fall under Article 92(1) EEC. For other R&D activities, a distinction is made between basic and applied research, basic research being theoretical and experimental work not leading directly to the creation of new products or production processes. For basic research, aid up to 50% of the cost is normally allowed. In the case of applied research the aid rate depends on the distance from the market but is typically limited to 25%. SMEs, firms in the least favoured regions and projects of special Community interest may receive additional aid of up to 10 percentage points.

Large projects are examined individually by the Commission.

Environment

In environmental matters, the Commission aims to move towards the 'polluter pays' principle. However, in a memorandum to Member States in 1974,[11] the Commission noted that 'environmental "costs" are either not taken into account or only inadequately taken into account in the economic systems of the Member States'. Consequently, it set out in this memorandum conditions on which it would be prepared to allow State aid for investments aimed at protecting the environment. These conditions were amended by a Commission communication issued in 1980.[12] During a transitional period[13] to give Member States time to implement the 'polluter pays' principle, such aid is considered to qualify for derogation under Article 92(3)(b) EEC (important projects of European interest), if it satisfies the following tests:

(i) The investment is needed to comply with major new obligations imposed by national or Community law.

(ii) Aid must not exceed 15% NGE of the investment cost.

(iii) The aid may be granted only for adapting installations which have been operating for at least two years before the introduction of the new environmental standards.

(iv) Any portion of the investment which leads to an increase in production capacity, normal replacement investments and operating costs shall be ineligible for assistance.

In these documents, the Commission also announced that it would consider derogations under Article 92(3)(c) (promotion of 'certain' activities and 'certain' areas) for aids to promote research and development work on less polluting products or processes, including the construction of pilot plants, and to subsidize certain investments made necessary by sudden, major changes in environmental standards.

In subsequent practice, however, the Commission has been prepared to accept under Article 92(3)(c) a further category of aids: those which provide an incentive to go beyond legally enforceable norms. In such cases, the Commission

[11] Commission of the EC (1974).
[12] Commission of the EC (1980).

[13] Originally until 1980, extended to 1986 and then prolonged indefinitely pending review.

takes a tolerant view provided that the aid does not cover the full additional cost of meeting the higher standards and that the conditions of aid do not discriminate according to the origin of the equipment required.

Rescue and restructuring[14]

Because of their potential harmful effects in delaying necessary adaptions to market conditions, aids in this category have to be strictly controlled.

Rescue aids are those granted to keep a firm in business while a recovery plan is being prepared. The Commission may be willing to authorize such aid if it is restricted to the minimum amount and time (generally six months) necessary.

Restructuring aid may be allowed if the restructuring plan offers good prospects of restoring viability and the aid is no more than is needed to support the firm until the plan bears fruit. Where the sector concerned is characterized by chronic overcapacity, the Commission normally requires an irreversible reduction in capacity.

General aid schemes

In the past some aid schemes have been tolerated even though they have no specific industrial or regional objectives. These are known as general aid schemes and are subject to special provisions on prior notification and annual reports, laid down in a letter from the Commission to Member States dated 14 September 1979.[15]

This letter specifies, with reference to the size of the investments concerned and the aid intensity, the cases when individual aid proposals must be cleared with the Commission in advance. It also requires annual reports on the operation of the schemes. The information contained in these reports must, *inter alia*, include a breakdown of the aid granted by sector and by type of region. This enables the Commission to judge whether particular competition problems are likely to arise from a concentration of aid on any sector and whether a scheme is hindering the implementation of regional policy by favouring non-assisted areas.

The importance of these rules is diminishing as the Commission takes steps to secure the abolition of general aid schemes.

[14] See Commission of the EC (1979a).
[15] Commission of the EC (1979b).

Cumulation of aids

In many cases the same project may be eligible for aid under more than one scheme operated by a Member State. In some of these cases the schemes contain rules, often inserted at the insistence of the Commission, which limit the total intensity[16] of aid from all sources for any one project. Where such rules do not exist, the Commission has taken steps to ensure that significant cases of aid cumulation do not escape its control.

In a communication published in 1985,[17] the Commission required prior notification of cases of cumulation where the investment cost exceeds ECU 12 million or total aid intensity exceeds 25% NGE. The following are exempted from this requirement:

(i) investments of less than ECU 3 million, whatever the cumulative aid intensity,

(ii) cumulation resulting in a total aid intensity of less than 10%, whatever the investment cost,

(iii) cases where the cumulative intensity is no more than the maximum authorized by the Commission in respect of any one of the schemes concerned.

These rules cover the subsidization of expenditure on fixed assets. Aid for staff training is also covered when this supplements investment aid and is directly linked to the investment.

When prior notification is required by these rules, Member States must also supply information on any other related aid, even if it is not directly linked to investment in fixed assets. This information enables the Commission to form a more complete picture of the circumstances surrounding the case.

Employment and training aids

The Commission's first survey identified employment and training aids in the Community of Ten averaging ECU 2 660 million per year in the period 1981-86. Although this is a substantial amount, almost equal to the spending on R&D aid in the same period, this figure was not included in the main findings, because of certain peculiarities of employment and training measures which make them difficult to treat in the same way as other State aids.

[16] i.e. aid as a proportion of the eligible costs of the project.
[17] Commission of the EC (1985).

Firstly, such measures are frequently non-specific, in the sense that they do not explicitly discriminate between sectors or regions. Hence, unless it can be shown that in practice these measures tend to favour certain types of enterprise or geographical areas, they do not fall under Articles 92 and 93 of the EEC Treaty. As they are usually targeted on certain disadvantaged groups (such as the long-term unemployed or women seeking to return to work), there is a possibility of some sectoral bias, e.g. towards industries which employ large numbers of unskilled workers or where women traditionally predominate. However, it can also be argued that any such bias arising solely from the choice of target group is unlikely to be sufficiently narrow to justify the application of the State aid rules. The Commission thus finds itself in the grey area where the distinction between State aids and general measures is unclear.

Where training measures are concerned, there are additional reasons for the Commission to be reluctant to interfere. Unless the training is heavily slanted towards the needs of the employer who receives the aid, normal labour mobility means that the externalities involved are extremely important: the skills acquired in training may be transferred not only between firms but between sectors and countries.[18] Furthermore, vocational training systems vary widely between Member States; the costs which in one country are borne by the employer may in another country be borne by the State as the provider of free educational and training facilities. Any training subsidy granted by the State in the first country will be notifiable under Article 93(3) EEC but will not necessarily confer a clear competitive advantage in comparison with the second country's (non-notifiable) expenditure on freely available training provision.

However unclear the legal position may be, the existence of training and employment aids does not normally present the Commission with practical problems, since the Community's policy in the social field is to promote efforts both to improve employment opportunities for disadvantaged groups and generally to upgrade the skills base of the Community economy. Consequently, the Commission adopts a generally favourable attitude towards aids of this sort and is therefore rarely called upon to pronounce on the applicability of the State aid provisions of the Treaty. However, should a case arise where the incidence of the aid is sufficiently specific and where the level of aid is judged to be excessive, the Commission would undoubtedly raise objections.

(c) Rules on different forms of aid

Measuring aid intensity

The intensity of an aid, i.e. the proportion of the firm's expenditure on a project which is covered by the aid, is an important factor in assessing its impact on competition. As aids can take many forms (capital grants, tax relief, interest rebates, etc.), the Commission had to devise methods for reducing them to a comparable measure of intensity. In most cases, this measure is the net grant equivalent (NGE). The principles for calculating the NGE of aids for investment were first applied to regional aid schemes[19] and later extended to other types of scheme. These principles cover capital grants, tax relief ('fiscal aid'), loans at reduced rates and interest rebates.In essence, the methodology consists of calculating the ratio between the present value of the aid (after tax) and the present value of the investment expenditure. For example, the gross grant equivalent of a soft loan is the present value of the recipient's interest savings, discounted at the appropriate reference rate and expressed as a percentage of the cost of the project.

As fiscal legislation usually stipulates that only the net cost to the investor can be depreciated, the tax liability of the firm increases if it receives aid. Consequently, the net benefit derived from the aid is reduced by an amount which depends on the tax rate and the depreciation rules. The net grant equivalent takes this effect into account and thus eliminates the influence of differences between tax systems. In calculating the NGE, it is assumed that the firm makes a profit from the outset, sufficient to pay the maximum taxes that could be levied on the aid.

State guarantees

The provision of a guarantee by the State or by a financial institution acting on its behalf can bestow a significant competitive advantage on a firm. This is particularly true where the conditions of the guarantee restrict the legal steps which a guarantor may take to recover the debt from a defaulting firm.

Consequently the Commission has declared[20] that it will not approve the granting of State guarantees unless their mobilization gives the guarantor the right to apply, if necessary, for a compulsory declaration of bankruptcy or a similar measure.

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[18] A minimum element of transferable skills is a normal condition, for example, for the co-financing of such schemes by the European Social Fund.

[19] Council Resolution of 20 October 1971. Commission of the EC (1979c) revises some aspects of the methodology.

[20] Commission of the EC (1989a).

Public authorities' holding in company capital

As in the case of dealings between States and public enterprises, the acquisition of public holdings in private companies may present particular problems in determining whether aid is involved. Consequently, the Commission has issued special guidelines on this subject.[21] In the light of the 'commercial investor principle', the guidelines identify four basic types of transaction:

(i) acquisition of a holding in an existing company without any injection of fresh capital,

(ii) an injection of fresh capital in circumstances which would be acceptable to a private investor under normal market conditions,

(iii) injections of fresh capital in circumstances where a private investor would be unwilling to invest,

(iv) capital injections which cannot be assigned with certainty to either category (ii) or category (iii).

In the cases referred to in point (i), there is clearly no aid and the Commission does not impose any special obligations on Member States. Although the transactions covered by point (ii) do not constitute aids either, the Commission requires regular reports on them in order to ensure, retrospectively, that the Member States are interpreting the 'commercial investor principle' correctly. These reports must also cover the uncertain cases referred to in point (iv).

However, those injections of fresh capital which are clearly aids (the third category) and any uncertain cases where there is a presumption of aid must be notified to and approved by the Commission before the transaction is carried out. The guidelines state that there is a presumption of aid when a capital injection is combined with aid in some other form or when the sector concerned is experiencing special difficulties.

6.3. Sectoral rules

Except in the case of transport, probably the most important problem taken into account in the specific sectoral rules is that of persistent overcapacity in the Community industries concerned. A general principle of the rules in such cases is that aid for investments which would increase the output of the products in question should be strictly limited or even forbidden outright.

[21] Commission of the EC (1984a).

(a) Coal and steel

Commission Decision 322/89/ECSC, valid until the end of 1991, allows limited aid to iron and steel companies for research and development, protection of the environment, costs related to the closures of plants and investments in Greece and the new German *Länder*, provided that they do not lead to an increase in capacity.

For the coal industry, Commission Decision 2064/86/ECSC, in force until the end of 1993, permits the following types of aid under certain conditions:

(i) aid to cover operating losses,

(ii) aid to allow rebates to be granted on the prices of supplies to the Community iron and steel industry, provided that there is no competition from extra-Community suppliers at the point of consumption,

(iii) aid up to 50% of investment costs, provided that the investment helps to improve competitivity and any new capacity created is economically viable,

(iv) employment aid for underground workers,

(v) aid to finance social grant schemes specific to the industry,

(vi) aid to cover inherited liabilities arising from restructuring.

(b) Agriculture[22]

The rules concerning both agriculture and fisheries distinguish between aids which are co-financed by the Community and others. Although the conditions of eligibility may be somewhat wider in the case of schemes without Community financial support, it is a general requirement that such schemes should not offer higher amounts or rates of aid than the equivalent Community schemes.

As far as investment aids for farmers are concerned, the rules are complex.[23] They specify in detail the conditions under which certain aids can be permitted, with particular emphasis on ensuring that aid schemes are less generous towards the larger and more productive farms and on reducing the costs of production. They also impose restrictions on aid to certain sectors where the problem of surplus

[22] Some of the aid schemes mentioned here are mandatory.
[23] See in particular Council Regulation (EEC)No 797/85.

production is especially serious; for example, most investments in egg and poultry farming are excluded and the eligibility of pig and dairy farming investments is strictly limited.

In order to help restore the balance between demand and supply, special provision is made for aiding investments in conversion to non-surplus products and afforestation of farm land.

Income support for farmers is permitted, within limits, in the following cases:

(i) set-aside of arable land,

(ii) extensification of production,

(iii) conversion to non-surplus products,

(iv) disadvantaged agricultural areas.

Farmers may also be compensated in environmentally sensitive areas for loss of income resulting from the adoption of more environment-friendly methods.

Under a transitional scheme,[24] more general income support can be given to the less productive farms for a maximum of five years. For each farmer the amount of the aid, which is degressive, is fixed in relation to the loss incurred as a result of changes in the common agricultural policy.

Price support measures in agriculture (e.g. intervention buying and export refunds), being Community measures, are not subject to the State aid rules.

(c) Fisheries

The rules for this sector cover the fishing fleet, fish farming and processing and marketing.[25]

A general principle of the control of State aids in this sector is that aid must be compatible with multiannual guidance programmes drawn up by the Member States and approved by the Commission under Council Regulation (EEC) No 4028/86. This means that the Commission can check the overall impact on the sector of the aid system operated by the Member State. For example, the Commission can ensure that the net effect of schemes to promote the modernization of the fishing fleet, on one hand, and to encourage the withdrawal of vessels from fishing activity, on the other hand, is to promote the efficiency of the sector rather than to create or perpetuate surplus capacity.

(d) Transport

As noted in Section 1, Article 77 of the EEC Treaty allows Member States to compensate undertakings in the road, rail and waterway sectors for the public service obligations imposed on them. Council Regulation (EEC) No 1191/69 defines the circumstances in which such obligations may be imposed, gives transport undertakings the right to compensation for fulfilling the obligations and lays down the procedures for paying such compensation. The obligations may be:

(i) to operate a service with a given frequency and capacity,

(ii) to carry passengers or goods at specified rates and conditions,

(iii) to apply preferential tariffs and conditions to certain categories of goods or passengers.

The obligations should be met in the least costly way and the compensation must be calculated so as to match exactly the net cost to the carrier.

Apart from preferential rates and conditions for certain categories of passenger, the latest amendment[26] of Regulation (EEC) No 1191/69 only allows public service obligations to be imposed in relation to urban, suburban and regional services. For long-distance services, and as a preferred option for all services, Member States must conclude freely negotiated 'public service contracts' with the transport undertakings if they wish non-commercial objectives to be taken into account. The contracts will, of course, make provision for compensatory payments.

Council Regulation (EEC) No 1107/70 allows transport undertakings to receive State aid to cover some other costs, notably:

(i) infrastructure costs,

(ii) research and development in the field of new transport technologies,

(iii) costs arising from the elimination of excess capacity.

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24 Council Regulation (EEC) No 768/89.

25 See in particular Commission of the EC (1988b).

26 Council Regulation (EEC) No 1893/91.

Council Regulation (EEC) No 1192/69 relates only to the railways and seeks to improve the transparency of financial relations between governments and the railway companies. It also allows some further types of aid to be given, in particular aid to cover specific social costs not borne by other enterprises and the costs of crossing facilities.

As far as the railways are concerned, the above regulations should, in principle, allow them to enjoy a high degree of commercial independence, by restricting the power of governments to impose obligations and by giving an entitlement to compensation when public service obligations are imposed. Furthermore, these regulations attempt to provide a 'level playing field' for competition between the modes of transport by allowing aid to cover costs, such as the construction and maintenance of infrastructure, which are not (or not directly and fully) borne by other transport enterprises. Nevertheless, Council Decision 75/327 still permits governments to pay general deficit subsidies to railway undertakings.

Air transport is dealt with in a policy paper and guidelines published by the Commission in 1984.[27] In the policy paper, the Commission states that it sees no need for special legislation on compensation for public service obligations imposed on air carriers, as the EEC Treaty rules are adequate for dealing with all known cases of aid in this sector. In view of the danger that liberalization of the regulatory system could lead to a 'subsidy race' in civil aviation, the document envisages tighter control of aid to the sector. This control is essentially based on the same principles as apply to other sectors under Articles 92 and 93 EEC.

However, the Commission announces its intention of applying the rules in such a way as not to put Community airlines at a competitive disadvantage in relation to airlines of non-member countries which give subsidies or other forms of preferential treatment. The Commission also expresses a generally favourable attitude towards aid for air services in underdeveloped regions. Aid to promote the purchase and use of particular types of aircraft, if it does no more than cover the additional costs of those aircraft, is considered to be indirect aid to the manufacturers, rather than to the airlines, and assessed as such.

The Commission's guidelines on aid to shipping companies[28] were drawn up in the context of world-wide excess capacity, high manning costs for Community companies compared with their main competitors and a general growth in both protectionism and the use of 'flags of convenience'. The Commission considers that the common interest is served by appropriate measures to maintain ships under Community flags and encourage the employment of Community seafarers. However, the amount of aid must be in proportion to the objective and is therefore subject to a ceiling fixed by the Commission with reference to the gap in operating costs between Community-registered ships and their main competitors. Aid must be temporary and preferably on a declining scale. Furthermore, aid should not contribute to the creation or maintenance of excess capacity in market segments where there is 'manifest overcapacity'.

(e) Shipbuilding

Aid to shipbuilding has been the subject of a series of Council directives since 1969. It is now governed by the seventh Directive, No 90/684. Like the sixth Directive of 1987, it provides for operating aid, including any aid given to shipowners for buying new ships, to be subject to a ceiling fixed annually by the Commission. The ceiling, which is to be progressively lowered, takes account of the difference between the costs of the most competitive Community yards and the prices charged by their main international rivals. Since 1987 the ceiling has been reduced for most ships from 28 to 13% in 1991 and for small, specialized vessels from 20 to 9%.[29] Depending on the form of the aid (contract-related or otherwise), the ceiling is applied as a percentage of either the contract value before aid or the shipyard's annual turnover in shipbuilding or conversion.[30] Where there is competition for a contract between shipyards in more than one Member State, the Commission may impose an aid limit lower than the ceiling. Operating aid for ship repairing is not allowed.

Investment aid may not be given for projects which would increase the Member State's shipbuilding capacity (except if the Member State has no existing capacity or only one shipyard). The Commission may allow aid to be given for permanent closures or reductions in capacity (e.g. to finance redundancy payments or conversion to non-shipbuilding activities) and for R&D.

(f) Synthetic fibres, textiles and clothing

In these sectors, the Commission will not approve aid for investments which would lead to increased capacity if for the product concerned there is structural excess capacity or

[27] Commission of the EC (1984b).
[28] Commission of the EC (1989c).

[29] From 1991 the lower ceiling applies also to all ship conversion.
[30] Export credits in accordance with the OECD understanding on export credits for ships are not counted towards the ceiling.

persistent stagnation of demand. However, aid for conversion to activities outside these sectors is, in principle, viewed favourably.

Each case of aid for the synthetic fibres industry has to be notified individually.

(g) Motor vehicles[31]

All cases of aid to this sector have to be notified individually. Investment aid in assisted regions is scrutinized carefully, the benefits for regional development being weighed against possible adverse effects on the sector as a whole.

Other investment aids may be permitted if they relate to fundamental rationalization, beyond the firm's capacity to finance from its own resources or borrowing, or to products or processes which are genuine innovations from the Community standpoint.

Rescue and restructuring aid is only allowed if the Commission is convinced that there is a Community interest in keeping the firm in business and there is a satisfactory restructuring plan. As a condition for approving aid, the Commission may require reductions in capacity.

No new operating aids are to be approved and all existing aids of this sort are to be phased out.

6.4. State aid policy and the Community's financial instruments

The Community has at its disposal various instruments for providing financial support directly or indirectly to firms. These include notably:

(i) the Guarantee Section of the European Agricultural Guidance and Guarantee Fund (EAGGF), which finances the price support mechanism in agriculture,

(ii) the structural Funds, i.e. the European Regional Development Fund (ERDF), the European Social Fund (ESF) and the Guidance Section of the EAGGF,

(iii) structural measures in the fisheries sector,

(iv) various provisions for promoting R&D and the development of energy resources,

(v) grants and loans under the ECSC Treaty for the coal and steel industries,

(vi) the European Investment Bank (EIB) and the New Community Instrument for borrowing and lending (NCI).

It can be said of these instruments generally that their exclusion from the competition provisions of the Treaties is justified by the fact that their resources are allocated according to Community criteria with the specific intention of avoiding any advantage to particular Member States which is not in conformity with Community policy.[32] However, it is essential for the Commission to ensure that the operation of the Community's financial instruments is consistent with State aid policy.

This consistency is assured in two ways. Firstly, State aid policy does not function in a vacuum: the compatibility of aids with the common market is largely determined by the common interest, which itself is a function of the whole spectrum of Community policies, including those which govern the Community's financial instruments. Secondly, decisions on the allocation of Community funds are made in the light of State aid policy, so that, for example, the structural Funds cannot co-finance aid schemes which have not been approved by the Commission. In many cases, the requirement of compatibility with competition policy is specifically mentioned in the relevant legislation. For example, Article 7(1) of the Framework Regulation[33] governing the structural Funds states that 'Measures financed by the structural Funds or receiving assistance from the EIB or from another existing financial instrument shall be in keeping with the provisions of the Treaties ... and with Community policies, including those concerning the rules on competition ...'.

In the case of the EAGGF Guidance Section, the rules on State aid to farmers and those concerning the award of Community grants are usually combined in the same regulation (notably Regulation (EEC) No 797/85).

There are, of course, occasions when the assessment of an aid under competition rules can differ from that made in the context of another Community policy. One example can be found in the context of regional policy. Both the Commission's State aid policy and Community structural policy

[31] Commission of the EC (1989b).

[32] Note also that it would be legally absurd for the Commission to sit in judgment, as the authority charged with controlling aids, on decisions which it has made as the authority responsible for executing the budget.

[33] Council Regulation (EEC) No 2052/88.

aim at concentrating aid on the regions in greatest need. However, State aid policy takes account of both the national and the regional contexts (see section 2(b) of this chapter), while the eligibility of areas for assistance from the structural Funds under regional objectives depends almost solely on their socio-economic conditions relative to a Community standard.

One consequence of this difference is that 10% of the Community's population live in areas where national schemes of regional aid are authorized but where the Community gives no financial support for regional development purposes. It can be argued that the granting of national aid in these areas weakens the effectiveness of Community structural policy to the extent that they compete for investment with the regions to which the Community accords a priority. However, the amounts and intensities of State aid awarded in such areas are usually small, so that the effect on other regions is not likely to be great.

Another result of the difference in criteria is that there are areas (covering 5,5 % of the Community's population) where the reverse situation holds, i.e. where national regional aid has not been authorized but where the Community intervenes to promote regional development. In such areas, the Community can contribute towards infrastructure, training and agricultural measures but assistance for investment in industry and services is limited to approved schemes of low-intensity aid for SMEs. Some would argue that in all areas where Community structural policy identifies a need there should be an automatic right to the full range of aid schemes. Here again, the problem has to be put into perspective. Firstly, the areas concerned are generally in the central regions of the Community and do not suffer from the most severe handicaps. Secondly, Community (i.e. ERDF) contributions for investment in industry and services represent only a part, and often a small part, of the expenditure of the structural Funds in any region. Finally, ineligibility for national regional aid can be the result not only of the application of the State aid rules but also of decisions made by the Member State.

From the above brief discussion it can be concluded that the integration of competition policy with other Community policies is, in general, adequate and that there is no reason to fear the occurrence of serious anomalies.

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Note: Documents marked with an asterisk are included in Commission of the EC (1990), *Competition law in the European Communities, Volume II: Rules applicable to State aids,* Brussels/Luxembourg.

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* 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, OJ L 156, 28.6.1969.

* Council Regulation (EEC) No 1192/69 of 26 June 1969 on common rules for the normalization of the accounts of railway undertakings, OJ L 156, 28.6.1969.

* Council Regulation (EEC) No 1107/70 of 4 June 1970 on the granting of aids for transport by rail, road and inland waterway, OJ L 130, 15.6.1970.

Council Regulation (EEC) No 797/85 of 12 March 1985 on improving the efficiency of agricultural structures, OJ L 93, 30.3.1985.

* Council Regulation (EEC) No 4028/86 of 18 December 1986 on Community measures to improve and adapt structures in the fisheries and aquaculture sector, OJ L 376, 31.12.1986.

Council Regulation (EEC) No 2052/88 of 24 June 1988 on the tasks of the structural Funds and their effectiveness and on coordination of their activities between themselves and with the operations of the European Investment Bank and the other existing financial instruments, OJ L 185, 15.7.1988.

Council Regulation (EEC) No 768/89 of 21 March 1989 establishing a system of transitional aid to agricultural income, OJ L 84, 29.3.1989.

Council Regulation (EEC) No 1893/91 of 20 June 1991 amending Regulation (EEC) No 1191/69 on action by Member States concerning the obligations inherent in the concept of a public service in transport by rail, road and inland waterway, OJ L 169, 29.6.1991.

Chapter 7

Current State aid policy

7.1. Introduction

Chapters 5 and 6 discussed the legal background of State aid control and the established rules for its implementation. The aim of the present chapter is to bring the overview of competition policy up to date and examine some proposals for further improvements. Section 2 of this chapter outlines the Commission's priorities for action and the areas of policy which are currently under review, with particular reference to the completion of the internal market. Section 3 discusses some possible improvements in the application of the policy which go beyond those already envisaged by the Commission.

7.2. The Commission's priorities

In recent years, the Commission has progressively tightened up its control over State aids.[1] In large measure, this tightening of discipline is a necessary concomitant of the drive towards the completion of the internal market and of the projected creation of an economic and monetary union (EMU).

The Commission's 1990 White Paper on industrial policy[2] notes the need for strict control to counter the danger that State aids will be used as a substitute for trade barriers which are being dismantled in the Community: 'As other forms of protectionism recede, the importance of State aids as an anti-competitive mechanism tends to grow.'

Furthermore, the White Paper notes that State aids can hinder the achievement of the Community's objective of improving the relative living standards and competitiveness of the less-developed regions (the cohesion objective), since 'large and well-developed Member States will always be able to outbid less-developed Member States on the periphery of the Community'.

To counteract this problem, the Commission suggests, in particular, that 'the effectiveness of the Community's policies to promote greater cohesion could be improved by some progressive reduction in aid intensities in the central and more prosperous regions'.

The Cecchini Report[3] observes, moreover, that an energetic competition policy is necessary if the full potential, in terms of economic efficiency, of the single market is to be realized, while the report 'One market, one money'[4] expresses the view that 'with EMU the need to restrict State subsidies is much increased'.

Thus the desire for stricter control of State aids is underpinned not only by pure competition policy considerations but also by concern for economic efficiency and cohesion. Gilchrist and Deacon (1990) summarize the issues in the following way:

'Without a firm and comprehensive aid policy there can therefore be no real internal market. Such a policy is in the interest of Member States. The poorer ones do not have the resources to compete with richer members. For the latter to compete in granting aid would amount to a beggar-my-neighbour policy. This is a negative-sum game, and costly in terms of budget and inflation.'

What steps is the Commission taking to respond to this challenge?

Firstly,[5] it has defined three urgent requirements for enhancing the effectiveness of control. These are:

(a) the review of existing schemes in accordance with Article 93(1) EEC,

(b) improving the quality of information on the impact of schemes,

(c) limiting the overall volume of aid granted.

Secondly, it has identified several types of aid which, because of the sums involved and their special potential to distort competition, merit particularly close attention. These are:

(d) general investment aid schemes,

(e) capital injections into publicly-owned enterprises and the acquisition of minority holdings in other companies by public authorities,

1 Some observers, like Andel (1990), consider that until the late 1980s 'the Commission was rather soft on subsidies'.
2 Commission of the EC (1990).

3 *European Economy* (1988), Part A.
4 *European Economy* (1990), Chapter 3.
5 See Brittan (1989).

(f) interventionist industrial policy aids to support national champions,

(g) export aids.

(a) Review of existing schemes

Article 93(1) EEC requires the Commission, in cooperation with the Member States, to 'keep under constant review all systems of aid existing in those States'. Until recently this task was carried out rather sporadically because of the heavy workload imposed by the examination of new aid cases. Resources have now been freed for reviewing existing schemes by streamlining the procedures for dealing with cases of minor importance (the large number of cases involving low-intensity aid schemes for SMEs and small changes to existing schemes).

The Commission's surveys showed that the bulk of the aid that is being granted by Member States is accounted for by existing schemes, many of which were approved by the Commission a long time ago. The re-examination of these schemes is thus essential not only because they constitute a large volume of expenditure but also because the circumstances which may initially have justified their existence may well have changed over the succeeding years. Furthermore, attitudes towards State aids, including that of the Commission, have evolved since the early 1980s and there are, indeed, some approved schemes which now seem difficult to reconcile with the Community rules in any circumstances.

For the reasons set out below, particular attention is being paid to reviewing general investment aid schemes. Since the beginning of 1990, the Commission has made recommendations concerning seven such schemes.

As a result of these recommendations, the Dutch Government has already terminated a scheme with an annual budget of ECU 26 million and the Belgian Government has agreed that, from mid-1991, it will no longer give general investment grants under the Economic Expansion Law of 1959, for which the budget in 1990 was ECU 96 million. For its part, the United Kingdom Government has reached an agreement with the Commission whereby every proposal to grant aid under the discretionary powers of Article 8 of the Industrial Development Act must be notified individually to the Commission.

A proposal has been addressed to France requiring, *inter alia*, the cessation of certain restructuring aids granted outside assisted areas and the prior notification of others (expenditure in 1986-89 totalling ECU 317 million). The Commission has also proposed winding up the Italian Special Fund for Technological Innovation, which had a budget of ECU 325 million in 1989, and ending aid under Luxembourg's Economic Expansion Law. Finally, the Dutch Government has been asked to abolish a scheme for providing State guarantees for general investment purposes at a net cost to the State in the period 1981-89 of about ECU 50 million.

The Commission has also recently taken steps to limit aids under other types of existing schemes, including four regional aid schemes. In one French case, the Commission has proposed ending the eligibility of several areas which do not meet its criteria. In another case, the Spanish Government has been asked to reduce the maximum rate of aid given in one area.

Should any Member State fail to comply with such proposals, the Commission can set in motion the procedure foreseen in Article 93(2) leading, if necessary, to a binding final decision.

In order to ensure that in future all schemes are regularly reviewed, the Commission proposes to limit the period of validity of its decisions approving new aid schemes. Their continuation after the expiry of that period will then require re-notification and a new Commission approval.

(b) Information

In order to be better able to assess the potential impact of new aid schemes or changes to existing schemes, the Commission is drawing up proposals for a standardized form of notification designed to elicit essential information, such as the budgetary provision and the estimated number of recipients as well as the precise conditions of eligibility. Furthermore, the Member States are to be asked to explain why the scheme should be considered compatible with the EEC Treaty. Such standardized forms should also help to reduce delays in reaching a decision resulting from the need for the Commission to ask for further information.

To improve the monitoring of existing schemes, the Commission is likely to introduce a generalized system of annual reports. Annual reports are commonly required by recent Commission decisions approving aids, but older schemes outside the 'sensitive' sectors (shipbuilding, motor vehicles, etc.) are often not subject to such a condition. It is suggested that these reports should contain data on the regional and sectoral distribution of aid. These data would enable the Commission to assess the extent to which non-regional aid systems may be interfering with regional policy objectives and whether there is an undue concentration of aid in any sector. In addition, it would be desirable to be able to identify individual large recipients of aid. The latter information would have to be treated as confidential by the Commission but is vital for a full appreciation of the trade-distortion effects of a scheme. In this context, it is worth noting that the 1 300 largest Community manufacturing firms account for two-thirds of the turnover in the sector and probably even more of the intra-Community trade.

(c) The overall volume of aid

Brittan (1989) states 'I believe it is necessary to examine the overall volume of aid'. This objective is to a large extent achieved by the Commission's two surveys. However, the means by which the Commission can limit the overall volume, as opposed to reacting to individual schemes, remain unclear. The Economic Policy Committee is currently examining a proposed opinion aimed at a regular review of the levels of aid and on agreement by Member States to reduce them. Beyond encouraging this initiative, the main role of the Commission would seem to lie in giving greater importance to assessing the volume of aid under each scheme in relation to the needs which the scheme addresses.

In this respect, the problem of poorer regions and countries being outbid by the richer ones is particularly relevant. Since the resources of the former are very limited, the fact that they are permitted to offer higher rates of investment aid (up to 75% in some cases) is often not decisive in attracting new activities. They are usually obliged to choose between giving much less than the maximum aid rate or assisting many fewer projects.[6] Thus, a prosperous region where only a low aid intensity is allowed may often succeed in attracting investment that would otherwise have gone to a less-developed area, simply because it has the budgetary resources to finance a large number of projects.

(d) General investment aid schemes

These are schemes without specific sectoral or regional objectives. Because the granting of aid is discretionary, they are subject to the State aid rules. As most of them were approved many years ago, for reasons which now seem difficult to understand, they are the subject of intensive review under the provisions of Article 93(1) EEC, as noted above.

The effects of such schemes can be especially distortive when the award of aid is biased towards certain sectors. Furthermore, they can hinder the achievement of Community objectives by diverting investment away from priority areas.

The need to eliminate or substantially modify such schemes is made all the greater by the large and increasing volumes of aid involved.

(e) Capital injections, public enterprises and State holdings

The rules governing aid to public enterprises and the acquisition of minority State holdings, including the 'commercial investor criterion' (see Chapter 5, Section 2(c)) are fairly well defined, if not always easy to apply. However, the major problem remains, in spite of the Commission's directives on the subject, a lack of transparency. It is still the case that some major aids to public enterprises only come to light as a result of press reports.[7] In carrying out the surveys, the Commission's services found a considerable volume of capital injections which seemed to include aid elements but which had never been notified.

The Commission is therefore working on ways of greatly improving the quality of information in this area.

(f) National champions

Some Member States are still committed to interventionist industrial policies in what they regard as 'strategic sectors'. Such policies are often designed to provide aid to so-called 'national champions' — well-known large companies. If every Member State is allowed to maintain artificially its own national champion in each 'strategic sector', the completion of the internal market will not yield the intended improvements in economic efficiency.

For this reason, Brittan (1989) proposes a strict check on aid to such firms.

(g) Export aids

The elimination of all aid for intra-Community exports — or at least all overt aid — is now complete. Until now the Commission has not attempted to tackle aids for exports to non-member countries, although the Member States are bound by OECD and GATT agreements.

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6 For example, the theoretically acceptable maximum for regional aid in Greece is 75% NGE but the actual maximum is 50% gross.

7 Gilchrist and Deacon (1990) quote the purchase in 1988 of Alfa Romeo by Fiat, which was found to involve aid.

Article 112 of the EEC Treaty provides for progressive harmonization of systems of aid for exports to third countries, 'to the extent necessary to ensure that competition between undertakings of the Community is not distorted' but this harmonization has not taken place. Article 112 does not seem to prevent the application of the other State aid provisions of the Treaty and, consequently, the Commission is now looking into the possibility of using the latter provisions to control these aids.

It is clear that these aids can distort intra-Community competition since firms from different Member States compete on the same extra-Community markets and because any aid can improve a firm's ability to compete on the domestic market. The Commission has started its review of these aids by asking Member States to notify their existing schemes and provide information on the exporters who are their main beneficiaries.

7.3. Proposals for further action

It is clear that the control of State aids has been tightened up considerably over the last two years and that this process is continuing. However, there are still some areas, such as export aids, where the Commission has yet to complete its examination of the possibilities for exerting stricter control. In some other fields, where intra-Community competition was previously almost unknown, the need for control may make itself felt with increasing force as progress is made towards the completion of the internal market.

For example, public utilities, and in particular telecommunications, electricity and gas supply are being opened up to intra-Community competition, but there is as yet no definite policy on aids to these undertakings.

The formulation of such a policy is complicated by the possibility that Article 90(2) EEC might be applicable in some cases (see Section 2 of Chapter 5). However, some control over State aids to these undertakings is necessary for the creation of an internal market in the sectors concerned. Moreover, the results of a lack of control can spill over into other sectors. For example, suppose that an electricity supplier has considerable excess capacity. With low marginal costs, the supplier will be willing to offer electricity at a low price in order to increase consumption and make use of the excess capacity. Such a decision would be commercially justifiable and would not, in principle, constitute the granting of State aid. However, if the excess capacity has been built up thanks to financial assistance from the government, then firms benefiting from the low electricity prices are in effect receiving an indirect subsidy from the State, which should be subject to Community control.

In other fields, some critics argue that the Commission's practice falls short of its declared intentions. This criticism is often directed towards the treatment of rescue and restructuring aids. Rescue aids can be a means of delaying essential rationalization and should therefore only be granted when there is a convincing restructuring plan, which is also an essential condition for allowing aid for the restructuring measures themselves. However, Gilchrist and Deacon (1990)[8] remark that:

'In practically all cases of rescue of major ailing companies, whatever the industrial sector, the Commission has approved all, or the major part of the aid.'

Clearly, such cases are complicated by short-term factors, particularly social and political considerations and it would be wrong to suppose that the Commission's task in these cases is easy. Nevertheless, the expectation that, if necessary, rescue aid will be forthcoming can lead firms to postpone making necessary adjustments instead of acting promptly at a time when the social, economic and political problems can be minimized.

Another area for concern relates to the privatization of public enterprises. Such privatization frequently occurs by selling not on the open market but by private agreement. In such cases, it is the Commission's task to check whether the price paid corresponds to the true value of the firm. If the price is lower, then the purchaser receives an aid from the State which gives him a definite competitive advantage. The valuation of a firm is an extremely complex task and can never be exact, since it is largely dependent on expected future profits. However, in forming its opinion about the value of privatized firms, the Commission tends to rely almost entirely on information provided by the Member State. In some major cases, at least, it would seem advisable to obtain a second opinion from an independent source, even though such a valuation may be quite costly and time-consuming. It might be worth considering the possibility of asking Member States to inform the Commission as soon as the decision on the principle of privatization is made, with a view to the joint appointment of an independent consultant. The valuation made by this consultant would

[8] Joseph Gilchrist and David Deacon are senior officials in the Commission's Directorate-General for Competition with great experience of State aid policy. The views expressed in the paper quoted here, although not necessarily representing the official position of the Commission, are therefore of considerable interest.

guide both the Member State in its negotiations with purchasers and the Commission in its examination of the ultimate transaction.

An interesting contribution from outside the Community institutions towards the debate on State aids is to be found in a recent report by a committee of the Dutch Social and Economic Council[9] which makes several further proposals for improving the control of State aids. On the general legal and procedural framework, the committee proposes that the Commission should be given clear powers to investigate suspected aid cases by examining the records of public authorities and also, in extreme cases, the books of firms which may have benefited from aid. The report also notes that the Commission normally only publishes detailed information on aids which are the subject of investigation under the procedure laid down in Article 93(2) EEC. It recommends that more information should be published concerning aids which the Commission has approved without initiating this procedure and that there should be improvements in the legal right of interested parties to appeal against approval decisions.[10]

On export aids, the report suggests in particular that Member States should end the practice of linking overseas development aid to orders for their own products and services since this practice serves to disguise aid for domestic firms as aid for underdeveloped countries.

9 Sociaal-Economische Raad (1991).
10 Gilchrist and Deacon (1990) make similar recommendations.

The report's recommendations on R&D aids include a more precise definition of what is meant by the concept of 'nearness to the market-place', so as to reduce the possibility of disguising productive activity as R&D. The committee also proposes that the Commission should control the award of research contracts by public authorities and the transfer of R&D results at less than cost from public research bodies to undertakings.

Gilchrist and Deacon (1990) take a much more radical line on aid for R&D. They suggest that such aid is often unnecessary for the achievement of the Community's goals, since 'most R&D aid is probably spent on projects that would go ahead anyway'. Furthermore, they argue that R&D resources are in inelastic supply in the short and medium term, so that aided projects may simply crowd out unaided ones without any overall benefit to the Community. They conclude that the money would be better spent on a general reduction in corporate taxes. As a second-best solution, they suggest general tax relief for R&D expenditure, without any conditions as to the nature of the projects undertaken.

Finally, Gilchrist and Deacon suggest that the Commission should concentrate much more of its efforts on overseeing the aids given to the Community's 1 500 largest firms, since aid to these firms is likely to have a disproportionate impact on trade and competition. They discuss the possibility of an outright ban on all aid to such firms except that granted under approved regional and R&D schemes. However, they conclude that such a ban might be too rigid and might require new legal powers, which the Council is unlikely to grant.

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Chapter 8

The international dimension

8.1. Introduction

The liberalization of trade has in principle been recognized as a major source of potential welfare improvements due to a specialization of production guided by comparative advantages, but also to a greater variety of goods available to consumers, faster dissipation of technical progress and greater dynamism induced by international competitive pressures.

Thus after the Second World War global, regional and bilateral efforts to create and strengthen a liberal trade system never ceased. But whereas trade liberalization almost always creates a potential for global welfare improvement, the size and the distribution of the gains depend on many factors and can be affected by government intervention. On the one hand governments may be induced to use 'strategic trade policy' to divert gains to the domestic economy or just to powerful domestic producers. On the other hand, as opening to trade implies losses in some sectors, governments are permanently under pressure to provide relief in the form of, for example, quotas to restrict imports quantitatively, voluntary export restraint agreements, countervailing or anti-dumping duties, non-tariff barriers in the form of domestic technical standards or domestic public procurement, or by means of subsidies. These pressures are difficult to resist in particular if foreign governments or enterprises are perceived as using unfair trading practices.[1] Thus trade liberalization is inextricably linked to the creation of a system of credible surveillance of national policies to assure a 'level playing field'. Otherwise there is the permanent threat that the potential gains from trade may evaporate under a barrage of trade interventions and counter-interventions.

In recognition of this link efforts to liberalize trade have been accompanied by attempts to supervise national interventions which may affect trade. The form and extent of such supervision depend on the willingness of the parties involved to trade off the potential gains from free trade against the implied reduction of national sovereignty.

1 Even if an export subsidy may actually improve the welfare of the importing country — see Chapter 3.3.

8.2. Specific international agreements

Only the European Community has developed a comprehensive internal competition policy disciplining certain activities by national governments or enterprises and transferring an important part of policy authority to the supranational level.[2] *Vis-à-vis* foreign trading partners the Member States have ceded their national powers over anti-dumping and anti-subsidy policies to the European Community.

Community procedures[3] follow current GATT practice (see below). They allow an EC industry which is affected by subsidized or dumped imports to seek measures to redress the injury, such as for example price undertakings or countervailing duties. The administrative responsibility is divided between the Commission, the Council and the Member States. The Commission investigates and determines whether there is sufficient evidence of a subsidy or of dumping, of material injury and of a causal link between them, to justify initiating a proceeding. It may impose provisional anti-dumping duties for up to six months. Only the Council can, based on a Commission proposal, order the imposition of definitive duties. Member States are closely associated with the proceedings in the context of the Advisory Committee which is consulted by the Commission. Finally, appeals may be filed against decisions made in the course of the proceedings with the Court of Justice.

Other international agreements rely on different combinations of monitoring and disciplining, defining some normative criteria for potentially trade-distorting policies, limiting recourse to countervailing interventions and providing for dispute settlement mechanisms.

The US-Canada Free Trade Agreement[4] for example, which entered into force on 1 January 1989 and which has the objective of establishing a free trade area between the two countries within 10 years, has so far only created a binational structure for resolving disputes arising out of each country's application of its own countervailing duty laws and established a working group to seek to develop a system of rules dealing with unfair pricing and subsidization.

The Organization for Economic Cooperation and Development (OECD) plays an important role in the discussion of the theory and practice of subsidy policies of the industrialized countries. Its Industry Committee has for many

2 See Chapters 5 to 7.

3 Currently based upon Council Regulation (EEC) No 2423/88 of 11 July 1988 and Commission Decision 2177/84/ECSC for coal and steel.

4 Hufbauer (1989).

years compiled information on national subsidy programmes and is trying to provide a classification according to their economic impacts. Full transparency and agreement on norms for national subsidy policies have not yet been achieved. But the OECD countries have reached an understanding on the minimum interest rates which should be applied for national export credits;[5] these minimum rates are calculated and published by the OECD bi-annually for the main international currencies.

The European Free Trade Association (EFTA) has defined general principles under which government aids are allowed and the conditions under which they contradict the spirit of their agreement (Article 13 of the Stockholm Convention). The EFTA Council periodically issues interpretations of these principles. Since 1987 member countries are required to notify the Secretariat on planned aid measures; once a year the countries must also report on past aid measures. On the basis of this information the Secretariat prepares its annual report to the Council on government aids within EFTA, but it has no resources to monitor and verify the information it receives. The measures are surveyed by the Association's Committee of Trade Experts, consisting of representatives from member States. There is no effective enforcement mechanism of Article 13: the EFTA Council may issue a recommendation which is, however, non-binding; at most, it can authorize a member State to take the counter-measures available through GATT proceedings.

The sparse surveillance of subsidies in EFTA may be due to the limited importance of intra-EFTA trade for EFTA members: in 1987 only 14 % of EFTA exports were destined for other EFTA nations; by contrast, some 59 % were directed to the European Community. The creation of a European economic space between the EC and the EFTA will certainly imply stronger surveillance of EFTA subsidies. Under discussion is a 'two-pillar' model: the EFTA would set up a surveillance of domestic subsidies identical to EC rules and procedures. This would enable the EC to abandon the possibility of applying countervailing duties. Differences between the EC and EFTA on the application of the rules would be settled by consultation with a joint court as final arbiter.

8.3. The existing GATT subsidy rules

The broadest attempt to introduce international surveillance over trade-distorting government interventions is undertaken within the framework of the General Agreement on Tariffs and Trade (GATT). It establishes at the same time a certain discipline on unilateral measures against imports and on subsidies. Article VI permits the imposition of countervailing duties (CVDs) to offset 'any bounty or subsidy determined to have been granted, directly or indirectly, on the manufacture, production or export of such product', but only after material injury to domestic industry has been established and not in excess of the subsidy. Article XVI requires notification of all trade-relevant subsidies and, in case of serious prejudice, consultation among the parties concerned. Furthermore, from 1958 the signatories should seek to avoid the use of export subsidies for primary products and shall cease export subsidies for non-primary products. Subsequently a list was agreed upon of practices defined as export subsidies. Article XXIII provides in principle the possibility to authorize counter-measures if a signatory fails to carry out its obligations. Thus the GATT cannot directly intervene in the policy of a signatory — contrary to the EC policy on State aids; it can only attempt to enforce its rules on subsidies by means of authorizing counter-measures.

Experience indicated that better interpretation of these general provisions was required to make them workable. A 'subsidies Code' was negotiated on the interpretation and application of Articles VI, XVI and XXIII during the Tokyo Round of multilateral trade negotiations (1974-79). In June 1989 there were 25 signatories to the Code including the USA, the EC and Japan.

The Code does not establish rules which are different from the basic GATT articles, but it attempts to make them more precise and to improve the links between them:[6] with regard to subsidies it underlines the prohibition of export subsidies except for agricultural products[7] and recommends restraint in the use of domestic subsidies that adversely affect the interest of other members. If a country can establish that any subsidy caused material injury to a domestic industry in its domestic market it may unilaterally impose countervailing duties but is bound to follow certain procedures ('track 1'); the Code provides general guidelines for such procedures, regulates the type of compensatory measures that can be imposed, sets forth broad criteria for the determination of adverse trade effects and calls for consultation among the parties. An alternative approach ('track 2') is multilateral: if a signatory considers any subsidy to be inconsistent with the provisions of the Code, it can invoke a dispute settlement procedure; at the end the Committee of the signatories may

5 It is, however, somewhat odd to achieve an 'understanding' on limits to export subsidies which the GATT signatories have agreed to abolish altogether (see Chapter 8.3).

6 Without achieving full consistency: it may still be that a subsidy is legal under the Code — because it is 'domestic' — and the countervailing duty against that subsidy is legal as well — because of injury to a domestic industry (Finger (1987), p. 154).

7 Including forestry and fishery.

authorize appropriate counter-measures. But the dispute settlement is based on consensus which can be blocked by the losing party. Special provisions are granted for developing countries.

The Code's main success has been the clarification of procedures for countervailing duties. It is still plagued, however, by the unresolved fundamental difference between the USA in particular and other countries on the legitimacy of domestic subsidies and of unilateral counter-measures: 'to the United States, the Code is an instrument to control subsidies. To the rest of the world, it is an instrument to control US countervailing duties'.[8] The economic argument for a differentiated treatment of domestic subsidies is that some subsidies may be distortion-correcting in cases of market failure and not distort efficient trade flows;[9] a countervailing measure against such subsidies would therefore not be justified. But in practice it may be difficult to fine-tune subsidies sufficiently to ensure that the correcting effects outweigh the distorting effects.

The fundamental difference manifests itself in different interpretations of the provisions of the Code, e.g. on definition and measurement of a subsidy, definition of primary and non-primary products (for example the cases of wheat flour and pasta), the definition of domestic industry or the determination of injury, which led to many trade frictions and disputes before the Committee on Subsidies and Countervailing Measures.

8.4. Subsidies in the Uruguay Round

The Code was therefore put to review at the ongoing Uruguay Round of GATT negotiations with the objective set in the Punta Del Este declaration of improving GATT disciplines relating to all subsidies and countervailing measures that affect international trade. The controversial question of subsidies in agriculture was referred to a separate negotiating group; the discussion in other groups, in particular on anti-dumping, but also on services and trade-related investment measures (TRIMs), also overlap to some extent with the negotiations on the subsidies Code.

Several countries have submitted contributions to the negotiations on subsidies. The proposal of the United States of America underlines its desire to broaden the category of prohibited subsidies and to facilitate the use of countervailing duties. It suggests a 'traffic light' proposal distinguishing between a prohibited 'red light' category of subsidies, actionable 'yellow light' subsidies and permitted 'green light' subsidies. The 'red light' category is to cover not only export subsidies in the broadest sense, but also all domestic subsidies exceeding a certain percentage of a firm's total sales; against such subsidies the importing country should be able to impose CVDs without having to establish injury. 'Green light' should be given only to general government measures, e.g. provision of infrastructure. Subsidies in between should not be permitted or prohibited outright, but should be actionable if material injury can be established.

The position of the European Community submitted in November 1989 applies a similar distinction between prohibited subsidies, non-prohibited but actionable subsidies and non-actionable government interventions. But it suggests that the existing approach to consider only export subsidies on products other than certain primary products as prohibited *per se* should be continued, and the injury test should still be required for a countervailing duty. It stresses that the current code establishes that domestic subsidies are *per se* legitimate instruments of social and economic policy and may only be subject to counter-measures if their negative effect on trade interests of other countries has been demonstrated; it suggests more precise criteria for judging whether a government measure is in fact a subsidy, whether it is specific and how to establish a negative trade effect. Furthermore, certain subsidies which do not significantly affect international trade should not be actionable at all: subsidies which do not exceed a certain percentage of sales (a *de minimis* threshold of x% *ad valorem*), regional aids to compensate for locational disadvantages, aid for generally available research and development, environmental aid, aid for energy savings, temporary aid for structural adjustment and aid improving security and diversification of energy supply.

In May 1990 Mr Cartland of Hong Kong, the chairman of the Subsidies Negotiation Group, tabled a draft text reflecting the different submissions and some of his own ideas. It follows the 'traffic light' approach.

It limits the category of 'prohibited subsidies' to the current illustrative list of export subsidies, possibly with some amendments, subsidies contingent on export performance and subsidies contingent on the use of domestic rather than imported goods as inputs (e.g. local content requirements); if the Subsidy Committee found a national subsidy to fall in this category, other signatories could take counter-measures.

8 Messerlin (1986), p. 16.
9 For details see Chapter 3.

Other subsidies would be considered 'actionable' if they caused adverse effects to other signatories, in particular if they caused injury to a domestic industry or caused serious prejudice, the latter being presumed if the overall rate of subsidization exceeded x% *ad valorem*, was contingent on trade performance or was granted to firms exporting x% or more of their production; the country granting the subsidy could rebut this presumption. This attempt to give content to the term 'serious prejudice' is the key new feature of the Cartland draft. If the Subsidies Committee finds adverse effects, counter-measures may be authorized.

'Non-actionable' are to be those subsidies which are either generally available or meet all of the following four criteria: the subsidy is for the purpose of regional development, pre-competitive R&D, environmental protection or worker adjustment assistance; the subsidy is limited in time and degressive; it is notified in advance and no signatory can demonstrate adverse effects. Furthermore, if a non-actionable subsidy in the second subcategory causes serious or long-lasting adverse effects the affected signatory could still resort to the remedy procedures for actionable subsidies.

The Cartland draft has so far met with considerable opposition from both the USA and the EC which had not been overcome when the Uruguay Round was adjourned in December 1990, mainly due to the lack of agreement on agricultural subsidies. If that specific problem can be resolved, there may be two possible outcomes to successfully conclude the negotiations of the Subsidies Group: an intermediate package with fewer categories of subsidies on the green list and a rather high threshold for the assumption of 'serious prejudice' or at least a 'mini-deal' where both the green list and the quantitative threshold for 'serious prejudice' would be dropped, but other elements of the draft (more precise definitions and procedures) could still provide some improvement. Both outcomes would be superior to the maintenance of the *status quo*, which would imply continuing tensions arising from the vagueness of existing rules and from the possibility of unilateral interpretations.

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Appendix

Selected documents concerning the control of State aids

A — Provisions of the ECSC Treaty

Article 4

The following are recognized as incompatible with the common market for coal and steel and shall accordingly be abolished and prohibited within the Community, as provided in this Treaty:

(a) import and export duties, or charges having equivalent effect, and quantitative restrictions on the movement of products;

(b) measures or practices which discriminate between producers, between purchasers or between consumers, especially in prices and delivery terms or transport rates and conditions, and measures or pratices which interfere with the purchaser's free choice of supplier;

(c) subsidies or aids granted by States, or special charges imposed by States, in any form whatsoever;

(d) restrictive practices which tend towards the sharing or exploiting of markets.

Article 54

The High Authority may facilitate the carrying out of investment programmes by granting loans to undertakings or by guaranteeing other loans which they may contract.

With the unanimous assent of the Council, the High Authority may by the same means assist the financing of works and installations which contribute directly and primarily to increasing the production, reducing the production costs or facilitating the marketing of products within its jurisdiction.

In order to encourage coordinated development of investment, the High Authority may, in accordance with Article 47, require undertakings to inform it of individual programmes in advance, either by a special request addressed to the undertaking concerned or by a decision stating what kind and scale of programme must be communicated.

The High Authority may, after giving the parties concerned full opportunity to submit their comments, deliver a reasoned opinion on such programmes within the framework of the general objectives provided for in Article 46. If application is made by the undertaking concerned, the High Authority must deliver a reasoned opinion. The High Authority shall notify the opinion to the undertaking concerned and shall bring the opinion to the attention of its Government. Lists of such opinions shall be published.

If the High Authority finds that the financing of a programme or the operation of the installations therein planned would involve subsidies, aids, protection or discrimination contrary to this Treaty, the adverse opinion delivered by it on these grounds shall have the force of a decision within the meaning of Article 14 and the effect of prohibiting the undertaking concerned from drawing on resources other than its own funds to carry out the programme.

The High Authority may impose on undertakings which disregard the prohibition referred to in the preceding paragraph fines not exceeding the amounts improperly devoted to carrying out the programme in question.

Article 67

1. Any action by a Member State which is liable to have appreciable repercussions on conditions of competition in the coal or the steel industry shall be brought to the knowledge of the High Authority by the Government concerned.

2. If the action is liable, by substantially increasing differences in production costs otherwise than through changes in productivity, to provoke a serious disequilibrium, the High Authority, after consulting the Consultative Committee and the Council, may take the following steps:

— if the action taken by that State is having harmful effects on the coal or steel undertakings within the jurisdiction of that State, the High Authority may authorize it to grant aid to these undertakings, the amount, conditions and duration of which shall be determined in agreement with the High Authority. The same shall apply in the case of any change in wages and working conditions which would have the same effects, even if not resulting from any action by that State;

— if the action taken by that State is having harmful effects on the coal or steel undertakings within the jurisdiction of other Member States, the High Authority shall make a recommendation to that State with a view to remedying these effects by such measures as that State may consider most compatible with its own economic equilibrium.

3. If the action taken by that State reduces differences in production costs by allowing special benefits to or improsing special charges on the coal or steel undertakings within its jurisdiction in comparison with the other industries in the same country, the High Authority is empowered to make the necessary recommendations to that State after consulting the Consultative Committee and the Council.

Article 95

In all cases not provided for in this Treaty where it becomes apparent that a decision or recommendation of the High Authority is necessary to attain, within the common market in coal and steel and in accordance with Article 5, one of the objectives of the Community set out in Articles 2, 3 and 4, the decision may be taken or the recommendation made with the unanimous assent of the Council and after the Consultative Committee has been consulted.

Any decision so taken or recommendation so made shall determine what penalties, if any, may be imposed.

If, after the end of the transitional period provided in the Convention on the Transitional Provisions, unforeseen difficulties emerging in the light of experience in the application of this Treaty, or fundamental economic or technical changes directly affecting the common market in coal and steel, make it necessary to adapt the rules for the High Authority's exercise of its powers, appropriate amendments may be made; they must not, however, conflict with the provisions of Articles 2, 3 and 4 or interfere with the relationship between the powers of the High Authority and those of the other institutions of the Community.

These amendments shall be proposed jointly by the High Authority and the Council, acting by a ten-twelfths majority of its members, and shall the submitted to the Court for its opinion. In considering them, the Court shall have full power to assess all points of fact and of law. If as a result of such consideration it finds the proposals compatible with the provisions of the preceding paragraph, they shall be forwarded to the European Parliament and shall enter into force of approved by a majority of three-quarters of the votes cast and two-thirds of the members of the European Parliament.[1]

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1 Fourth paragraph as amended by Article 13 of the Act of Accession of Spain and Portugal.

B — Provisions of the EEC Treaty

Article 42

The provisions of the Chapter relating to rules on competition shall apply to production of and trade in agricultural products only to the extent determined by the Council within the framework of Article 43(2) and (3) and in accordance with the procedure laid down therein, account being taken of the objectives set out in Article 39.

The Council may, in particular, authorize the granting of aid:

(a) for the protection of enterprises handicapped by structural or natural conditions;

(b) within the framework of economic development programmes.

Article 77

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.

Article 90

1. In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in this Treaty, in particular to those rules provided for in Article 7 and Articles 85 to 94.

2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in this Treaty, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Community.

3. The Commission shall ensure the application of the provisions of this Article and shall, where necessary, address appropriate directives or decisions to Member States.

Article 92

1. 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.

2. The following shall be 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.

3. The following may be considered to be compatible with the common market:

(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;

(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 interest. However, the aids granted to shipbuilding as of 1 January 1957 shall, in so far as they serve only to compensate for the absence of customs protection, be progressively reduced under the same conditions as apply to the elimination of customs duties, subject to the provisions of this Treaty concerning common commercial policy towards third countries;

(d) 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.

Article 93

1. The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing

in those States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the common market.

2. If, after giving notice to the parties concerned to submit their comments, the Commission finds that aid granted by a State or through State resources is not compatible with the common market having regard to Article 92, or that such aid is being misused, it shall decide that the State concerned shall abolish or alter such aid within a period of time to be determined by the Commission.

If the State concerned does not comply with this decision within the prescribed time, the Commission or any other interested State may, in derogation from the provisions of Articles 169 and 170, refer the matter to the Court of Justice direct.

On application by a Member State, the Council, may, acting unanimously, decide that aid which that State is granting or intends to grant shall be considered to be compatible with the common market, in derogation from the provisions of Article 92 or from the regulations provided for in Article 94, if such a decision is justified by exceptional circumstances. If, as regards the aid in question, the Commission has already initiated the procedure provided for in the first subparagraph of this paragraph, the fact that the State concerned has made its application to the Council shall have the effect of suspending that procedure until the Council has made its attitude known.

If, however, the Council has not made its attitude known within three months of the said application being made, the Commission shall give its decision on the case.

3. The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the common market having regard to Article 92, it shall without delay initiate the procedure provided for in paragraph 2. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.

Article 94

The Council may, acting by a qualified majority on a proposal from the Commission, make any appropriate regulations for the application of Articles 92 and 93 and may in particular determine the conditions in which Article 93(3) shall apply and the categories of aid exempted from this procedure.

Article 101

Where the Commission finds that a difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortion needs to be eliminated, it shall consult the Member States concerned.

If such consultation does not result in an agreement eliminating the distortion in question, the Council shall, on a proposal from the Commission, acting unanimously during the first stage and by a qualified majority thereafter, issue the necessary directives. The Commission and the Council may take any other appropriate measures provided for in this Treaty.

Article 102

1. Where there is reason to fear that the adoption or amendment of a provision laid down by law, regulation or administrative action may cause distortion within the meaning of Article 101, a Member State desiring to proceed therewith shall consult the Commission. After consulting the Member States, the Commission shall recommend to the States concerned such measures as may be appropriate to avoid the distortion in question.

2. If a State desiring to introduce or amend its own provisions does not comply with the recommendation addressed to it by the Commission, other Member States shall not be required, in pursuance of Article 101, to amend their own provisions in order to eliminate such distortion. If the Member State which has ignored the recommendation of the Commission causes distortion detrimental only to itself, the provisions of Article 101 shall not apply.

Article 112

1. Without prejudice to obligations undertaken by them within the framework of other international organizations, Member States shall, before the end of the transitional period, progressively harmonize the systems whereby they grant aid for exports to third countries, to the extent necess-

ary to ensure that competition between undertakings of the Community is not distorted.

On a proposal from the Commission, the Council, shall, acting unanimously until the end of the second stage and by a qualified majority thereafter, issue any directives needed for this purpose.

2. The preceding provisions shall not apply to such drawback of customs duties or charges having equivalent effect nor to such repayment of indirect taxation including turnover taxes, excise duties and other indirect taxes as is allowed when goods are exported from a Member State to a third country, in so far as such drawback or repayment does not exceed the amount imposed, directly or indirectly, on the products exported.

C — Transparency of financial relations between Member States and public undertakings

Commission Directive 80/723/EEC[1] of 25 June 1980 on the transparency of financial relations between Member States and public undertakings

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 90 (3) thereof,

Whereas public undertakings play a substantial role in the national economy of the Member States;

Whereas the Treaty in no way prejudices the rules governing the system of property ownership in Member States and equal treatment of private and public undertakings must therefore be ensured;

Whereas the Treaty requires the Commission to ensure that Member States do not grant undertakings, public or private, aids incompatible with the common market;

Whereas, however, the complexity of the financial relations between national public authorities and public undertakings tends to hinder the performance of this duty;

Whereas a fair and effective application of the aid rules in the Treaty to both public and private undertakings will be possible only if these financial relations are made transparent;

Whereas such transparency applied to public undertakings should enable a clear distinction to be made between the role of the State as public authority and its role as proprietor;

Whereas Article 90 (1) confers certain obligations on the Member States in respect of public undertakings; whereas Article 90 (3) requires the Commission to ensure that these obligations are respected, and provides it with the requisite means to this end; whereas this entails defining the conditions for achieving transparency;

Whereas it should be made clear what is to be understood by the terms 'public authorities' and 'public undertakings';

Whereas public authorities may exercise a dominant influence on the behaviour of public undertakings not only where they are the proprietor or have a majority participation but also by virtue of powers they hold in management or supervisory bodies as a result either of the rules governing the undertaking or of the manner in which the shareholdings are distributed;

Whereas the provision of public funds to public undertakings may take place either directly or indirectly; whereas transparency must be achieved irrespective of the manner in which such provision of public funds is made; whereas it may also be necessary to ensure that adequate information is made available as regards the reasons for such provision of public funds and their actual use;

Whereas Member States may through their public undertakings seek ends other than commercial ones; whereas in some cases public undertakings are compensated by the State for financial burdens assumed by them as a result; whereas transparency should also be ensured in the case of such compensation;

Whereas certain undertakings should be excluded from the application of this Directive by virtue either of the nature of their activities or of the size of their turnover; whereas this applies to certain activities which stand outside the sphere of competition or which are already covered by specific Community measures which ensure adequate transparency, to public undertakings belonging to sectors of activity for which distinct provision should be made, and to those whose business is not conducted on such a scale as to justify the administrative burden of ensuring transparency;

Whereas this Directive is without prejudice to other provisions of the Treaty, notably Articles 90 (2), 93 and 223;

Whereas, the undertakings in question being in competition with other undertakings, information acquired should be covered by the obligation of professional secrecy;

Whereas this Directive must be applied in close cooperation with the Member States, and where necessary be revised in the light of experience,

[1] OJ L 195, 29.7.1980.

HAS ADOPTED THIS DIRECTIVE:

Article 1

The Member States shall ensure that financial relations between public authorities and public undertakings are transparent as provided in this Directive, so that the following emerge clearly;

(a) public funds made available directly by public authorities to the public undertakings concerned;

(b) public funds made available by public authorities through the intermediary of public undertakings or financial institutions;

(c) the use to which these public funds are actually put.

Article 2

For the purpose of this Directive:

— 'public authorities' means:
the State and regional or local authorities,

— 'public undertakings' means:
any undertaking over which the public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern it.

A dominant influence on the part of the public authorities shall be presumed when these authorities, directly or indirectly in relation to an undertaking:

(a) hold the major part of the undertaking's subscribed capital;

or

(b) control the majority of the votes attaching to shares issued by the undertakings;

or

(c) can appoint more than half of the members of the undertaking's administrative, managerial or supervisory body.

Article 3

The transparency referred to in Article 1 shall apply in particular to the following aspects of financial relations between public authorities and public undertakings:

(a) the setting-off of operating losses,

(b) the provision of capital,

(c) non-refundable grants, or loans on privileged terms,

(d) the granting of financial advantages by forgoing profits or the recovery of sums due,

(e) the foregoing of a normal return on public funds used,

(f) compensation for financial burdens imposed by the public authorities.

Article 4

This Directive shall not apply to financial relations between the public authorities and

(a) public undertakings, as regards services the supply of which is not liable to affect trade between Member States to an appreciable extent;

(b) public undertakings, as regards activities carried on in any of the following areas:

— water and energy, including in the case of nuclear energy the production and enrichment of uranium, the re-processing of irradiated fuels and the preparation of materials containing plutonium,

— posts and telecommunications,

— transport;

(c) public credit institutions;

(d) public undertakings whose turnover excluding taxes has not reached a total of ECU 40 million during the two financial years preceding that in which the funds referred to in Article 1 are made available or used.

Article 5

1. Member States shall ensure that information concerning the financial relations referred to in Article 1 be kept at the disposal of the Commission for five years from the end of the financial year in which the public funds were made available to the public undertakings concerned. However, where the same funds are used during a later financial year, the five-year time-limit shall run from the end of that financial year.

2. Member States shall, where the Commission considers it necessary so to request, supply to it the information referred to in paragraph 1, together with any necessary background information, notably the objectives pursued.

Article 6

1. The Commission shall not disclose such information supplied to it pursuant to Article 5 (2) as is of a kind covered by the obligation of professional secrecy.

2. Paragraph 1 shall not prevent publication of general information of surveys which do not contain information relating to particular public undertakings to which this Directive applies.

Article 7

The Commission shall regularly inform the Member States of the results of the operation of this Directive.

Article 8

Member States shall take the measures necessary to comply with the Directive by 31 December 1981. They shall inform the Commission thereof.

Article 9

This Directive is addressed to the Member States.

Done at Brussels, 25 June 1988.

Commission Directive 85/413/EEC[1] of 24 July 1985 amending Directive 80/723/EEC on the transparency of financial relations between Member States and public undertakings

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 90 (3) thereof,

Whereas Article 4 (b) and (c) of Commission Directive 80/723/EEC[2] excludes from its scope public undertakings carrying on activities in the sectors of water and energy, posts and telecommunications, transport and public credit institutions;

Whereas public undertakings operating in these sectors play an important role in the economies of the Member States; whereas the need for transparency of financial relations between the Member States and public undertakings in certain sectors previously excluded has proved greater than before in view of developments in the competitive situation in the sectors concerned and the progress made towards closer economic integration;

Whereas equal treatment of public and private undertakings must also be ensured in these sectors; whereas in particular transparency of financial relations between the Member States and public undertakings in these sectors must be established for the same reasons and to the same extent as for the undertakings covered by Directive 88/723/EEC;

Whereas the Commission is required by the Treaty to ensure that Member States do not grant undertakings, whether public or private, in the said sectors aids incompatible with the common market;

Whereas the Commission advised the Member States when notifying Directive 80/723/EEC to them that the exclusion of these sectors was only temporary;

Whereas by virtue of Article 232 (1) of the EEC Treaty the provisions of that Treaty shall not affect those of the ECSC Treaty; whereas the ECSC Treaty contains special provisions governing the obligations of Member States as far as public undertakings and aid are concerned; whereas Article 90 of the EEC Treaty is therefore inapplicable to public undertakings carrying on activities coming under the ECSC Treaty;

Whereas by virtue of Article 232 (2) of the EEC Treaty the provisions of that Treaty shall not derogate from those of the Euratom Treaty, but whereas the latter does not contain any special provisions on public undertakings or aid; whereas Article 90 of the EEC Treaty therefore applies to the nuclear energy field;

Whereas the transparency of the Member States' financial relations with public undertakings in the rail, road and inland waterway transport sectors is already regulated to a considerable extent by legislation enacted by the Council; whereas this Directive is without prejudice to that legislation;

Whereas Directive 80/723/EEC contains provisions, particularly in Articles 3 and 5, which may facilitate the Commission's task in meeting the obligations it has assumed under the said Council legislation, in particular as regards the preparation of periodical reports on the performance of those public undertakings;

Whereas the scope of Directive 80/723/EEC should therefore be extened to cover all the transport sector;

Whereas Member States' financial relations with credit institutions belonging to the public sector are also covered by

[2] OJ L 229, 28.8.1985.
[3] OJ L 195, 29.7.1980.

this Directive; whereas, however, the Directive should not apply to Member States' relations with central banks which are responsible for the conduct of monetary policy;

Whereas public authorities often deposit short-term funds with public credit institutions on normal commercial terms; whereas such deposits do not confer special advantages on the credit institutions and should therefore not be covered by the Directive;

Whereas the economic importance of credit institutions does not depend on their turnover but on their balance-sheet total; whereas the threshold laid down in Article 4 (d) of Directive 80/723/EEC should therefore be set as far as credit institutions are concerned by reference to that criterion,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Article 4 of Directive 80/723/EEC is hereby replaced by the following:

'*Article 4*

This Directive shall not apply to financial relations between the public authorities and:

(a) public undertakings, as regards services the supply of which is not liable to affect trade between Member States to an appreciable extent;

(b) central banks and the Institut Monétaire Luxembourgeois;

(c) public credit institutions, as regards deposits of public funds placed with them by public authorities on normal commercial terms;

(d) public undertakings whose total turnover before tax over the period of the two financial years preceding that in which the funds referred to in Article 1 are made available or used has been less than ECU 40 million. However, for public credit institutions the corresponding threshold shall be a balance-sheet total of ECU 800 million'.

Article 2

Member States shall take the necessary measures to comply with this Directive by 1 January 1986. They shall inform the Commission thereof.

Article 3

This Directive is addressed to the Member States.

Done at Brussels, 24 July 1985.

D — Regional aid

Commission communication[1] on the method for the application of Article 92(3) (a) and (c) to regional aid

On 21 December 1978 the Commission informed the Member States of the principles which in accordance with the powers vested in the Commission by Article 92 *et seq.* of the EEC Treaty, it would apply to regional aid systems in force or to be established in the regions of the Community. These principles were set out in the form of a communication which was published in the *Official Journal of the European Communities*.[2] This communication partly redefined the principles of coordination already established[3] and amended and supplemented the methods for their implementation, including the common method of evaluation of the intensity of aid.

In its 1979 communication the Commission established a number of differentiated ceilings of aid intensity for various categories of region in order to avoid the bidding up of aid level in the wake of the removal of customs and trade barriers inside the common market. The very nature of regional aid requires that it be awarded selectively. Many regions in the Community do not need regional aid. Regions that are shown to need assistance should receive aid in proportion to the gravity of the regional imbalances they face. The ceilings set out in the communication are intended to act as maximum limits reflecting the nature and gravity of regional problems across the Community. Within these parameters the Member States notify proposed levels of regional aid to the Commission, often at lower levels, which subsequently approves or amends them in its decisions under Articles 92 and 93.

Article 92(3) provides two distinct possibilities where the Commission may consider regional aid compatible with the common market — Articles 92(3) (a) and (c) which apply to different degrees of regional disadvantage. The Commission adopted a method for the application of Article 92(3) (c) in 1983 and this method has been used for all the decisions which the Commission has taken since then.

Only occasional use has been made of Article 92(3) (a) when approving national regional aid in the past. However, successive enlargements of the Community have broadened the range of its regional diversity and confirmed the need to develop new policy instruments for the control of regional aid. At the same time Article 130 of the Single European Act gives a new impetus to greater economic and social cohesion and provides that in particular the Community shall aim at reducing disparities between various regions and the backwardness of the least-favoured regions. In response to these needs the Commission has in 1983 adopted a method for the application of Article 92(3) (a) to national regional aid.

In order to promote a greater understanding and transparency of the decisions taken by the Commission under Articles 92 and 93 with respect to national regional aid systems, the Commission, with the support of the European Parliament, has decided to publish its methods of assessment which are described below.

I. Method for the application of Article 92(3) (a) to national regional aid

Article 92(3) (a) provides that aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment may be considered compatible with the common market.

1. Principles of method

In applying Article 92(3) (a) the Commission bases its decisions on a method of assessing the relative level of development of different regions compared to the Community average. The method is based on the following principles:

- the socio-economic situation of Article 92(3) (a) regions is assessed primarily by reference to per capita GDP/PPS using the Community index for the region;
- regions are assessed on the basis of NUTS[1] level III geographical units;
- the relative level of regional development is compared to the Community average;
- regions to be classified as Article 92(3) (a) regions are those regions where a majority of the level III regions located in a level II region have a GDP/PPS threshold of 75 or lower thus indicating an abnormally low standard of living and serious underemployment.

[1] OJ C 212, 12.8.1988.
[2] OJ C 31, 3.2.1979.
[3] Communications of 26 February 1975 and 23 June 1971.

[1] Nomenclature of Statistical Territorial Units. There are 822 NUTS level III regions in the Community of Twelve.

2. Choice of indicators

The method uses GDP per capita measured in purchasing power standards (PPS), a measure based on a comparison of the prices in the Member States for the same sample of production and services. This provides a method of measuring living standards which allows for differences in the cost of living between the regions of different Member States.

Underemployment concerns all those who are not fully employed in some way. In general, where underemployment is great, productive output will tend to be low and as such will also be reflected in GDP data. For the areas concerned—predominantly rural areas with an underdeveloped industrial base or a limited level of service activities—unemployment statistics are not a satisfactory measure of underemployment. The general low level of technology in the industrial infrastructure and the unsophisticated range of service activities lead to a relative emphasis on labour in the productive process. This can mask a significant level of underemployment which remains unrevealed by unemployment data.

3. Geographical unit

The basic geographical unit used in the analysis is the level III region. However, for the purposes of determining eligibility as a 92(3) (a) region, reference is made to the situation of the majority of level III regions in the larger (level II) region. This allows the situation of an individual level III region which differs sharply from the surrounding regions to be taken into account. If a relatively favourable region is located in an otherwise backward area, it can be included under 92(3) (a) provided a majority of the level III regions in the corresponding level II region satisfy the GDP/PPS threshold requirement. On the other hand, however, a more disavantaged region will be excluded if this requirement is not satisfied.

A list of the regions selected by this method is attached in Annex I. It can be seen that these regions lie mainly on the southern and western periphery of the Community.

4. Exceptional regions

In addition to the regions selected by the above method, two further regions have been added to the list in order to take account of their exceptional situations. One is Northern Ireland because of its particularly difficult situation. The other is Teruel which, although adjacent to other more developed regions, is one of the most underdeveloped regions in Spain, is very sparsely populated, has a high level of dependence on agriculture and neighbours other 92(3) (a) regions.

5. Aid ceilings

The 1979 principles of coordination set 75% net grant equivalent of initial investment as the highest permissible aid intensity. It has therefore been decided to fix 75% net grant equivalent as the ceiling on aid intensity which will apply in 92(3) (a) areas.

The principles of coordination[1] provide that ceilings of aid intensity must be adapted according to the kind, intensity or urgency of the regional problems. Whilst all 92(3) (a) regions have severe regional problems relative to a Community standard, significant disparities in living standards and underemployment may exist between regions inside the same Member State.

Consequently, the Commission will use its discretionary power to require a regional differentiation in aid intensity below 75% NGE. As such the relevant ceiling of aid intensity for a regional aid system will be the maximum notified by the Member State to the Commission in accordance with Article 93(3) and approved by the Commission when making its subsequent decision under Articles 92 and 93.

6. The range of aid instruments required to promote regional development in Article 92(3) (a) areas

Regional aid in the Community can be broadly divided into two categories: aid linked to initial investment or job creation and that of a continuing character, designed to overcome particular or permanent disadvantages (operating aid).

Given the severe disadvantages of 92(3) (a) regions, aid linked to initial investment may not always be suitable or sufficient to attract investment into the region or to allow indigenous economic activity to develop. Companies located in these regions typically face additional cost burdens because of location and infrastructure deficiencies which can permanently hamper their competitiveness. Under certain conditions, some operating aid can bring a positive benefit to the poorest parts of the Community. Firstly, some regions may experience such serious cost and infrastructural disadvantages that even the maintenance of existing investment is extremely difficult. In the early stages of development,

[1] OJ C 31, 3.2.1979.

maintenance of existing investment, perhaps on a short to medium-term basis, can form a *sine qua non* for the attraction of new investment which will help in turn to develop the region. In many Article 92(3) (a) regions, a broadly based industrial structure does not yet exist. Most of the companies are very small, they operate in traditional sectors and will not expand without an outside stimulus. In such difficult environments, it may be justified to permit certain types of assistance such as marketing aid in order to enable companies in these regions to participate effectively in the Community's internal market, both as producers and consumers. Without them, the opportunities offered by the internal market may remain out of reach. Secondly, some regions may suffer from such severe structural disadvantages, for example, those caused by remote location, that they are almost insuperable. As a practical example, island regions in peripheral locations can suffer a permanent cost disadvantage with respect to trade because of the burden of additional transportation expenses. The same holds true for communication costs. Operating aid of this type can foster closer links between the least-developed regions and the central regions, thereby promoting overall economic integration in the Community. In recognition of the special difficulties of these regions, the Commission may, by way of derogation, authorize certain operating aid in Article 92(3) (a) regions under the following conditions:

— that the aid is limited in time and designed to overcome the structural handicaps of enterprises located in Article 92(3) (a) regions;

— that aid be designed to promote a durable and balanced development of economic activity and not give rise to a sectoral overcapacity at the Community level such that the resulting Community sectoral problem produced is more serious than the original regional problem; in this context a sectoral approach is required and in particular the Community rules, directives and guidelines applicable to certain industrial (steel, shipbuilding, synthetic fibres, textiles and clothing) and agricultural sectors, and those concerning certain industrial enterprises involving the transformation of agricultural products are to be observed;

— that such aid is not granted in violation of the specific rules on aid granted to companies in difficulty;

— that an annual report on their application is sent to the Commission, indicating total expenditure (or loss of revenue in the case of tax concessions and social security reductions) by type of aid and an indication of the sectors concerned;

— that aid designed to promote exports to other Member States is excluded.

II. Method for the application of Article 92(3) (c) to national regional aid

Article 92(3) (c) provides that aid to facilitate the development of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest, may be considered compatible with the common market.

1. Principles of method

In applying Article 92(3) (c), the Commission bases its decisions on a method which allows the socio-economic situation of a region to be examined, both in its national and its Community context. This enables the Commission, in the Community interest, to verify that a significant regional disparity exists and, if so, to authorize the Member State concerned, irrespective of its level of economic development, to pursue a national regional policy. The Commission's decisions are based on the following principles:

— regions are assessed on the basis of the NUTS level III geographical unit (in justified exceptional circumstances a smaller unit may be used);

— in the first stage of analysis, the socio-economic situation of a region is assessed on the basis of two alternative criteria: per capita gross domestic product (GDP) or gross value added at factor cost (GVA) and structural unemployment;

— a second stage of analysis considering other relevant indicators completes the first stage.

2. First stage of analysis

The socio-economic situation of a region is considered in relation to certain thresholds which are calculated in two steps. The first step relates to a minimum regional disparity in a national context whilst in the second step this minimum required disparity is adjusted to take account of the situation of those Member States which have a more favourable level of development in a Community context.

Since aid can only be accepted when it facilitates the development of certain economic areas, this requires a certain backwardness of the region within the Member State, that is to say a minimum negative regional disparity in the national context notwithstanding the relative situation of the Member State within the Community. This minimum regional disparity in the national context is considered to be satisfied for the region, if:

— income as measured by per capita GDP/GVA (gross domestic product/gross value added) is at least 15% below the Member State average;
and/or
— structural unemployment is at least 10% above the Member State average.

This is achieved if the GDP/GVA index for the region is not above a basic threshold of 85 and/or if the structural unemployment index is not below a basic threshold of 110. In each case the index for the Member State equals 100.

A relatively more flexible threshold for structural unemployment has been fixed to take into account the important need to reduce unemployment.

At the same time aid can only be accepted when it does not adversely affect trading conditions to an extent contrary to the common interest. Since it is against the common interest to increase the existing differences between regions and the backwardness of less-favoured areas, the Commission has determined that for aid to be granted to regions in Member States for which the indicator shows a more favourable situation than the Community average, the national regional disparities of such regions must be correspondingly greater.

It is therefore necessary to establish the relative position of the Member States within the Community. In measuring this position, two European indices are calculated for each Member State. They express the Member State's position with respect to income and to structural unemployment as a percentage of the corresponding Community average. These indices are calculated as average values over a five-year period and are updated annually. in the second step the European index is used to adjust the respective basic threshold for each Member State which is better off than the Community average, according to its relative position within the Community, by applying the following formula:

$$\left(\text{basic threshold} + \frac{\text{basic threshold} \times 100}{\text{European index}}\right) : 2 = \text{modified threshold}$$

Since the situation of each region is examined in the first place in the national context, the construction of the formula attenuates the impact of the European index. The better the situation of a Member State compared with the Community average, the more important must be the disparity of a region within the national context in order to justify the award of aid.

The thresholds in force on 1 November 1987 are shown in Annex II. Annex III contains a list of regions currently approved for regional aid under Article 92(3) (c) together with the maximum intensities approved by the Commission for those regions.

In order to avoid the situation where the structural unemployment threshold becomes too rigorous, a maximum required disparity corresponding to an index of 145 is fixed. This facilitates the award of aid in regions with a very difficult unemployment situation in a national context even though the same situation may not be so unfavourable in a Community context. Given the smaller variation in the threshold for GDP/GVA it has not been necessary to establish a maximum required disparity.

3. Second stage of analysis

The first stage of analysis outlined above permits a basic examination of the socio-economic situation of a region in its national and Community context in terms of unemployment and income levels. However, many other economic indicators can also be used to bring into more precise focus the socio-economic situation of a particular region. Therefore, meeting the relevant threshold in the first stage does not automatically qualify a region to receive State aid. The first basic stage of analysis must be complemented by a second stage which allows other relevant indicators based on available Community and national statistical data to be taken into account. These other relevant indicators may include the trend and structure of unemployment, the development of employment, net migration, demographic pressure, population density, activity rates, productivity, the structure of economic activity (in particular the importance of declining sectors), investment, geographic situation and topography and infrastructure. In some circumstances, and especially for regions which are at the margin of the thresholds applied in the first stage of analysis, it is possible that the second stage may reveal an adequate justification for regional aid even in regions which do not fully satisfy the thresholds established in the course of the first stage.

4. Ceilings of aid intensity

Differentiated ceilings of aid intensity are established in accordance with the principle fixed at point 9 (iv) of the coordination principles.[1] This provides that aid intensity must be adapted according to the kind, intensity or urgency of regional problems, as has been envisaged by the different ceilings fixed under point 2 of the coordination principles (20, 25 and 30 %).

In practice the ceilings approved by the Commission when taking Article 92 and 93 decisions are often lower, and frequently significantly lower, than the above maxima.

[1] OJ C 31, 3.2.1979.

ANNEX I

List of Article 92 (3) (a) regions

GREECE		
IRELAND	All of Member State	
PORTUGAL		
FRANCE	Overseas departments	Guadeloupe Guyane Martinique Réunion
ITALY	Calabria	Reggio di Calabria Cosenza Catanzaro
	Basilicata	Potenza Matera
	Sicilia	Agrigento Enna Palermo Messina Trapani Caltanissetta Catania Ragusa Siracusa
	Puglia	Brindisi Lecce Fogga Bari Taranto
	Campania	Napoli Benevento Avellino Salerno Caserta
	Molise	Campobasso Isernia
	Sardinia	Nuoro Oristano Cagliari Sassari
	Abruzzi	Teramo L'Aquila Pescara Chieti
SPAIN	Extremadura	Badajoz Cáceres
	Andalucía	Granada Córdoba Jaén Sevilla Almería Málaga Cádiz Huelva
	Castilla-La Mancha	Albacete Cuenca Toledo Ciudad Real Guadalajara
	Galicia	Orense Pontevedra Lugo La Coruña
	Castilla and León	Zamora Ávila Salamanca Soria León Palencia Valladolid Segovia Burgos
	Murcia	
	Canarias	Las Palmas Tenerife
	Teruel	
	Ceuta and Melilla	
UNITED KINGDOM	Northern Ireland	

ANNEX II

Thresholds used by the Commission on 1 October 1987

	GDP/GVA per capita	Structural unemployment
Belgium	82	110
France	77	118
Netherlands	79	110
Denmark	73	121
Federal Republic of Germany	74	136
United Kingdom	83	110
Italy	85	116
Ireland	85	110
Luxembourg	77	145
Greece	85	128
Spain	85	110
Portugal	85	125

ANNEX III

Regions approved for regional aid under Article 92 (3) (c) on 1 October 1987

Note: Unless otherwise indicated aid intensity ceilings are given in gross terms in France, Germany, Luxembourg and the Netherlands and in net terms in Belgium, Denmark, Italy, Spain and the United Kingdom.

1. FRANCE

A. Aid intensity limited to 25 % or FF 50 000 per job created

Creuse, Cantal, Aude, Lozère, Pyrénées-Orientales, Haute-Corse, Corse du Sud. Parts of Ardennes, Nord, Pas-de-Calais, Meurthe-et-Moselle, Meuse, Moselle, Vosges, Bas-Rhin, Haut-Rhin, Loire-Atlantique, Côtes-du-Nord, Finistère, Ille-et-Vilaine, Morbihan, Charente-Maritime, Pyrénées-Atlantiques, Ariège, Aveyron, Lot, Tarn, Corrèze, Haute-Vienne, Ardèche, Loire, Allier, Haute-Loire, Puy-de-Dôme, Gard, Hérault.

B. Aid intensity limited to 17 % or FF 35 000 per job created

Calvados, Manche, Maine-et-Loire, Mayenne, Vendée, Charente, Deux-Sèvres, Vienne, Dordogne, Landes, Lot-et-Garonne, Gers, Hautes-Pyrénées, Tarn-et-Garonne. Parts of Ardennes, Haute-Marne, Aisne, Somme, Seine-Maritime, Cher, Indre, Orne, Nord, Pas-de-Calais, Meurthe-et-Moselle, Meuse, Moselle, Vosges, Haut-Rhin, Haute-Saône, Loire-Atlantique, Côtes-du-Nord, Finistère, Ille-et-Vilaine, Morbihan, Charente-Maritime, Gironde, Pyrénées-Atlantiques, Ariège, Aveyron, Haute-Garonne, Lot, Tarn, Corrèze, Haute-Vienne, Ardèche, Loire, Allier, Haute-Loire, Puy-de-Dôme, Gard, Hérault, Bouches-du-Rhône, Var.

2. ITALY[1]

(until 31 December 1987)

A. Aid intensity limited to 15 %

Parts of Toscana, Marche, Umbria, Lazio.

B. Aid intensity limited to 8 %

Parts of Piemonte, Valle d'Aosta, Liguria, Lombardia, Trentino-Alto Adige, Veneto, Friuli-Venezia, Giulia, Emilia-Romagna.

C. Aid intensity limited to 7 %

Parts of Toscana, Marche, Umbria, Lazio, Piemonte, Valle d'Aosta, Liguria, Lombardia, Trentino-Alto Adige, Vento, Friuli-Venezia Giulia, Emilia-Romagna.

3. THE NETHERLANDS

A. Aid intensity limited to 20 % net

Nijmegen, Zuidoost-Drenthe, Delfzijl. Parts of Oost-Groningen, Zuid-Limburg.

B. Aid intensity limited to 25 %

Overig Groningen, Twente, Helmond, Lelystad, Tilburg, Den Bosch, Maastricht, Valkenburg, Sittard. Parts of Oost-Groningen, Noord-Friesland, Zuidoost-Friesland.

C. Aid intensity limited to 15 %

Arnhem, Zuidwest-Friesland. Parts of Noord-Limburg, Noord-Friesland, Zuidoost-Friesland, Noord-Overijsel.

[1] With effect from 1 January 1988, nearly all regional aid in centre-north Italy has been withdrawn.

4. BELGIUM

A. Aid intensity limited to 20 % or ECU 3 500 per job created with a maximum of 25 %

Hasselt, Maaseik, Tongeren, Liège, Charleroi, Mons. Parts of Soignies, Thuin.

B. Aid intensity limited to 15 % or ECU 2 500 per job created with a maximum of 20 %

Turnhout, Diksmuide, Veurne, Ieper, Bastogne, Marche-en-Famenne, Neufchâteau, Dinant, Philippeville, Arlon, Virton. Parts of Thuin, Huy, Verviers, Namur.

5. LUXEMBOURG

A. Aid intensity limited to 25 %

Parts of Esch-sur-Alzette, Capellen.

B. Aid intensity limited to 20 %

Parts of Esch-sur-Alzette, Capellen.

C. Aid intensity limited to 17.5 %

Luxembourg, Grevenmacher, Wiltz, Clervaux.

6. UNITED KINGDOM

A. Aid intensity limited to 75 % or ECU 10 000 per job created (for enterprises with no more than 10 employees and where fixed investment does not exceed ECU 600 000)

Shetland Islands, Orkney Islands, Thurso, Wick, Sutherland, Invergordon and Dingwall, Skye and Wester Ross, Inverness, Forres and Upper Moray, Badenoch, Lochaber, Western Isles, Oban, Islay/Mid Argyll, Dunoon and Bute, Campbeltown.

B. Aid intensity limited to 30 % or ECU 5 500 per job created with a maximum of 40 %

England:

Liverpool, Widnes and Runcorn, Wigan and St Helens, Wirral and Chester, Workington, Bishop Auckland, Hartlepool, Middlesbrough, Newcastle-upon-Tyne, South Tyneside, Stockton-on-Tees, Sunderland, Rotherham and Mexborough, Scunthorpe, Whitby, Corby, Falmouth, Helston, Newquay, Penzance and St Ives, Redruth and Camborne.

Scotland:

Arbroath, Bathgate, Cumnock and Sanquhar, Dumbarton, Dundee, Glasgow, Greenock, Irvine, Kilmarnock, Lanarkshire.

Wales:

Aberdare, Cardigan, Ebbw Vale and Abergavenny, Flint and Rhyl, Holyhead, Lampeter and Aberaeron, Merthyr and Rhymney, Neath and Port Talbot, Pontypridd and Rhondda, South Pembrokeshire, Wrexham.

C. Aid intensity limited to 20 % or ECU 3 500 per job created with a maximum of 25 %

England:

Accrington and Rossendale, Blackburn, Bolton and Bury. Parts of Manchester, Oldham, Rochdale, Darlington, Durham, Morpeth and Ashington, Barnsley, Bradford, Doncaster, Grimsby, Hull, Sheffield, Birmingham, Coventry and Hinckley, Dudley and Sandwell, Kidderminster, Telford and Bridgnorth, Walsall, Wolverhampton, Gainsborough, Bodmin and Liskeard, Bude, Cinderford and Ross-on-Wye, Plymouth.

Scotland:

Ayr, Alloa, Badenoch, Campbeltown, Dunfermline, Dunnon and Bute, Falkirk, Forres, Girvan, Invergordon and Dingwall, Kirkcaldy, Lochaber, Newton Stewart, Skye and Wester Ross, Stewartry, Stranraer, Sutherland, Western Isles, Wick.

Wales:

Bangor and Caernarfon, Bridgend, Cardiff, Fishguard, Haverfordwest, Llanelli, Newport, Pontypool and Cwmbran, Porthmadog and Ffestiniog, Pwllheli, Swansea.

D. Aid intensity limited to 11 % where aid does not exceed ECU 100 000

Inner urban areas of Hackney, Islington, Lambeth, Brent, Hammersmith and Fulham, Leeds, Leicester, Nottingham, Tower Hamlets, Wandsworth, Burnley, Ealing, Greenwich, Haringey, Lewisham, Newham, Southwark.

E. Aid intensity limited to 7.5 % or ECU 3 500 per job created with a maximum of 11 %

Administrative districts of Ceredigion, Meirionnydd, Brecknock, Montgomery, Radnor.

7. DENMARK

A. Aid intensity limited to 25 % or ECU 4 500 per job created with a maximum of 30 %

Bornholm, Færøerne, Samsø and other Islands. Parts of Viborg, Nordjylland.

B. Aid intensity limited to 20 % or ECU 2 500 per job created with a maximum of 25 %

Parts of Sønderjylland, Lolland, Fyn, Langeland.

C. Aid intensity limited to 17 % or ECU 3 000 per job created with a maximum of 22 %

Parts of Nordjylland, Viborg, Ringkøbing, Ribe, Sønderjylland, Århus.

8. SPAIN

A. Aid intensity limited to 45 %

Parts of Madrid, Asturias.

B. Aid intensity limited to 30 %

Cantabria. Parts of Alicante, Castellón, Valencia, Asturias, Zaragoza, Vizcaya, Álava.

C. Aid intensity limited to 20 %

Guipúzcoa. Parts of Zaragoza, Vizcaya, Álava, Huesca, Navarra, Barcelona.

9. GERMANY[1, 2]

A. Aid intensity limited to 23 %

Amberg, Schwandorf.

[1] The Zonenrandgebiet, Berlin (West) and the *Länder* regional schemes are not included in this list.
[2] With effect from 1 January 1988.

B. Aid intensity limited to 18 %

Heide-Meldorf, Cuxhaven, Bremerhaven, Wilhemshaven, Emden-Leer, Ammerland-Cloppenburg, Oldenburg, Meppen, Nordhorn, Lingen, Detmold-Lemgo, Steinfurt, Ahaus, Bocholt, Kleve-Emmerich, Recklinghausen, Brilon, Alsfeld-Ziegenhain, Daun, Idar-Oberstein, Cochem-Zell, Trier, Bitburg-Prüm, Saarbrücken, Rothenburg o. d. T., Pirmasens, Nordfriesland, Straubing, Passau. Parts of Landau/Pfalz.

C. Aid intensity limited to 15 %

Stade-Bremervörde, Syke, Unterweser, Bremer, Rotenburg/Wümme, Fallingbostel, Grafschaft Diepholz-Vechta, Nienburg-Schaumburg, Hameln, Coesfeld, Duisburg-Oberhausen, Bochum, Dortmund-Lüdinghausen, Soest, Bad Kreuznach, Alzey-Worms, Weißenburg in Bayern, Neumarkt/Oberpfanz, Nördlingen, Itzehoe, Soltan, Holzminden-Höxter, Neustadt/Saale, Bamberg, Weiden/Oberpfalz, Regensburg. Parts of Osnabrück.

D. Aid intensity limited to 12 %

Flensburg-Schleswig, Lüneburg, Deggendorf.

Commission communication on the method of application of Article 92 (3) (a) to regional aid[1]

(90/C 163/05)

Change in application of method

In a previous communication[2] the Commission has already described its method for the application of Article 92 (3) (a) to national regional aid. The basic geographical unit used in the analysis is the (NUTS) level III region. However, for the purposes of determining eligibility as an Article 92 (3) (a) region, reference is made to the situation of the majority of level III regions in the larger, level II region. The reasons for this approach are explained under point I (3) of the communication.

The Commission has decided to maintain the level III region as the appropriate geographical unit for aid assessment purposes. However, for determining eligibility under Article 92 (3) (a), reference will now be made to the situation of the level II region as a whole in which the level III region is located. Furthermore, when regions are assessed by using the per capita GDP/PPS indicator, the corresponding index will be averaged over a minimum period of three years based on the last three years, where possible.

[1] OJ C 163, 4.7.1990.
[2] OJ C 212, 12.8.1988, p. 2.

E — Sectoral policies

Commission Decision No 2064/86/ECSC[1] of 30 June 1986 establishing Community rules for State aid to the coal industry

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Coal and Steel Community, and in particular the first paragraph of Article 95 thereof,

Having consulted the Consultative Committee and the European Parliament and with the unanimous assent of the Council,

Whereas:

I. Structural changes on the international and Community energy markets have been forcing the coal industry to make exceptional rationalization and restructuring efforts since the early 1960s. To the competition from crude oil and natural gas has been added the growing pressure from coal imported from outside the Community. As a result, many coal undertakings are in financial difficulties and require State aid.

Since 1964, the High Authority/Commission has on a number of occasions laid down rules[2] designed to reconcile State aid to the coal industry with the objectives of the ECSC Treaty. Each new set of aid rules has been designed to take account of developments in the economy in general, and developments on the energy market and the coal market in the Community in particular.

All the Decisions in question laid down objectives and principles guaranteeing that State aid was in the common interest, was limited to what was strictly necessary in terms of volume and duration, and did not disturb the functioning of the common market. They also obliged Member States to obtain prior authorization from the High Authority/ Commission before granting aid.

II. Both the economy in general and the particular conditions on the energy and coals markets in the Community have altered significantly since Decision No 528/76/ECSC was adopted.

Energy prices in general have risen following the steep rise in oil prices. On the energy supply side, this has given rise to adjustment measures resulting in new production capacity for all energy sources throughout the world. On the energy demand/consumption side, considerable efforts have been made to save energy. The efforts to find substitutes have been particularly effective in the power station sector where heating oil has been replaced by coal to some extent. The changes in the behaviour of energy users have changed the direction of the trend on the Community's coal market, since the constantly falling trend in coal consumption in the Community in the years leading up to the first oil crisis has now levelled off, apart from a few short-term fluctuations, at a level of around 300 million tonnes (EUR 10).

The coal industry in the Community has scarcely benefited from this development. On the contrary, between 1975 and 1985 production in the Community dropped from 257 million tonnes to 201 million tonnes (partly as a result of the coalminers' strike in the United Kingdom), while coal imports from outside the Community more than doubled from 41 million tonnes to 86 million tonnes.

Although the competitive position of the Community's coal industry *vis-à-vis* oils and gas improved considerably as a result of the steep increase in oil prices, further strong competition in the shape of coal imports from outside the Community with which it cannot compete fully has come on to the scene. The geological conditions for the production of coal are more favourable in the United States, Australia, Canada and South Africa, etc. and so, despite the lengthy transport entailed, producers in those countries can enjoy competitive advantages which the Community's coal industry cannot offset unless further restructuring is undertaken.

The opportunities for rationalization in the coal industry in the Community are limited because of the unfavourable geological conditions. Despite considerable investment and the closure of 120 or so pits, productivity has only risen by 1.5 % on a year-to-year basis on average for the Community as a whole in the last 10 years. Even though the US dollar, the decisive currency where international coal prices are concerned, rose in value against other currencies until 1984, the competitive position of Community coal *vis-à-vis* imported coal did not improve. Moreover, the dollar exchange rate has dropped consideraby since 1985. Consequently, the financial situation of Community coal undertakings has

[1] OJ L 177, 1.7.1986.
[2] Decision No 3/65/ECSC (OJ 31, 25.2.1965), Decision No 27/67/ECSC (OJ 261, 28.10.1967), Decision No 3/71/ECSC (OJ L 3, 5.1.1971) and Decision No 528/76/ECSC (OJ L 63, 11.3.1976).

steadily deteriorated in the last 10 years. Their losses and the aid required has risen appreciably. In 1984 the aid granted to them totalled ECU 4 000 million and in 1985 it amounted to ECU 3 000 million.

As a result of the fall in oil prices since the end of 1985, falling world market prices for coal and the reduction in the rate of the dollar, it is unlikely that the Community's coal industry will become fully competitive again in the years ahead.

In view of this situation on the energy and coal markets, it is necessary to adapt to the foreseeable demand and to make this branch of industry competitive again by restructuring, modernizing and rationalizing it in an ordered and socially acceptable fashion. This will demand more financial resources than the undertakings themselves can provide. Nor does the ECSC have at its disposal the resources needed in order to bridge this gap. Nevertheless, the restructuring efforts must not be abandoned, as otherwise the attainment of the general objectives set out in the second paragraph of Article 2 of the ECSC Treaty and the specific objectives set out in Article 3 (c), (d), (e) and (g) would be jeopardized. Moreover, this could result in serious disturbances affecting the mining areas in the Community concerned by the restructuring process.

The Community is therefore once again confronted with a situation for which no provision is made in the Treaty but concerning which action must nevertheless be taken. Consequently, recourse must be had to the first paragraph of Article 95 of the Treaty in order to enable the Community to continue to pursue the objectives set out in the opening articles of the Treaty and, to this end, to establish new Community rules for State aid to the coal industry.

III. Such recourse to the first paragraph of Article 95 of the Treaty must fit into the general context of the Community's energy policy. On a proposal from the Commission, the Council is in the process of adopting new Community energy policy objectives for 1995 which envisage that the solid fuels producing industry (including the coal industry) in the Community should continue its restructuring efforts so as to become more competitive. In this context, it is considered desirable to maintain and, if possible, increase the market share of solid fuels. The creation of more secure supply conditions, *inter alia* by developing domestic energy sources in the Member States of the Community under satisfactory economic conditions, is an essential element of Community energy policy. For this reason Community coal production offers the advantage of rather greater security of supply and a degree of protection against extreme price swings on the world market. However, as the Commission has already stated,[1] in the long run these benefits as regards coal users and those employed in this branch of industry can only be achieved with a more competitive coal industry.

In addition, Community policy in this sector must take into account the fact that the restructuring measures will affect the employment situation, and the provisions of the ECSC Treaty must therefore be used.

On the basis of the coal policy guidelines set out in the preceding paragraphs, the Commission should examine State aid to the coal industry before it is granted, in order to ascertain whether it contributes to the achievement of the following aims:

— improvement of competitiveness of the coal industry, which contributes to assuring a better security of supply;

— creating new capacities provided that they are economically viable;

— solving the social and regional problems to developments in the coal industry.

In pursuit of these aims, it is essential that aid should not exceed what is absolutely necessary, and should not depart from the rules of the Treaty except where that is unavoidable in order to solve problems encountered in the Community, and that in particular indirect subsidies to industrial coal users should be avoided.

IV. The Commission's approval of proposed State aid must be based on precise and full knowledge of the aid in question, and must take due account of the economic and social context. Consequently, the Member States should be required to provide the Commission regularly with full information on the direct or indirect aid proposed to the coal production and marketing and to external trade in coal, and also on the reasons for and the scope of the proposed aid. The Member States must, in good time for the period 1987-93, provide the Commission with a statement of intentions and objectives for the coal industry giving a clear indication of medium-term policy with regard to coal production.

In assessing aid granted on the basis of this Decision, the Commission should also take into consideration all other financial aid to the coal industry.

[1] COM(85) 245 final.

V. Lastly, it is necessary to define the various forms of the aid for which advance approval can be given by the Commission, and to assign to them criteria corresponding to the aims of this Decision:

(a) In view of the weak competitive position of and the losses made by coal undertakings in the Community, it would be necessary to close down a large proportion of pits in the short term if these losses ware not covered. In addition to supply problems, this would also give rise to considerable regional and employment problems. Consequently, aid to cover operating losses is admissible provided that it does not exceed the difference between the foreseeable average costs of coal production and the average returns achievable in the following calendar year. The financial imbalance of an untertaking may make it necessary to cover, in addition, losses wich the undertaking actually incurred in the previous two years, provided that evidence is produced that failure to cover the losses would have consequences incompatible with the aims of this Decision.

(b) In order to guarantee sales of Community coal and coke to the steel industry, special aid may be granted, provided that it does not exceed the extent necessary to keep such coal competitive.

As not all areas in the Community actually face competition from coal and coke from outside the Community, and hence certain coal producers are unable to align their prices for sales of coal and coke to the steel industry pursuant to Article 60 (2) (b) of the Treaty, the aims of this Decision can only be achieved if the undertakings in question are allowed to grant reductions on their list prices (fictitious alignment) even though there is no actual competition at the place of consumption, provided that long-term supply contracts are concluded.

(c) The coal industry can only become more competitive if existing capacity is rationalized and new economically viable capacity is created. This will require investment, and aid towards the financing of such investment is admissible provided that it does not exceed 10 % of the investment expenditure.

(d) In order to maintain the productivity of the coal industry, expenditure will be needed on the maintenance of a skilled underground workforce. In order to finance such expenditure, aid may be authorized provided that it is granted in the context of existing schemes.

(e) State aid to finance social security benefits by way of compensation for anomalous burdens on the coal industry resulting from the decline in coal production may be considered compatible with the common market provided that they bring the ratio between the burder per mineworker in employment and the benefits per person in receipt of benefit into line with the corresponding ratio in other industries.

(f) As a result of the decline in coal production in recent decades, the undertakings are confronted with various kinds of anomalous high burdens. State aid, to finance such burdens with a view to covering them in whole or in part, may be considered compatible with the common market provided that supervision of such aid by the Commission is guaranteed and the relevant categories of such inherited liabilities are defined.

VI. The proper implementation of this Decision must be ensured through provisions which enable the Commission to exercise its power of approval. The Commission may make its approval subject to any appropriate conditions, carry out all necessary checks subsequently, and withdraw its approval if it is no longer justified. The Commission must also be in a position to object to aid granted to undertakings which apply artificially low prices. Consequently, provision should also be made for the possibility of suspending this Decision in the event of serious supply and market disturbances or a change in the basic economic conditions which led to its adoption. The Commission will report to the Council, the European Parliament and the Consultative Committee each year on the application of this Decision.

In view of the changes at present occuring in the conditions on the Community's coal and energy markets, it is appropriate that the period of validity of this Decision should be seven-and-a-half years,

HAS ADOPTED THIS DECISION:

Section I

Framework and general objectives

Article 1

1. All aid to the coal industry, whether specific or general, financed by Member States or through State resources in any form whatsoever, may be considered Community aid and therefore compatible with the proper functioning of the common market only if it conforms to the general objectives and criteria set out in Articles 2 to 8. Such aid shall be put into effect only in accordance with the procedures established in this Decision.

2. The concept of aid includes aid granted by central, regional or local authorities and any aid elements contained in the financing measures taken by Member States in respect of the coal undertakings which they directly or indirectly control and which cannot be regarded as the provision of risk capital according to standard company practice in a market economy.

Article 2

1. Aid granted to the coal industry may be considered compatible with the proper functioning of the common market provided that it helps to achieve at least one of the following objectives:

— improvement of the competitiveness of the coal industry, which contributes to assuring a better security of supply;

— creating new capacities provided that they are economically viable;

— solving the social and regional problems related to developments in the coal industry.

2. Any measures concerning the grant of aid referred to in Articles 3 to 8 shall be without prejudice of the criteria which are specific to them and defined by the same Articles; they shall also be appraised having regard to their suitability in relation to the objectives set out in paragraph 1 above.

Section II

Member States' aid

Deficit grant aid

Article 3

1. Aid covering operating losses may be considered compatible with the common market provided that it does not exceed, for each tonne produced and for each individual coal region or undertaking, the difference between foreseeable average costs and the foreseeable average returns in the following financial year (coal production year).

Member States shall, without prejudice to the provisions of Article 9, submit to the Commission all details for the calculation of costs and returns per tonne.

2. In its examination of such aid, the Commission shall include, in its calculation of production costs per tonne, normal depreciation and effective interest charges on capital borrowed. If the Commission finds that the difference between the average costs of coal production and the average returns achievable is due to changes in the situation of coal undertakings which are out of keeping with satisfactory economic conditions, it may fix a maximum amount for aid covering losses.

3. The reduction in costs resulting from the grant of aid in accordance with Articles 4 to 8 must be allowed for in calculating the production costs or operating losses of pits.

4. In those exceptional cases where the financial balance of an undertaking is seriously threatened by past losses which have not been covered, aid which goes beyond that permitted in paragraph 1 may be considered compatible with the common market provided that it is limited to covering a previously uncovered difference between the production costs incurred and the returns on the coal produced during a period not exceeding the two preceding financial years. In such a case, Member States shall, without prejudice to the provisions of Article 9, supply the Commission with:

— documentary evidence covering the points referred to in paragraphs 2 and 3 for the period during which the losses were incurred;

— information regarding the extent to which such losses have in the mean time been reduced as a result of aid as defined in Article 1 (2).

Sales aid

Article 4

Aid for supplying coal and coke to the Community's iron and steel industry may be considered compatible with the common market provided that it does not exceed the rebates referred to in Article 12.

Investment aid

Article 5

1. Investment aid may be considered compatible with the common market provided that:

— it covers no more than 50% of the costs of the investment;

— such investment has been notified to the Commission as required by High Authority Decision No 22/66,[1] amended by Decision No 2237/73/ECSC[2] or by any subsequent decision;

— the Commission has delivered a favourable opinion on the project so notified.

2. The aid referred to in paragraph 1 may be granted for investment programmes or for individual investment projects.

3. In the case of investment programmes, Member States shall, without prejudice to Article 9, inform the Commission at least once a year, in respect of each individual project in the programme which it has been decided to carry out, of the amount of investment expenditure assigned to it and the amount of aid involved.

4. Where the proposed aid concerns investments which have already benefited from measures taken under Articles 54 and 55 of the ECSC Treaty, the amount of such benefits shall be shown separately for each project.

Aid for underground staff

Article 6

1. Aid granted under existing schemes to maintain the underground labour force in deep mines may be considered compatible with the common market.

2. The aid referred to in paragraph 1 must be of a specific character which enables it to be calculated separately in relation to aid granted under the provisions of Articles 3 to 5.

Financing of social grants in the coal industry

Article 7

1. State aid to finance social grant schemes specific to the coal industry may be considered compatible with the common market provided that, for coal undertakings, it brings the ratio between the burden per mineworker in employment and the benefits per person in receipt of benefit into line with the corresponding ratio in other industries.

2. The Governments of the Member States shall, without prejudice to Article 9, submit to the Commission the necessary basic data and details of the calculation of the ratios between the burdens and benefits referred to in paragraph 1.

Inherited liabilities

Article 8

1. State aid to coal undertakings to cover the costs arising from the restructuring of the coal industry which are not related to current production (inherited liabilities) may be considered compatible with the common market provided that it does not exceed such costs. Such aid may be used to cover:

— the costs incurred only by undertakings which are carrying out or have carried out restructuring;

— the costs incurred by several undertakings.

2. Categories of costs arising from the restructuring of the coal industry are defined in Annex 1 to this Decision.

3. The aid may be granted as a lump sum and shall not exceed the actual amount of the inherited liabilities.

4. Member States shall submit to the Commission the necessary basic data and the details of the calculation of the ratio between the actual total inherited liabilities of the undertakings and the proposed measure.

Section III

Notification, appraisal and authorization procedures

Article 9

1. All Member States which intend to grant aid to coal undertakings in 1986, shall, by October 1986, provide the Commission with:

(i) a statement of intentions and objectives for the industry for the period 1987-93;

(ii) the information specified in paragraph 2.

[1] OJ 219, 29.11.1966.
[2] OJ L 229, 17.8.1973.

2. If, in any subsequent financial year, a Member State seeks authorization of measures in accordance with Article 10, it shall provide the Commission, at least three months before the measuers enter into force and separately for each coalfield or coal undertaking, with information in all measures which the State in question proposes to take in the following year in order to give direct or indirect support to the coal industry. The relevant detailed information to be supplied, which will be used in the analysis of the situation by the Commission, is specified in Annex 2 to this Decision.

3. If a Member State intends to take further financial measures in addition to measures already notified or to modify existing measures during the financial year, it must inform the Commission thereof so that the latter can express an opinion in accordance with the procedures defined in Article 10.

4. Member States shall notify the Commission not later than 30 June of each year of the amounts of aid actually paid in the preceding financial year.

Article 10

1. As regards the direct aid in respect of current production referred to in Articles 3 to 6, Member States shall put the proposed measures into effect only with the approval of the Commission, acting pursuant to the objectives set out in Article 2 and the criteria laid down in the abovementioned articles, and subject to the conditions laid down by the Commission. The Commission shall inform the Member States concerned of its decision.

2. In so far as they are governed by the Treaties, the Commission shall give its opinion on all other aid and measures that are also referred to in this Decision in accordance with the procedures and rules of the Treaties.

3. In its examination of the amount of planned aid, the Commission shall take account, to the extent to which that is compatible with the objectives of this Decision, of any other aid previously granted, regardless of its objectives.

4. In assessing the measures and programmes submitted to it as regards the closure of particularly unprofitable pits or the creating of new capacities in the light of the objective laid down in Article 2, the Commission shall take account of the special situation of individual coalfields or Member States.

5. If, from the date of receipt of the notification of the proposed measures pursuant to paragraphs 1 and 2 of this Article, a period of three months elapses without the Commission having taken a decision, the proposed measures may be implemented provided that the Member State has informed the Commission of its intention beforehand.

However, the above period shall be reduced to two months from the date of receipt of the notification of measures proposed pursuant to Article 9 (3).

Section IV

Pricing provisions

Article 11

1. The Commission shall ensure that aid does not lead to discrimination, within the meaning of the ECSC Treaty, as between Community buyers or users of coal or coke.

2. In order to ensure that direct aid in respect of current production which it authorizes is used exclusively for the purposes set out in Articles 3 to 6, the Commission may, in the case of undertakings in receipt of aid, limit or modify the right of alignment provided for in Article 60 of the ECSC Treaty and require such undertakings to comply with minimum prices. Any infringements shall be dealt with under Article 64 of the ECSC Treaty.

3. The Commission may carry out any appropriate checks on undertakings.

4. The Commission shall revoke approval of aid or shall amend the terms of approval if it finds that the aid no longer fulfils the conditions imposed by Articles 3 to 6 of this Decision or that the actual consequences of such aid or the use to which it is put are contrary to the conditions required for approving the grant thereof.

Article 12

1. (a) Where there is no actual competition from coal or coke from non-member countries at the point of consumption, coal undertakings shall be authorized, where necessary, to grant rebates on their list prices or production costs, for deliveries of coking coal, blast-furnace coke and coal for injection blast-furnaces for the iron and steel industry of the Community under long-term contract.

(b) The rebates allowed under subparagraph (a) above shall not cause the delivered prices of Community coal and coke to work out lower than those which would be charged for coal from non-member countries and coke made from non-member-country coking coal.

2. The delivered prices of coking coal from non-member countries referred to in parapraph 1 (b) shall be calculated from the prices cif Community ports for comparable transactions. For this purpose the Commission shall fix guide cif prices.

3. The delivered prices of blast-furnace coke referred to in paragraph 1 (b) shall be calculated from the cif prices for coking coal from non-member countries referred to in paragraph 2 in such a way as to cover in full the net coking costs of the supplying coking plants.

Section V

General and final provisions

Article 13

In deciding whether the financial measures proposed by Member States are compatible with the common market, the Commission shall give due consideration to any aid which may be granted under Commission Decisions Nos 759/84/ECSC[1] and 3612/85/ECSC.[2]

Article 14

The Commission shall report annually to the Council, the European Parliament and the Consultative Committee on the application of this Decision.

Article 15

The Commission shall, after consulting with the Council, take all the measures necessary to implement this Decision.

Article 16

1. This Decision shall enter into force on 1 July 1986.

However, Articles 4 and 12 shall apply from 1 January 1987.

This Decision shall expire on 31 December 1993.

2. The Commission shall submit by the end of 1990 a report to the Council on the experiences and problems encountered in applying this Decision. It may propose in accordance with the procedure laid down in the first paragraph of Article 95 of the ECSC Treay any modification which may be appropriate.

This Decision shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 30 June 1986.

ANNEX I

Definition of the costs referred to in Article 8(2)

I. Costs arising only for undertakings which are carrying out or have carried out restructuring

limited to the following:

(a) costs of social grants incurred through pensioning of workers before they reach the legal retiring age;

(b) other exceptional expenditure for workers made redundant because of restructuring;

(c) the payment of pensions and allowances outside the statutory insurance scheme to workers made redundant because of restructuring, and to those who were entitled to such payments before the restructuring;

(d) free coal deliveries to workers made redundant because of restructuring and to those who were entitled to such coal before the restructuring;

(e) residual charges arising out of tax provisions;

(f) additional safety work that has to be carried out underground as a result of restructuring;

(g) subsidence or similar damage attributable to areas which were previously mined;

(h) residual charges in respect of payments to bodies dealing with water supply and disposal of waste water;

1 OJ L 80, 24.3.1984.
2 OJ L 344, 27.12.1985.

(i) other residual charges in respect of water supply and disposal of waste water;

(j) residual costs in respect of sickness insurance scheme contributions on behalf of former mineworkers;

(k) exceptional material loss caused by the restructuring of the industry where cover for these losses is vital to the continuing existence of the undertaking.

II. Costs arising from several undertakings

(a) increases in the contributions needed to cover social security obligations outside the statutory insurance scheme where such increases result from a reduction, due to restructuring, in the number of those liable to pay contributions;

(b) expenditure caused by restructuring, in respect of water supply and disposal of waste water;

(c) increases in payments to bodies dealing with water supply and disposal of waste where these increases are attributable to a reduction, following restructuring, in the production of coal on which the levy must be paid.

ANNEX 2

Information to be supplied to the Commission pursuant to Article 9

This information will include details of:

(a) capital contributions, the cancellation of liabilities *vis-à-vis* public authorities and the granting of credit guarantees;

(b) any other measures linked to the production or marketing of, and external trade in, coal even if they do not directly impose a burden on public budgets, which give an economic advantage to coal undertakings;

(c) in the case of measures relating to social grants in the coal industry:

(i) the legal and administrative provision in force or changes in existing provisions which have already been notified;

(ii) the total amount of social grants, broken down by category, paid during the preceding financial year to workers and former workers in the coal industry and to their dependants, the number of recipients of these grants and the corresponding information for the general system:

(iii) the various resources drawn upon and the corresponding amounts allocated for the financing of the grants referred to in (c) (ii);

(d) in the case of measures designed to cover inherited liabilities of coal undertakings:

(i) the type of liabilities to be covered;

(ii) the probable amount of the liabilities for the year in which aid is granted;

(iii) the extent to which undertakings have incorporated inherited liabilities into the costs of current production or have built up special financial reserves to cover such liabilities themselves;

(e) the reasons for, and the scope of, the various measures, together with all further information for their assessment in accordance with the Decision;

(f) available information on proposed closures of pits or parts thereof, the consequences for the workforce and for the regions concerned, and re-employment of redundant workers in connection, where applicable, with regional development programmes.

Commission Decision No 322/89/ECSC[1] of 1 February 1989 establishing Community rules for aid to the steel industry

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Coal and Steel Community, and in particular the first and second paragraphs of Article 95 thereof,

Having consulted the Consultative Committee and with the unanimous assent of the Council,

[1] OJ L 38, 10.2.1989.

Whereas:

I. After a period of comprehensive aid-granting during 1981 to 1985[2] assisting the restructuring of the Community steel industry, Commission Decision No 3484/85/ECSC[3] established rules under which aid could be granted to the industry only for a few purposes and to a very limited extent during the period 1 January 1986 until 31 December 1988.

The cessation of the quota system by mid-1988 and the continuing presence of excess production capacities for most product categories makes it of particular importance to pursue a strict aid policy, comprising both specific and non-specific aid, and the close monitoring of State assistance of any form to the steel industry, in order to assure that competition conditions are being determined by normal market forces.

Nevertheless, the reasons for permitting limited aid for the sector, provided for by Decision No 3484/85/ECSC, principally still remain.

The Community thus finds itself faced with a situation not specifically provided for in the ECSC Treaty and yet requiring action. In these circumstances, recourse must be had to the first paragraph of Article 95 of the EEC Treaty, so as to enable the Community to pursue the objectives set out in the initial Articles thereof.

It is emphasized that any subsidies in any form whatsoever and whether specific or non-specific, which Member States might grant to their steel industries, other than aid expressly provided for and duly authorized under this Decision, is prohibited under Article 4 (c) of the Treaty.

II. It would be unjustified, and would be treating the industry differently from other industries, to deny the Community steel industry aid for research and development or for bringing plants into line with new environmental standards. Aid for these purposes which is in the public interest and satisfies the conditions laid down in this Decision should be available to the steel industry, just as similar aid is permitted to other industries under Articles 92 and 93 of the EEC Treaty.

The overcapacity that still persists in a number of product categories also justifies the authorization of aid to accelerate the closure of inefficient plants which, if kept in service even temporarily, could depress the market to the detriment of all firms in the sector, and to encourage the least competitive firms to cease production entirely.

Having in a recent span of years been offered the opportunity with the assistance of a suitable framework of aid rules to put their technical and financial structure in a competitive state, there is no justification for allowing any further operating or investment aid to the Community's steel undertakings. This is even more the case since the evolution of the financial position of steel undertakings has generally been very satisfactory.

As the special provisions on aid to the steel industries in the Act of Accession of Spain and Portugal expire by end-1988 and end-1990 respectively, this Decision is immediately applicable to Spain while it is without prejudice to the provisions contained in the Act of Accession of Portugal until 1 January 1991 when it also becomes fully applicable to that Member State.

To avoid discrimination due to the variety of forms which State aid may take, transfers of State resources to public or private steel firms, in the form of acquisitions of shareholdings or provisions of capital or similar financing, must be subject to the same procedures as aid so that the Commission can determine whether such operations involve an aid element. This will be the case where the financial transfer is not a genuine provision of risk capital according to usual investment practice in a market economy. The compatibility of any such aid elements with the Treaty must be assessed by the Commission in the light of the criteria laid down in this Decision. For this purpose, all such financial transfers must be notified to the Commission and may not be implemented if before the end of the standstill period laid down in Article 6 (5) the Commission determines that they contain aid elements and initiates the procedure provided for in Article 6 (4).

To ensure the orderly functioning of the common market for an appropriate period, during which the steel industry finds again normal market conditions, this Decision should apply until 31 December 1991,

HAS ADOPTED THIS DECISION:

Article 1

1. Aid to the steel industry, whether specific or non-specific, financed by Member States or their regional or local authorities or through State resources in any form whatsoever may be deemed Community aid and therefore

[2] Commission Decision No 2320/81/ECSC (OJ L 228, 13.8.1981, p. 14), as amended by Decision No 1018/85/ECSC (OJ L 110, 23.4.1985, p. 5).

[3] OJ L 340, 18.12.1985, p. 1.

compatible with the orderly functioning of the common market only if it satisfies the provisions of Articles 2 to 5.

2. The term 'aid' also covers the aid elements contained in transfers of State resources by Member States, regional or local authorities or other bodies to steel undertakings in the form of acquisitions of shareholdings or provisions of capital or similar financing (such as bonds convertible into shares, or loans the interest on which is at least partly dependent on the undertaking's financial performance) which cannot be regarded as a genuine provision of risk capital according to usual investment practice in a market economy.

3. Aid coming within the terms of this Decision may be granted only after the procedures laid down in Article 6 have been followed and shall not be payable after 31 December 1991.

Article 2

Aid for research and development

1. Aid granted under general aid schemes to defray expenditure by steel undertakings on research and development projects may be deemed compatible with the orderly functioning of the common market provided that the research and/or development project has one of the following objectives:

— reduction in production costs, in particular through energy conservation or improvements in productivity,

— improvements in the quality of products,

— improvements in the performance of iron and steel products or extensions of the range of applications of steel,

— improvements in the environment and in working conditions (higher health and safety standards).

2. The total amount of aid granted for this purpose may not exceed 35 % net grant equivalent of the eligible costs in the case of basic industrial research and 25 % in the case of applied research and development.

3. Basic industrial research is defined as original theoretical or experimental work whose objective is to achieve a new or better understanding of the laws of science and technology as they apply to an industrial sector or the activities of a particular undertaking.

4. The eligible costs shall be only those directly related to research and development, excluding those related to industrial applications or commercial exploitation of the results.

Article 3

Aid for environmental protection

1. Aid granted to steel undertakings under general aid schemes for bringing into line with new statutory environmental standards plants which entered into service at least two years before the introduction of the standards may be deemed compatible with the orderly functioning of the common market.

2. The total amount of aid granted for this purpose may not exceed 15 % net grant equivalent of the investment costs directly related to the environmental measures concerned. Where the investment is associated with an increase in the capacity of the plant, the eligible costs shall be proportionate to the initial capacity of the plant.

Article 4

Aid for closures

1. Aid towards the costs of payments to workers make redundant or accepting early retirement may be deemed compatible with the orderly functioning of the common market provided that:

— the payments do not exceed those customary under the rules in force in the Member States on 1 October 1985 and actually arise from the partial or total closure of steel plants that have been in regular production up to the time of notification of the aid and whose closure has not already been taken into account for the purposes of applying Commission Decisions Nos 257/80/ECSC,[1] 2320/81/ECSC or 3484/85/ECSC or granting a favourable opinion under Article 54 of the ECSC Treaty;

— the aid does not exceed 50 % of that portion of such payments which is not defrayed directly by the Member State or by the Community pursuant to Article 56 (1) (c) or (2) (b) of the ECSC Treaty but is payable by the undertaking concerned.

[1] OJ L 29, 6.2.1980.

2. Aid to steel undertakings which permanently cease production ECSC iron and steel products may be deemed compatible with the orderly functioning of the common market, provided that the undertakings:

- became a legal entity before 1 October 1985;
- have been regularly producing hot-rolled products up to the date of notification of the aid;
- have not reorganized their production or plant structure since 1 October 1985; and
- are not directly or indirectly controlled, within the meaning of Decision No 24/54 of the High Authority,[1] by, and do not themselves directly or indirectly control, an undertaking that is itself a steel undertaking or controls other steel undertakings,

and that the closure of their plants has not already been taken into account for the purposes of applying Decisions Nos 257/80/ECSC, 2320/81/ECSC or 3484/85/ECSC or granting a favourable opinion under Article 54 of the ECSC Treaty.

The amount of aid may not exceed the higher of the following two values, as determined by an independent consultant's report:

- the discounted value of the contribution to fixed costs obtainable from the plants over a three-year period, less any advantages the aided firm derives from their closure; or
- the residual book value of the plants (ignoring that portion of any revaluations since 1 January 1980 which exceeded the national inflation rate).

Article 5

Aid granted to steel undertakings for investment under general regional aid schemes may be deemed compatible with the orderly functioning of the common market, provided that:

- the aided investment does not lead to an increase in production capacity; and
- the aided undertaking is located on the territory of a Member State which was not authorized to grant any aid under decisions Nos 257/80/ECSC or 2320/81/ECSC, and which during the period of validity of these Decisions had already become a member of the Community.

Article 6

1. The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid of the types referred to in Articles 2 to 5. It shall likewise be informed of plans to grant aid to the steel industry under schemes on which it has already taken a decision under the EEC Treaty. The notifications of aid plans required by the Article must be lodged with the Commission by 30 June 1991 at the latest.

2. The Commission shall be informed, in sufficient time for it to submit its comments, and by 30 June 1991 at the latest, of any plans for transfers of State resources, by Member States, regional or local authorities or other bodies to steel undertakings in the form of acquisitions of shareholdings or provisions of capital or similar financing.

The Commission shall determine whether the financial transfers involve aid elements within the meaning of Article 1 (2) and, if so, shall examine whether they are compatible with the common market under the provisions of Articles 2 to 5.

3. The Commission shall seek the views of the Member States on plans for closure aid and other major aid proposals notified to it before adopting a position on them. It shall inform the Member States of the position it has adopted on all aid proposals, specifying the form and volume of the aid.

4. Where, after inviting interested parties to submit their comments, the Commission finds that aid in a given case is incompatible with the provisions of this Decision, it shall inform the Member State concerned of this decision. The Commission shall take such a decision not later than three months after receiving the information needed to assess the proposed aid. Article 88 of the ECSC Treaty shall apply in the event of a Member State's failing to comply with that decision. The planned measures falling within paragraph 1 or 2 may be put into effect only with the approval of and subject to any conditions laid down by the Commission.

5. If the Commission fails to initiate the procedure provided for in paragraph 4 or otherwise to make its position known within two months of receiving notification of a proposal, the planned measures may be put into effect provided that the Member State first informs the Commission of its intention to do so.

[1] OJ of the ECSC 9, 11.5.1954.

6. All individual awards of the types of aid referred to in Article 4 shall be notified to the Commission in accordance with the procedure provided for in paragraph 1. The Commission also reserves the right to require that some or all individual awards of aid of the types referred to in Articles 2 and 3 be notified in accordance with paragraph 1.

Article 7

Member States shall supply the Commission twice a year with reports on the aid disbursed over the previous six months, the uses to which the aid was put and the results obtained over the same period. The reports shall include particulars of all financial operations carried out by the Member States or local or regional authorities in relation to publicly-owned steel undertakings. They must be supplied within two months following the end of each six-month period and be set out in a form determined by the Commission.

Article 8

The Commission shall draw up regular reports on the implementation of this Decision for the Council and, for information, for the Parliament and the Consultative Committee.

Article 9

This Decision shall not apply until 1 January 1991 to Portugal in which Member State aid will be governed until then by the Act of Accession.

Article 10

This Decision shall apply from 1 January 1989 until 31 December 1991.

This Decision shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 1 February 1989.

Motor vehicle industry

Community framework on State aid to the motor vehicle industry[1]

1. Necessity and scope of the measure

The motor vehicle industry is of strategic industrial and employment importance to the Community. Its well-being has a vital impact on a whole range of upstream and downstream industries and services and estimates suggest that 10% of the Community's employment is dependent on it. Furthermore, many areas of Community policy such as the internal market, competition and commercial policy have a direct bearing on the sector.

The motor vehicle industry is now, to a large extent, a world industry. In order to survive, manufacturers must compete and sell on world markets. The future viability of the European industry will be determined firstly by its competitiveness and dynamism in the internal market. The Commission can contribute to the healthy development of the sector and ensure that the companies adapt and adjust in time to changing market circumstances.

The Commission's future aid policy must be geared to the process of creating a single market without internal frontiers by 1992. As market integration progresses, distortions of competition caused by the granting of aid are felt more and more keenly by competitors not receiving any aid. All manufacturers are entitled to a consistent approach compatible with the Treaty. At the same time, the market integration process may provoke a growing tendency for Member States to provide aid to firms that are no longer able to stand up to fair competition in this more efficient market, so as to ensure their survival. Furthermore, over-reliance on State aid to solve problems of industrial adjustment *vis-à-vis* third country producers undermines competitiveness of the Community car manufacturing by hindering the economically healthy influence of market forces.

In view of the growing sensitivity of competition in the motor vehicle sector as described above, the Commission decided to introduce a framework for State aid in the motor vehicle industry in the form of appropriate measures on the basis of Article 93 (1) of the EEC Treaty. These measures were examined by the Member States' representatives at a multilateral meeting. The objective of the framework is to establish full transparency of aid flows to the industry and

[1] OJ C 123, 18.5.1989.

impose at the same time a stricter discipline to the granting of aids in order to assure that the competitiveness of the Community industry is not distorted by unfair competition. The Commission can operate an effective policy only if it is able to take a position on individual cases before the aid is paid.

Therefore, the framework foresees the prior notification of all significant aid cases irrespective of their objective as well as an annual report of all aid payments.

Having completed its examination, the Commission decided to propose to the Member States under Article 93 (3) of the EEC Treaty that they notify in advance from 1 January 1989, in accordance with the rules set out below, significant cases of aid to the motor vehicle sector.

2. Rules of notification

2.1. *Definition of sector*

Under 'motor vehicle sector' is understood the manufacture and assembly of motor vehicles and manufacture of motor vehicle engines.

Under 'motor vehicles' is understood passenger cars (volume, specialist and sports cars), vans, trucks, road tractors, buses, coaches and other commercial vehicles.

Excluded hereof are racing cars, non-traffic cars (e.g. snow and golf cars), motorcycles, trailers, agricultural and forestry tractors, caravans, special purpose lorries and vans (e.g. fire engines, mobile work-shops), dumpers, work trucks (e.g. fork lifts, travel carriers, platform trucks) and military vehicles.

Under 'motor vehicle engines' is understood compression and spark engines for the above defined 'motor vehicles'.

Excluded are all parts and accessories for both motor vehicles and motor vehicle engines.

However, if a motor vehicle manufacturer or its subsidiary obtains aid for the manufacture of parts or accessories, or if any aid is granted for the manufacture of parts or accessories under licence or patents of a vehicle manufacturer, or of its subsidiary, such aid should be notified a priori.

2.2. *Aids to be notified*

All aid measures to be granted by public authorities within the scope of an approved aid scheme to (an) undertaking(s) operating in the motor vehicle sector as defined above, where the cost of the project to be aided exceeds ECU 12 million are subject to prior notification on the basis of Article 93 (3) of the EEC Treaty. As regards aid to be granted outside the scope of an approved aid scheme, any such project, whatever its cost and aid intensity, is of course subject without exception to the obligation of notification pursuant to Article 93 (3) of the EEC Treaty. Where aid is not directly linked to a particular project, all proposed aid must be notified, even if paid under schemes already approved by the Commission. Member States shall inform the Commission, in sufficient time to enable it to submit its comments, of any plan to grant or alter aid.

The Member States are requested to provide the Commission with an annual report which shall contain all aid payments under whatever form granted to all motor vehicle and motor vehicle engine producers during the year of reference. Aid payments which do not fulfil the threshold of prior notification should also be included in the annual report. The report should reach the Commission at the end of the first quarter which follows the year of reference. For details on the various categories of aid to be notified or reported, see Annex II.

2.3. *Format of notification and of annual report*

The standard forms of notification and of annual reporting are presented in Annexes I and II. These forms should be addressed directly to the Directorate-General for Competition.

2.4. *Community instruments*

In view of the need to ensure that measures financed by the structural Funds or receiving assistance from the European Investment Bank (EIB) or from another existing financial instrument are in keeping with the provisions of the Treaty on State aid, the Commission will monitor all applications and approvals for assistance under Community instruments and ensure coherence with the present guidelines.

2.5. *Date of introduction and validity*

The appropriate measures shall enter into force on 1 January 1989. All aid projects, which have not yet received a final approval by the competent public authority by 31 December 1988, shall be subject to prior notification from 1 January 1989 onwards. The appropriate measures shall be valid for two years. The Commission shall at the end of this period review the utility and the scope of the framework.

3. Guidelines for appreciation of aid cases

The purpose of having prior notification of all aid to the motor vehicle sector is to allow the Commission to verify more directly the compatibility of the aid in this sector with the competition rules of the Treaty.

Evaluation of aid has to take account of general economic and industrial factors as well as sector and company-specific considerations together with regional and social factors. However, the Commission is not seeking to impose an industrial policy strategy on the sector; such decisions are best left to the industry and the market itself. In view both of the important volume of aid granted in the past and the improved overall situation of Community producers, the aim of the Commission in the sector is to ensure that Community motor vehicle manufacturers operate in the future in a climate of fair competition, thus removing the trade distortions resulting from aid within the internal market and creating a generally competitive environment which will promote the industry's productivity and competitiveness.

The criteria which will guide the Commission in its future assessment of aid cases will vary according to the objectives pursued by the aid in question. However, in all cases, it will be necessary to ensure that aid granted is in proportion to the problems it seeks to solve. For the various aid objectives the main assessment criteria of the Commission shall be as follows:

RESCUE AND RESTRUCTURING AID

In principle, rescue and restructuring aid should only be approved in exceptional circumstances. The aid must be linked to a satisfactory restructuring plan, and only granted where it can be demonstrated that the Community interest is best served by keeping a manufacturer in business and by re-establishing its viability. It will be necessary to ensure that the aid will not allow a beneficiary to increase its market share at the expense of its unaided competitors. In cases where certain companies still have excess capacity, e.g. in the commercial vehicle sector, the Commission may require reductions in capacity in order to contribute to the overall recovery of the sector.

REGIONAL AID

One of the main types of aid benefiting this sector is regional aid for new implantations and capacity extensions as well as for an engagement in an activity involving a fundamental change in the product or production process of an existing establishment (by means of rationalization, restructuring or modernization). The Commission acknowledges the valuable contribution to regional developments which can be made by the implantation of new motor vehicle and component production facilities and/or the expansion of such existing activities in disadvantaged regions. For this reason the Commission has a generally positive attitude towards investment aid granted in order to help overcome structural handicaps in disadvantaged parts of the Community. This aid is usually granted automatically in accordance with modalities previously approved by the Commission. By requiring prior notification of such aids in future, the Commission should give itself an opportunity to assess the regional development benefits (i.e. the promotion of a lasting development of the region by creating viable jobs, linkages into local and Community economy) against possible adverse effects on the sector as a whole (such as the creation of important overcapacity). Such an evaluation does not seek to deny the central importance of regional aid for the achievement of cohesion within the Community but rather to ensure that other aspects of Community interest such as the development of the Community's industry are also taken into account.

INVESTMENT AID FOR INNOVATION, MODERNIZATION OR RATIONALIZATION

In the context of a genuine internal market for motor vehicles, competition between producers will become even more intense and the distortive impact of aid will be greater. Therefore, the Commission will take a strict attitude towards aid for modernization and innovation. These are activities to be undertaken by the companies themselves and normally financed from their own resources or by commercial loans as part of their normal company operation in a competitive market environment. Aid for fundamental rationalization will have to be carefully examined in order to verify that it brings about a necessary, radical change in the structure and organization of the company's activities and that the financing required goes beyond that which companies should normally be expected to finance from own resources. Similarly, proposed aid for innovation will be examined in order to determine whether it really relates to the introduction of genuinely innovative products or processes at Community level.

AID FOR RESEARCH AND DEVELOPMENT

The Commission will continue to have a positive attitude towards aid for pre-competitive R&D. However, the Commission will ensure, in keeping with its 'Framework on State aid for R&D',[1] at the same time that a clear distinction is established between genuine research and development and the introduction of new technologies inherent to production investment (modernization).

AID FOR ENVIRONMENTAL AND ENERGY SAVING

The development of less polluting and energy-saving vehicles is a standard requirement for the industry, partly imposed by Community legislation, and should thus be financed from the company's own resources. Aid for general pollution control, e.g. granted under the terms of the environmental aid framework, may still be acceptable under the existing aid schemes. Such cases will have to be examined individually.

AID FOR VOCATIONAL TRAINING LINKED TO INVESTMENTS

The Commission has a generally positive attitude towards training, retraining and reconversion programmes. Aid proposed for such purposes will have to be examined in order to ensure that it does not simply alleviate the cost burden which companies would normally have to bear, in particular that they do not undermine the present guidelines.

Therefore, within the scope of the framework, the Commission intends to carefully examine aid for company-specific vocational training measures which are prompted by, and thus directly linked to, investments. The Commission will ensure that:

- such aid does not exceed a reasonable intensity, whenever linked with production investments,
- the vocational training measures involved in the project correspond to genuinely qualitative changes in the required qualifications of the labour force and relate to a significant proportion of the workers, so that it can be assumed that these measures are intended to safeguard employment and develop new employment possibilities for persons at risk of unemployment.

Vocational training measures specific to one or all companies prompted by investments which do not fulfil these above-mentioned criteria are to be considered as part of the investment, and submitted to the criteria regarding the different forms of investment aids as set out above.

Vocational training measures which are related to workers being retrained for continued employment in the company which are not linked to investment and which are intended to safeguard employment and develop new employment possibilities for persons at risk of unemployment in the framework of restructuring can be considered compatible.

OPERATING AID

As operating aid has a direct and ongoing distortive effect in a sensitive sector such as motor vehicles, it should not be authorized, even in disadvantaged regions. No new operating aid will be authorized in this sector and the Commission will propose, on the basis of Article 93 (1) of the EEC Treaty, the progressive disappearance of existing operating aid to those Member States which currently grand such aid.

[1] OJ C 83, 11.4.1986.

Part II

The ecu and its role in the process towards monetary union

This study was prepared by André Louw.

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Introduction

The name 'ecu' means different things to different people. For some, it is the acronym for European currency unit. For others, it is the name of a medieval French coin. But for all it has become the household name for a monetary unit that in barely 10 years' time has developed into a major currency on the international markets.

The ecu began its existence in March 1979 as the central unit of the European Monetary System. It soon expanded outside its official setting. Adopted by the private markets, the ecu successfully developed into a monetary unit possessing all the functional characteristics of a currency and being used as such in international financial and commercial transactions.

This paper is conceived as an introduction to the ecu,to its market performance, its qualities and weaknesses, its ultimate goal and, in particular, to the role it could and should play in the process leading towards the final stage of Europe's monetary integration process.

I — Basic notions

1. Definition of the ecu

The ecu is the European currency unit as defined by Community legislation, enacted in the framework of the European Monetary System (EMS) set up at the end of 1978.

This legislation, i.e. a regulation issued by the Council of Ministers of the European Communities,[1] defines the ecu as a currency basket composed of specific amounts of each of the currencies of the Member States of the European Communities. These amounts are presently the following:

Belgian franc	(BFR):	3,301
Danish krone	(DKR):	0,1976
Deutsch mark	(DM):	0,6242
Greek drachma	(DR):	1,440
Portuguese escudo	(ESC):	1,393
French franc	(FF):	1,332
Dutch guilder	(HFL):	0,2198
Irish pound	(IRL):	0,008552
Luxembourg franc	(LFR):	0,130
Italian lira	(LIT):	151,8
Spanish peseta	(PTA):	6,885
Pound sterling	(UKL):	0,08784

[1] See Annexes 1, 2, 3a and 3b.

2. Value

Theoretically, the value (or rate) of the ecu in terms of any of its component currencies is equal to the sum of the following elements: the physical amount by which that currency is represented in the ecu and, converted into that currency at the going exchange rate, the amounts of the other currencies in the ecu. Similarly, the ecu's value in dollars is equal to the sum of the dollar values of all the ecu's components.

Each day, on the basis of the exchange market situation of 2.15 p.m., the Commission of the European Communities calculates the rate of the ecu in terms of each of its component currencies. The ecu rates of 13 other major currencies are also calculated. Being calculated only once a day, these rates will differ somewhat from the buying and selling rates quoted throughout the day by the commercial banks that are active in the ecu market.

The Commission's rates are official in the sense that they apply to the uses of the ecu in the European Monetary System (EMS) and in other official Community areas. They are widely publicized.[2]

3. Rules for the revision of the ecu's composition

The amounts of the currencies in the ecu basket are not fixed once and forever. Two developments may lead to a revision of the ecu's composition:

(a) The evolution of the weights of the currencies in the ecu

The 'weight' of a currency in the ecu is the ratio, in percentage terms, between the number of units of that currency in the ecu and the value (rate) of the ecu in terms of that particular currency. Thus, for example, on 4 July 1991 the ecu was worth LIT 1 528,70 and, since there are LIT 151,8 in the ecu's basket, the lira's weight in the ecu on that day was 151,8 : 1 528,7 = 9,93%.

Weights do change. They increase for a currency that appreciates against the other component currencies because the fixed factor (amount of that currency in the ecu) will increase relative to the variable factor (value of the ecu in that currency). The reverse happens in case of a depreciation.

[2] See Annex 4 for details on calculation method and publication.

The weights of the currencies in the ecu are subject to a five yearly re-examination which may lead to an actual revision of the ecu's composition if it is agreed that these weights have grown too much out of line with the underlying economic realities of the Member States involved.

(b) The adhesion of new Member States

Under its present rules, the Community grants new Member States the right to have their currencies incorporated in the ecu. Timing and modalities are settled in the Accession Treaties.[1]

II — The revisions of the ecu

1. The September 1984 revision

On 15 September 1984 the composition of the ecu was changed, following the first five-yearly re-examination. The change became effective on Monday, 17 September 1984.

The decision to adjust the ecu's composition was taken because the weights had changed considerably. In 1979, the Deutschmark had a weight of 33 %. By mid-1984, it had risen to about 37 %. Over the same period, the weight of the lira dropped from 9,5 % to less than 8 % and the weight of the French franc also declined considerably. These changes reflected exchange-rate movements rather than shifts in relative economic importance. The Community authorities therefore decided to revise the ecu's composition in order to restore a closer relationship between the Member States' currency share in the ecu and their relative economic weight.

On this occasion, and in accordance with the provisions of the Treaty of Accession, the Greek drachma was introduced in the ecu with a weight of 1,3 %.

In deciding to revise the ecu's composition, consideration was given to the impact of the new weights on the ecu's interest rates. Indeed, by reducing the weights of low interest-rate currencies like the Deutschmark and the guilder and increasing those of higher interest-rate currencies such as the lira and the French franc, the interest rate on the ecu was bound to rise. In fact, on the day of the change, the calculated[2] short-term interest rate on the new ecu was about 0,8 points higher than on the old one. However, the actual market rate increased from 9,45 % to 9,60 % only. This minimal rise was due to the pre-emptive increase in market rates that the financial intermediaries, which had correctly anticipated the ecu revision, had been initiating for some time. No noticeable interest-rate effect was felt on the long-term ecu market.

2. The September 1989 revision

Five years later, in 1989, a second revision of the ecu's composition took place. As in 1984, it aimed at correcting the weight structure, though the shifts that had taken place in the currencies' weights were less pronounced than in the previous period.

In consideration of the ever-growing importance of the ecu's development on the private markets a two stage procedure was adopted to implement the revision: on 19 June 1989 the Council of Finance Ministers agreed on the weights and announced that they were to come into force later in the year, i.e. on 21 September. This allowed the ecu market operators to prepare for a smoother transition from the old to the new ecu, especially in view of the uncertainties that surrounded the incorporation of the peseta and the escudo. If the effect on the interest-rate shift was reduced to a minimum, the new procedure did not succeed in avoiding a slow-down in ecu market activity during the run-up period to the actual revision, which also comprised the enlargement of the ecu basket to include the peseta and the escudo.

Table 1 provides a more precise insight into the relevant data of the two revisions. It clearly shows the slow-down in weight-shifts in 1984-89 as compared to 1979-84. It also highlights that today's weights (July 1991) are still closely in line with those of the September 1989 revision. This is due to the absence of realignments in the EMS. If this stability record proves sustainable, the 1994 re-examination of the developments of the weights in the ecu is not likely to indicate a need for another revision.

[1] See Annex 5 for a more detailed explanation of the revision procedures.

[2] Calculated: weighted average of the interest rates quoted on the Euromoney markets for the component currencies.

Table 1

Revisions of the ecu, 1984 and 1989: new composition and weights before and at revision

Ecu component currencies	Initial composition and weights[1]		New 1984 composition and weights[1] on revision day and on previous day			New 1989 composition and weights[1] on revision day and on previous day			Weights[1] on
	13.3.1979		14.9.1984	17.9.1984		20.9.1989	21.9.1989		4.7.1991
BFR	3,66	(9,1)	(8,1)	3,71	(8,2)	(7,6)	3,301	(7,6)	(7,8)
DKR	0,217	(3,0)	(2,7)	0,219	(2,7)	(2,7)	0,1976	(2,45)	(2,5)
DM	0,828	(33,0)	(36,9)	0,719	(32,0)	(34,7)	0,6242	(30,1)	(30,4)
DR	—	—	—	1,15	(1,3)	(0,6)	1,440	(0,8)	(0,6)
ESC	—	—	—	—	—	—	1,393	(0,8)	(0,8)
FF	1,15	(19,8)	(16,7)	1,31	(19,0)	(18,7)	1,332	(19,0)	(19,1)
HFL	0,286	(10,5)	(11,3)	0,256	(10,1)	(10,9)	0,2198	(9,4)	(9,5)
IRL	0,00759	(1,1)	(1,0)	0,00871	(1,2)	(1,1)	0,008552	(1,1)	(1,1)
LFR	0,14	(0,4)	(0,3)	0,14	(0,3)	(0,3)	0,130	(0,3)	(0,3)
LIT	109,0	(9,5)	(7,9)	140,0	(10,1)	(9,4)	151,8	(10,15)	(9,9)
PTA	—	—	—	—	—	—	6,885	(5,3)	(5,3)
UKL	0,0885	(13,6)	(15,1)	0,0878	(15,0)	(13,0)	0,08784	(13,0)	(12,6)

[1] Weights given in parentheses.

III — The 'official' ecu: central unit of the European Monetary System (EMS)

The EMS, which started operating in March 1979, aims to stabilize the exchange rates within the Community with the ultimate objective of furthering price stability and economic growth. Indeed, the founders of the System held the view that in Europe's open economies — the foreign sector represents more than 50 % of GNP in some Member States — large currency fluctuations were a drag on growth and a stimulus to inflation. At present, all Member States participate in the exchange-rate mechanism of the EMS, except Greece and Portugal.

In this system, the ecu plays a central role:

(a) The ecu is the *numeraire* for the central rates, also called parities, of the participating currencies in the EMS. By crossing the ecu parities, one derives for each of these currencies a set of bilateral parities. Intervention limits are then fixed at 2 ¼ % on either side of the bilateral parities. For the pound sterling and the peseta this margin is 6 %. Each participating central bank undertakes to maintain its exchange rate against the other EMS currencies within these limits (see Table 2).

If market forces push a currency to its upper or lower limit against another currency, then the central banks involved must take action (intervention, interest-rate moves, other measures) to the full extent necessary to keep the limits from being crossed.

However, parity rates are not fixed once and forever; they can be adjusted or 'realigned' (see Table 3). The existing parities cannot be adjusted unilaterally by the country involved; it requires a unanimous decision of the Member States' Finance Ministers in a Community procedure involving also the central bank governors and the Commission.

(b) The ecu is the denominator for the claims and liabilities that may arise between the central banks as a result of the latter's interventions in each other's currency. Indeed, when a limit is reached, the strong currency that needs to be sold on the markets against the weak one can be borrowed on a short-term basis from the issuing central bank. These credit operations are registered in ecus.

Table 2

ERM: Bilateral central rates and intervention limits in force since 8 October 1990

		BFR 100	DKR 100	DM 100	PTA 100	FF 100	IRL 1	LIT 1 000	HFL 100	UKL 1	ECU 1
Brussels	+ 2,25%		553,000	2 109,50	33,6930	628,970	56,5115	28,1930	1 872,15	64,6050	
BFR	**CR**	**100**	**540,723**	**2 062,55**	**31,7316**	**614,977**	**55,2545**	**27,5661**	**1 830,54**	**60,8451**	**42,4032**
	−2,25%		528,700	2 016,55	29,8850	601,295	54,0250	26,9530	1 789,85	57,3035	
Copenhagen	+2,25%	18,9143		390,160	6,23100	116,320	10,4511	5,21400	346,240	11,9479	
DKR	**CR**	**18,4938**	**100**	**381,443**	**5,86837**	**113,732**	**10,2186**	**5,09803**	**338,537**	**11,2526**	**7,84195**
	−2,25%	18,0831		373,000	5,52600	111,200	9,99130	4,98500	331,020	10,5976	
Frankfurt	+2,25%	4,95900	26,8100		1,63300	30,4950	2,74000	1,36700	90,7700	3,13200	
DM	**CR**	**4,84837**	**26,2162**	**100**	**1,53847**	**29,8164**	**2,67894**	**1,33651**	**88,7526**	**2,95000**	**2,05586**
	−2,25%	4,74000	25,6300		1,44900	29,1500	2,61900	1,30650	86,7800	2,77800	
Madrid	+6%	334,619	1 809,40	6 901,70		2 057,80	184,892	92,2400	6 125,30	203,600	
PTA	**CR**	**315,143**	**1 704,05**	**6 500,00**	**100**	**1 938,06**	**174,131**	**86,8726**	**5 768,83**	**191,750**	**133,631**
	−6%	296,802	1 604,90	6 121,70		1 825,30	163,997	81,8200	5 433,10	180,590	
Paris	+2,25%	16,6310	89,9250	343,050	5,47850	100,000	9,18900	4,58450	304,440	10,5055	
FF	**CR**	**16,2608**	**87,9257**	**335,386**	**5,15981**	**100,000**	**8,98480**	**4,48247**	**297,661**	**9,89389**	**6,89509**
	−2,25%	15,8990	85,9700	327,920	4,85950	100,000	8,78500	4,38300	291,040	9,31800	
Dublin	+2,25%	1,85100	10,0087	38,1825	0,609772	11,3830		0,510246	33,8868	1,16920	
IRL	**CR**	**1,80981**	**9,78604**	**37,3281**	**0,574281**	**11,1299**	**1**	**0,498895**	**33,1293**	**1,10118**	**0,767417**
	−2,25%	1,76950	9,56830	36,4964	0,540858	10,8825		0,487799	32,3939	1,03710	
Rome	+2,25%	3 710,20	20 062,0	76 540,0	1 222,30	22 817,0	2 050,03		67 912,0	2 343,62	
LIT	**CR**	**3 627,64**	**19 615,4**	**74 821,7**	**1 151,11**	**22 309,1**	**2 004,43**	**1 000**	**66 405,3**	**2 207,25**	**1 538,24**
	−2,25%	3 546,90	19 179,0	73 157,1	1 084,10	21 813,0	1 959,84		64 928,0	2 078,79	
Amsterdam	+2,25%	5,58700	30,2100	115,235	1,84050	34,3600	3,08700	1,54000		3,52950	
HFL	**CR**	**5,46286**	**29,5389**	**112,673**	**1,73345**	**33,5953**	**3,01848**	**1,50590**	**100**	**3,32389**	**2,31643**
	−2,25%	5,34150	28,8825	110,1675	1,63250	32,8475	2,95100	1,47250		3,13050	
London	+6%	1,74510	9,43610	35,9970	0,553740	10,7320	0,964240	0,481050	31,9450		
UKL	**CR**	**1,64352**	**8,88687**	**33,8984**	**0,521514**	**10,1073**	**0,908116**	**0,453053**	**30,0853**	**1**	**0,696904**
	−6%	1,54790	8,36970	31,9280	0,491160	9,51910	0,855260	0,426690	28,3340		

Note: The drachma and the escudo do not participate in the exchange-rate mechanism; their notional central ecu rates are respectively 205,311 and 178,735.
CR = Central rates.

(c) The ecu is a reserve instrument. The European Monetary Cooperation Fund (EMCF),[1] for which the Bank for International Settlements (BIS) acts as agent, has issued ecus to the EMS central banks against the deposit (on a revolving swap basis) of 20 % of their gold and 20 % of their dollar holdings. The total amount of ecu reserves issued stands presently (June 1991) at 48,5 billion. These ecus can be used to settle the ecu debts that originate from the borrowings of Community currencies for the support operations mentioned in (b) above. For the settlement of these debts, the ecu is 'legal tender', i.e. creditor central banks have agreed to accept full settlement in ecus. Other payments in ecus between EEC central banks can only be made by mutual consent.

The 'official' ecu circuit therefore consists of a small number of European central banks,[2] among which the ecu can be used as a means of payment, but to a limited extent so far. On this circuit the exchange rate used is the 'official' rate as calculated by the Commission (see Chapter I.2 above), and the interest rate applicable is calculated as the weighted average of the interest rates on the most representative domestic money market instruments of the ecu's component currencies.

[1] The EMCF was set up in 1973 as the forerunner of Europe's central bank in the framework of the previous currency stabilization scheme ('snake'). This system was replaced by the EMS.

[2] In 1985, the official ecu circuit was opened to central banks of third countries and to international monetary institutions, provided they had been granted the status of 'other holder' by the EMCF. So far, the Bank for International Settlements (BIS) and the central banks of Austria, Switzerland, Malta and Norway have acquired this status.

Table 3

Changes in ecu composition, central rates and weights

		BFR	DKR	DM	DR[1]	PTA	FF	IRL	LIT	HFL	ESC[1]	UKL[2]
13.3.1979[3]		**3,80**	**0,217**	**0,828**			**1,15**	**0,00759**	**109**	**0,286**		**0,0885**
	CR	39,4582	7,08592	2,51064			5,79831	0,662638	1148,18	2,72077		0,663247
	%	9,63	3,06	32,98			19,83	1,15	9,49	10,51		13,34
24.9.1979	CR	39,8456	7,36594	2,48557			5,85522	0,669141	1159,42	2,74748		0,649821
	%	9,54	2,95	33,31			19,64	1,13	9,40	10,41		13,62
30.11.1979	CR	39,7897	7,72336	2,48208			5,84700	0,668201	1157,79	2,74362		0,648910
	%	9,55	2,81	33,36			19,67	1,14	9,41	10,42		13,64
23.3.1981	CR	40,7985	7,91917	2,54502			5,99526	0,685145	1262,92	2,81318		0,542122
	%	9,31	2,74	32,53			19,18	1,11	8,63	10,17		16,32
5.10.1981	CR	40,7572	7,91117	2,40989			6,17443	0,684452	1300,67	2,66382		0,601048
	%	9,32	2,74	34,36			18,63	1,11	8,38	10,74		14,72
22.2.1982	CR	44,6963	8,18382	2,41815			6,19564	0,686799	1305,13	2,67296		0,557037
	%	8,50	2,65	34,24			18,56	1,11	8,35	10,70		15,89
14.6.1982	CR	44,9704	8,23400	2,33379			6,61387	0,691011	1350,27	2,57971		0,560453
	%	8,45	2,64	35,48			17,39	1,10	8,07	11,09		15,79
21.3.1983	CR	44,3662	8,04412	2,21515			6,79271	0,717050	1386,78	2,49587		0,629848
	%	8,57	2,70	37,38			16,93	1,06	7,86	11,46		14,05
18.5.1983	CR	44,9008	8,14104	2,24184			6,87456	0,725690	1403,49	2,52595		0,587087
	%	8,46	2,67	36,93			16,73	1,05	7,77	11,32		15,07
17.9.1984[4]		**3,85**	**0,219**	**0,719**	**1,15**		**1,31**	**0,00871**	**140**	**0,256**		**0,0878**
	CR	44,9008	8,14104	2,24184	87,4813		6,87456	0,725690	1403,49	2,52595		0,585992
	%	8,57	2,69	32,07	1,31		19,06	1,20	9,98	10,13		14,98
22.7.1985	CR	44,8320	8,12857	2,23840	100,719		6,86402	0,724578	1520,60	2,52208		0,555312
	%	8,59	2,69	32,12	1,14		19,09	1,20	9,21	10,15		15,81
7.4.1986	CR	43,6761	7,91896	2,13834	135,659		6,96280	0,712956	1496,21	2,40935		0,630317
	%	8,81	2,77	33,62	0,85		18,81	1,22	9,36	10,63		13,93
4.8.1986	CR	43,1139	7,81701	2,11083	137,049		6,87316	0,764976	1476,95	2,37833		0,679256
	%	8,93	2,80	34,06	0,84		19,06	1,14	9,48	10,76		12,93
12.1.1987	CR	42,4582	7,85212	2,05853	150,792		6,90403	0,768411	1483,58	2,31943		0,739615
	%	9,07	2,79	34,93	0,76		18,97	1,13	9,44	11,04		11,87
21.9.1989[5]		**3,431**	**0,1976**	**0,6242**	**1,440**	**6,885**	**1,332**	**0,008552**	**151,8**	**0,2198**	**1,393**	**0,08784**
	CR	42.4582	7,85212	2,05853	150,792	133,804	6,90403	0,768411	1483,58	2,31943	172,085	0,728627
	%	8,08	2,52	30,32	0,95	5,15	19,29	1,11	10,23	9,48	0,81	12,06
8.1.1990	CR	42,1679	7,79845	2,04446	187,934	132,889	6,85684	0,763159	1529,70	2,30358	177,743	0,728615
	%	8,14	2,53	30,53	0,77	5,18	19,43	1,12	9,92	9,54	0,78	12,06
8.10.1990	CR	42,4032	7,84195	2,05586	205,311	133,631	6,89509	0,767417	1538,24	2,31643	178,735	0,696904
	%	8,09	2,52	30,36	0,70	5,15	19,32	1,11	9,87	9,49	0,78	12,60

[1] Notional central rates.
[2] Notional central rates until entry of sterling into the ERM on 8 October 1990.
[3] Ecu composition at the start of the European Monetary System.
[4] Revised composition of the ecu and inclusion of the drachma.
[5] Revised composition of the ecu and inclusion of the peseta and the escudo. The central rate of the peseta was fixed on 19 June 1989 when it entered the exchange rate mechanism.
CR = Central rates.
% = Percentage weights.

IV — The 'market' ecu: a major currency on the international exchange, money, and financial markets

1. Anatomy of the ecu as a foreign currency

The ecu is nowhere a 'national' currency as there is no 'eculand', but on the international markets it has become a major 'foreign' currency. Indeed, European nationals, and others as well, can use the ecu for their international financial and commercial dealings in the same way as they would use the dollar or the Deutschmark.

This is borne out by the facts: the ecu is bought and sold on the foreign exchange markets against most national currencies; banks use the ecu alongside other currencies for their international borrowing and lending operations; governments, international institutions, and a wide range of corporate businesses increasingly float ecu bonds on the international capital markets; and, finally, to some extent at least, exporters have started to invoice in ecus and importers to pay in ecus.

Table 4

Exchange rates of the ecu

(Yearly average)

	BFR	DKR	DM	DR	PTA	FF	IRL	LIT	HFL	ESC	UKL
1979	40,1653	7,20793	2,51097	50,7569	91,973	5,82981	0,669446	1 138,43	2,74876	67,014	0,646304
1980	40,5980	7,82736	2,52421	59,4178	99,702	5,86896	0,675997	1 189,21	2,76027	69,552	0,598488
1981	41,2947	7,92256	2,51390	61,6230	102,676	6,03993	0,691021	1 263,18	2,77511	68,495	0,553111
1982	44,7116	8,15687	2,37599	65,3419	107,558	6,43117	0,689605	1 323,78	2,61391	78,007	0,560455
1983	45,4380	8,13189	2,27053	78,0884	127,503	6,77078	0,714956	1 349,92	2,53720	98,689	0,587014
1984	45,4421	8,14648	2,23811	88,4154	126,569	6,87166	0,725942	1 381,38	2,52335	115,680	0,590626
1985	44,9137	8.01877	2,22632	105,739	129,135	6,79503	0,715168	1 447,99	2,51101	130,252	0,588977
1986	43,7979	7.93565	2,12819	137,425	137,456	6,79976	0,733526	1 461.88	2,40090	147,088	0,671543
1987	43,0410	7,88472	2,07153	156,268	142,165	6,92910	0,775448	1 494,91	2,33418	162,616	0,704571
1988	43,4285	7,95152	2,07440	167,576	137,601	7,03644	0,775672	1 537,33	2,33479	170,059	0,664434
1989	43,3806	8,04929	2,07015	178,840	130,406	7,02387	0,776818	1 510,47	2,33526	173,413	0,673302
1990	42,4257	7,85652	2,05209	201,412	129,411	6,91412	0,767768	1 521,98	2,31212	181,108	0,713851
1991 (Jan.-Aug.)	42,2812	7,90295	2,05399	222,801	128,096	6,97281	0,768948	1 532,09	2,31460	179,096	0,698480

(Yearly average)

	USD	YEN	SFR	NKR	SKR	FMK	ÖS	CAD	AUD	NZD	SDR	MTL	TRL
1979	1,37047	300,461	2,27865	6,93700	5,87171	5,32202	18,3095	1,60564	—	—	1,06058	—	—
1980	1,39233	315,044	2,32777	6,86548	5,88097	5,17224	17,9686	1,62609	—	—	1,06869	—	—
1981	1,11645	245,379	2,18714	6,38700	5,63465	4,79298	17,7151	1,33793	0,951677	1,31290	0,94548	—	—
1982	0,97971	243,546	1,98634	6,31294	6,14336	4,70721	16,6991	1,20822	0,964741	1,30379	0,88448	—	—
1983	0,89022	211,354	1,86753	6,49113	6,82115	4,94819	15,9689	1,09671	0,987346	1,33143	0,83253	—	—
1984	0,78903	187,089	1,84753	6,41698	6,51098	4,72408	15,7349	1,02066	0,897143	1,38172	0,76777	—	—
1985	0,76309	180,559	1,85572	6,51104	6,52133	4,69423	15,6428	1,04204	1,09208	1,52805	0,749042	—	—
1986	0,98417	164,997	1,76086	7,27750	6,99567	4,97974	14,9643	1,36731	1,47800	1,88331	0,837563	—	—
1987	1,15444	166,598	1,71780	7,76498	7,31001	5,06517	14,5710	1,53020	1,64733	1,94744	0,892137	—	—
1988	1,18248	151,459	1,72822	7,70054	7,24192	4,94362	14,5861	1,45589	1,51397	1,80385	0,879875	—	—
1989	1,10175	151,938	1,80010	7,60381	7,09939	4,72301	14,5695	1,30430	1,39279	1,84216	0,859756	0,395987	2 661,04
1990	1,27343	183,660	1,76218	7,94851	7,52051	4,85496	14,4399	1,48540	1,63021	2,13185	0,937068	0,403632	3 329,06
1991 (Jan.-Aug.)	1,23725	168,508	1,75922	8,01562	7,48908	4,91000	14,4530	1,42430	1,59589	2,11227	0,905845	0,399095	4 696,96

Spurred by these market developments, the monetary authorities of the 12 Member States have, between 1981 and 1987, all granted their residents the right to use the ecu on the same terms and conditions as those applicable to foreign currencies.

The ecu's story is unique in modern monetary history: market forces transforming a currency basket into a fully usable foreign currency.

It is important to note that the ecu used by the markets is the ecu as defined by Community legislation, including the revisions made to its initial composition. Preserving the definitional link with the official ecu is vital for the development of the market ecu as it ensures the unity and marketability of present and future ecu-denominated market instruments. For their part, the Community authorities responsible for the ecu's definition have increasingly taken the market needs into consideration (see Chapter II above).

Although linked by a common definition, the official ecu and market ecu are used on two completely separated circuits. The 'official' ecus are issued by an official monetary institution and only EEC central banks and other designated official holders can hold and use them. The 'market' ecus are created by the private sector and can be held and used by any market operator.

The absence of central bank involvement in the management of the market ecu raises a number of questions about the way the ecu is created, how its exchange and interest rates are determined and about its usability as a means of payment considering that ecu notes and coins do not exist.

These questions are best answered by going through the various steps of a concrete ecu transaction such as, for example, the purchase by a Dutch investor of an ecu bond issued on the international market by a French corporation.

Such a bond is priced in ecus and has to be paid in ecus. How does the Dutch buyer acquire these ecus? Quite simply by addressing his bank and either buying ecus against his own or another currency, or obtaining a credit in ecus. Since ecu bank notes do not exist, the bank will deliver the ecus by crediting the customer's sight account in its books for the amount of the ecus bought or borrowed.

Table 5

Operations rates of the EMCF and interest rates and yields of ecu investments

(%)

	EMCF	Deposits				Bonds		
		1 month	3 months	6 months	1 year	< 5 years	5-7 years	> 7 years
1987	6,77	7,00	7,10	7,16	7,27	7,85	8,24	8,51
1988	6,71	6,67	6,88	7,05	7,18	7,70	7,89	8,18
1989	9,25	9,10	9,30	9,41	9,49	8,86	8,70	8,76
1990	10,52	10,07	10,32	10,55	10,69	10,83	10,42	10,37
1990								
April	10,50	10,19	10,37	10,69	10,89	11,50	10,93	10,68
May	10,50	10,03	10,22	10,47	10,66	11,04	10,60	10,54
June	10,25	9,84	10,05	10,30	10,47	10,47	10,33	10,31
July	10,25	9,77	10,08	10,27	10,42	10,27	10,03	9,99
August	10,50	9,90	10,17	10,40	10,52	10,41	10,23	10,27
September	10,25	9,66	9,97	10,28	10,50	10,86	10,46	10,56
October	10,25	9,59	9,86	10,02	10,28	10,90	10,42	10,56
November	10,50	9,64	9,94	10,01	10,07	10,69	10,20	10,36
December	10,75	10,33	10,39	10,42	10,39	10,66	9,97	10,01
1991								
January	10,75	10,11	10,41	10,48	10,52	10,55	9,99	10,02
February	10,50	9,62	9,78	9,86	9,94	10,04	9,30	9,32
March	10,25	9,28	9,30	9,33	9,34	9,70	9,20	9,19
April	10,00	9,23	9,28	9,33	9,39	9,63	9,07	9,08

Acquiring ecu holdings in the form of sight deposits is not enough, however, to complete the purchase of the ecu bond. The Dutch buyer must also be able to transfer the ecu assets which he has with his bank to the bank in whose books the seller has his ecu account. In other words, he must be able to use the ecus in his sight account as a means of payment. Just like for any national 'bank' money, an ecu interbank clearing system exists that allows anybody to make and receive ecu payments world-wide.

As can be seen, for the Dutch investor, this purchase of an ecu bond is not different from a similar transaction in any other foreign currency.

However, in order to grasp the full extent of this achievement, clarification is needed on the following points.

(a) Ecu creation and the ecu basket

A bank creates ecu money (sight deposits) much in the same way as it creates domestic money: 'loans make deposits'. But there are differences. In creating the domestic money in this way, a bank does not run an exchange risk and it has the possibility, in case of liquidity need, to turn to a lender of last resort to monetize its short-term loan portfolio: the central bank.

In creating ecus by a lending operation, a bank faces an exchange risk on its ecu loan portfolio as well as a liquidity problem when the borrower draws on his ecu account. It will cover itself by matching its ecu asset position (ecu loans) with an equivalent ecu liability (ecu borrowings). In other words, it will borrow the ecus that it lends.

However, if this is possible for a single bank, it is not so for the whole of the banking sector in situations where the amount of ecu resources (deposits by non-banks) is less than the customers' demand for ecu credit. In the absence of a central bank as lender of last resort, a small number of banks have specialized in the role of intermediaries between the ecu and the ecu's component currencies: they volunteer to lend ecus to the banks in need of liquidity and, in turn, cover themselves in the basket of the ecu's components. Actually, it is the money markets of the component currencies of the ecu that provide the lender of last resort facilities to the ecu market. This link between the ecu and its basket and the commitment of a number of financial intermediaries in ensuring it, are essential to the depth, resilience and liquidity of the ecu market. Without this basket-recourse, ecu assets and ecu liabilities would have to be matched at all times ecu against ecu. This constraint would have fatally compromised the growth of the ecu market, if not its very existence.

(b) The ecu's exchange and interest rates

The ecu deposits that market operators buy, sell, transfer, borrow or lend are ecus; they are not baskets. However, since the ecu is defined as a basket of currencies, its exchange rate *vis-à-vis* its component currencies and third currencies should remain closely aligned to the basket's value in terms of these currencies. As to the ecu's interest rates, they should be equivalent to the weighted average of the interest rates on the basket's currencies in the international money markets.

The 'equal' value between the ecu and its basket is effectively ensured by the 'last resort' financial intermediaries referred to above.

The equivalence is not perfect as these intermediaries will fix their buying and selling rates of the ecu against the basket, as well as their bid and offered interest rates on the ecu, in function of the global situation of the ecu market. In other words, in a buyers' market, i.e. when a net demand for ecu deposits prevails, the ecu will behave like any strong currency: it will tend to appreciate against its basket while its interest rate will decrease. The reverse evolution will occur in a sellers' market. Competition between the 'basket makers' will ensure that the exchange and interest rate differentials between the ecu and its basket remain minimal (see Graph 1).

(c) The ecu clearing system

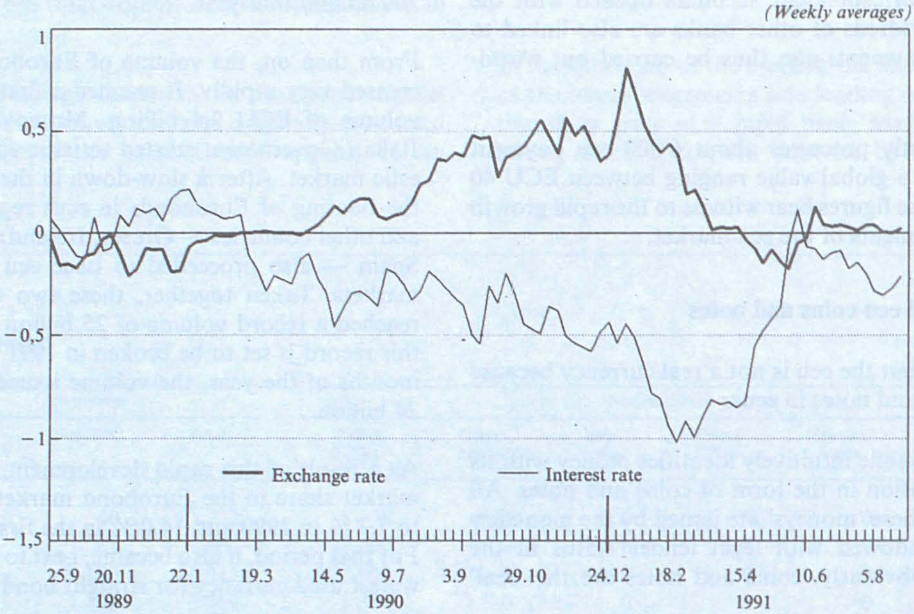
The ecus held in sight accounts with banks can only be used efficiently (in terms of cost and speed) for making payments provided that a clearing system exists for processing the payment instruments used (payment orders, cheques, bank cards). Such systems exist in each country for the national currency. They are managed by, or operated under, the control of the central bank.

For the ecu, a privately run international clearing system is in operation for payment orders related to bank accounts. It is managed by the Ecu Banking Association (EBA), in association with Swift (Society for World-wide Interbank Financial Telecommunication) and the BIS (Bank for International Settlements).

The operating principle of a clearing system is simple: each participating bank (clearing bank) must carry out the payment orders received from the other clearing banks

GRAPH 1: Differential between the market ecu and the ecu basket

(Weekly averages)



Source: Commission services.

i.e. credit the accounts of the beneficiaries in its books. Its own payment orders to other clearers in favour of beneficiaries having an account with the latter are dealt with likewise. At the end of each day, these payment orders are netted and each clearing bank has only one amount to pay or to cash: the difference between the total amount of the payment orders received and of those sent out.

More specifically, the ecu clearing system functions as follows: most banks use the Swift network for the transmission of their payment orders to other banks, whatever the currency. So do the ecu clearing banks. But when they send ecu payment orders, a copy is automatically made and stored in a computer installed at Swift's headquarters in Belgium. From the data thus collected, Swift calculates, in the afternoon of each business day, the net debit or credit position in ecus of each clearing bank in relation to all the others. Each bank receives notification of its own balance, the BIS receiving the whole set.

From then on the BIS takes over. Its role is twofold: it is the EBA's agent for the clearing and the banker of the clearing banks. As an agent, it keeps the record of the credit and debit positions and carries out the daily settlement operations necessary to balance the accounts. As a banker it accepts ecu sight deposits from the clearing banks in its books. The amounts held in these accounts represent the countervalue of the ecu's component currencies that have been transferred by the clearing banks to the accounts held by the BIS with each of the central banks issuing these currencies.

Although that had originally been the intention, the ecu sight deposits hardly serve to settle the clearing balances. Indeed, since the settlement operations have to be made 'value same day', a depleted ecu account cannot be adjusted in time by a debtor bank in order to have the necessary funds for the settlement of its debt. Consequently, the settlement of the debit balances is funded by overnight borrowings: the banks with debit positions borrow ecus, repayable the next day, from the banks with credit positions. This raises no technical difficulties as the ecu clearing system is a closed system, in which the sum of the debit balances is necessarily equal to that of the credit balances. But it implies, of course, an overnight credit risk for the creditor banks.

Numbering seven at the beginning, there are at present 45 clearing banks in the system, all located within the Community although some, given the international character of the ecu market, are branches of Swiss, Japanese or American banks. Through correspondent accounts opened with the clearing banks, hundreds of other banks are also linked to the system. Ecu payments can thus be carried out worldwide.

The system currently processes about 6 000 ecu payment orders per day for a global value ranging between ECU 40 and 50 billion. These figures bear witness to the rapid growth of the different segments of the ecu market.

(d) The absence of ecu coins and notes

It is often argued that the ecu is not a real currency because there are no coins and notes in ecus.

It is true that the public intuitively identifies money with its physical representation in the form of coins and notes. All the more so since these 'moneys' are issued by the monetary authorities and endowed with legal tender status in the issuing country. Obviously, coins and notes are the 'real' thing!

This being said, one should consider that the volume of coins and notes, in percentage of the total money volume (coins, notes, plus sight accounts with banks), is on the low side in most European countries. If it peaks at 64 % in Greece, it represents 35 % of the money supply in Germany and 16 % in France. It barely reaches 8 % in the UK. Considering these facts, the difference with the ecu, a 100 % bank money, is more a difference of degree than of substance. Another factor should also be considered : so far, the ecu is an international currency; it is nowhere a national currency. For international transactions, coins and notes are hardly used or useful. They are of course useful at the national level for the settlement of retail transactions. That means that the minting of ecu coins and the printing of notes will become relevant when the process towards EMU reaches its final stage and when national coins and notes are poised to be replaced by ecu coins and notes.[1]

2. The market development of the ecu : a general overview

The market development of the ecu has been impressive, particularly in its financial uses.

[1] In fact, ecu coins have been issued by Belgium, France, Ireland and Spain in denominations ranging from ECU 1 to ECU 100. However, the metal (silver or gold) content of these coins is worth much more than their face value. Consequently, they qualify as collector's items, not as money.

Ecu syndicated loans made their first appearance in 1980 and Eurobonds in ecus were launched in 1981 and totalled 200 million that year.

From then on, the volume of Eurobond issues in ecus increased very rapidly. It reached a first peak in 1985 with a volume of ECU 9,4 billion. Moreover, in that year, the Italian Government started to issue ecu bonds on its domestic market. After a slow-down in the two following years, the floating of Eurobonds in ecus regained its momentum and other countries — Greece, Ireland, Belgium, France and Spain — also proceeded to issue ecu bonds on their own markets. Taken together, these two types of bond issues reached a record volume of 25 billion in 1990. If anything, this record is set to be broken in 1991 as, for the first seven months of the year, the volume issued amounts already to 24 billion.

As a result of this rapid development, the ecu increased its market share in the Eurobond market from 4,8 % in 1988 to 7,3 % in 1990 and 14,0 % in the first six months of 1991. For that period, it also became, next to the dollar, the second widest used currency for straight bond issues.

Its volume set apart, other features also indicate that the ecu bond market is presently a mature market to be considered on par with the dollar, yen, Deutschmark and Swiss franc markets.

Thus, the average size of the ecu bond issues increased from 100 million in 1988 to 160 million in 1990. Benchmark issues exist for the quasi totality of the yield curve.

Ample evidence is also available that the liquidity of the market is satisfactory. Indeed, for the sole month of February of this year the market absorbed a number of issues totalling 8,7 billion of which two issues were of 2,5 billion each.

Liquidity has also increased on the secondary market where turnover in ecu bonds reported by Cedel and Euroclear more than doubled last year.

Finally, the depth and liquidity of the ecu market have also been enhanced by the launching of derivative financial instruments in ecus such as long-term and short-term interest-rate futures by Liffe, London, and Matif, Paris, and the renewed attempt by Finnex, New York, to issue ecu/dollar futures and exchange option contracts.

One particular aspect of the ecu bond market should be stressed : it is very much a sovereign issuers' market. Indeed, the governments and official bodies of the Member States and of third countries, as well as the Commission of the

European Communities and the European Investment Bank are very active market participants; they account together for about 50 % of the total volume of Eurobonds issued in 1990.

The presence of sovereign issuers in the ecu bond market has produced a shift in its investor base : originally supported by the retail investor, the market now appeals to an increasing extent to the institutional investor (see Tables 6 and 7 for more detailed statistical information).

In the short end of the market, the ecu also scored successes as the banks' borrowing and lending operations in ecu continued to grow at a rapid pace. Moreover, a particularly strong demand for ecu deposits by the non-bank sector

Table 6

Main bond-type ecu issues[1]

(million ECU)

Year of payment	Euro-issues			National issues						Total
	EEC	Non-EEC	Total	Italian CTEs	Greek bonds	Irish bonds	French OATs[2]	Spanish bonds	Total	
1981	192	40	232	0	0	0	0	0	0	232
1982	595	65	660	1 200	0	0	0	0	1 200	1 860
1983	815	1 100	1 915	600	0	0	0	0	600	2 515
1984	2 274	1 295	3 569	1 300	0	0	0	0	1 300	4 869
1985	5 301	4 161	9 462	2 500	0	0	0	0	2 500	11 962
1986	4 226	2 614	6 840	1 600	166	0	0	0	1 766	8 606
1987	4 303	2 933	7 236	1 500	218	100	0	0	1 818	9 054
1988	5 275	3 913	9 188	7 250	0	0	0	0	7 250	16 438
1989	6 461	4 666	11 127	6 000	1 538	0	1 652	0	9 190	20 317
1990	10 525	4 515	15 040	5 250	2 379	0	2 357	500	10 486	25 526

[1] Issues recorded on payment date, excluding short-term securities.
[2] The ECU 1 500 million 10.0% 2001 OAT issued on 6 November 1990 is included under Euro-issues.
Source: Eurostat (figures as at 31 January 1991).

Table 7

The ecu secondary market in 1991 — Fixed income bonds

(million ECU)

	Cedel			Euroclear			Total			% ECU/total	% DM/total
	ECU	DM	Total	ECU	DM	Total	ECU	DM	Total		
January-March											
Eurobonds	78 731	8	238 644	67 643	4 826	266 991	146 374	4 834	505 634	28,95	0,96
Others	26 547	61 178	199 137	37 554	160 831	314 513	64 101	222 009	513 650	12,48	43,22
Total	105 278	61 186	437 781	105 197	165 657	581 504	210 475	226 843	1 019 284	20,65	22,26
April-June											
Eurobonds (April/May)	41 666	49	146 315	37 247	4 376	215 459	78 913	4 425	361 774	21,81	1,22
Others	17 114	33 077	111 972	21 950	88 822	203 579	39 064	121 899	315 551	12,38	38,63
Total	58 781	33 126	258 287	59 197	93 197	419 038	117 978	126 323	677 325	17,42	18,65

brought the ecu asset and liability position of the banking sector in near balance whereas, almost continuously up to now, a very sizeable excess asset position had prevailed (see Table 8).

The Italian Government pursued its issue programme of ecu treasury notes initiated in 1987. The outstanding amount of these notes, which have a one-year maturity, is presently (June) 4,7 billion. Early in 1989, the British Government also launched an issue programme of ecu treasury bills. Their maturities are one, three and six months which qualifies them more particularly as reserve instruments for central banks. The amount of outstanding ecu treasury bills is now (June) 3,6 billion.

Table 8

Structure of the ecu banking market

(billion ECU)[1]

	Assets of the banking sector *vis-à-vis*:							Liabilities of the banking sector *vis-à-vis*:						
	87 IV	88 IV	89 IV	90 I	90 II	90 III	90 IV	87 IV	88 IV	89 IV	90 I	90 II	90 III	90 IV
Total	**80,8**	**100,0**	**124,1**	**135,8**	**137,7**	**144,8**	**142,7**	**66,5**	**85,9**	**112,1**	**129,2**	**134,7**	**144,3**	**141,3**
Non-residents	59,3	73,3	92,4	100,7	104,9	109,8	108,2	50,2	64,6	84,3	97,2	105,7	111,8	111,0
Residents	21,5	26,7	31,7	35,1	32,8	35,0	34,5	16,3	21,3	27,8	32,0	29,0	32,5	30,3
Non-banking sector	**21,5**	**24,5**	**31,2**	**32,4**	**34,5**	**34,0**	**34,1**	**7,2**	**7,7**	**14,4**	**14,2**	**14,3**	**16,7**	**16,5**
Non-residents	13,0	15,4	20,2	21,0	23,2	23,7	23,6	4,1	4,5	8,2	8,8	8,6	10,0	10,1
Residents	8,5	9,1	11,0	11,4	11,3	10,3	10,5	3,1	3,2	6,2	5,4	5,7	6,7	6,4
Banking sector	**59,3**	**75,5**	**92,9**	**103,4**	**103,2**	**110,8**	**108,6**	**59,3**	**78,2**	**97,7**	**115,0**	**120,4**	**127,6**	**124,8**
Non-residents	46,3	57,9	72,2	79,7	81,7	86,1	84,6	46,1	60,1	76,1	88,4	97,1	101,8	100,9
Residents	13,0	17,6	20,7	23,7	21,5	24,7	24,0	13,2	18,1	21,6	26,6	23,3	25,8	23,9
Liabilities in the ecu's component currency								**14,3**	**14,1**	**12,0**	**6,6**	**3,0**	**0,5**	**1,4**
Grand total	**80,8**	**100,0**	**124,1**	**135,8**	**137,7**	**144,8**	**142,7**	**80,8**	**100,0**	**124,1**	**135,8**	**137,7**	**144,8**	**142,7**

[1] Amounts outstanding in billion ECU at the end of period.
Source: ECU, No 16, 1991 based on BIS data.

In sharp contrast to its very successful financial development, the ecu's performance as an international commercial vehicle, that is to say, as a currency in which exports are priced, invoiced and paid remains disappointing. On average, less than 1 % of the EC countries' total exports are invoiced in ecu. The figures are somewhat higher in Portugal and Spain but close to zero in Germany. They are also somewhat better for the current-account transactions as these include the servicing payments on the financial transactions in ecus (see Table 9).

Some signs point to an incipient improvement. Indeed, a number of major international organizations have discovered how they can use the ecu to their advantage. For example: since the beginning of last year Eurocontrol has replaced the dollar by the ecu as the currency in which it sets the fees which are charged to the airline companies for their use of European airspace.

The European railway system has also turned to the ecu. The railroad companies routinely acquire reciprocal claims on each other as the fare for an international journey is paid in one country while the actual transportation is partly done by other railroad companies.

Table 9

Share of the ecu in commercial trade and current account

Country	Period	Goods				Current account[1]			
		Exports		Imports		Receipts		Payment	
		Mio ECU	%	Mio ECU	%	Mio ECU	%	Mio ECU	%
BLEU	1986	248	0,4	50	0,1	2 461	2,4	1 459	1,5
	1987	132	0,2	53	0,1	2 197	2,1	1 391	1,3
	1988	189	0,4	71	0,1	2 699	2,0	1 492	1,2
	1989	247	0,3	180	0,2	3 422	2,4	2 309	1,7
	Jan.-June 1990	170	0,4	109	0,3	2 354	3,1	1 864	2,5
DK	1987	9	0,0	9	0,1	89	0,3	245	0,7
	1988	18	0,1	12	0,1	134	0,3	338	1,0
	1989	23	0,1	11	0,1	154	0,4	401	1,0
	Jan.-Aug. 1990	33	0,2	11	0,1	143	0,5	404	1,3
D	1986	n.a.	n.a.	39	0,0	n.a.	n.a.	n.a.	n.a.
	1987	n.a.	n.a.	65	0,0	n.a.	n.a.	n.a.	n.a.
	1988	n.a.	n.a.	133	0,1	n.a.	n.a.	n.a.	n.a.
	1989	n.a.	n.a.	216	0,1	n.a.	n.a.	n.a.	n.a.
	Jan.-June 1990	n.a.	n.a.	99	0,1	n.a.	n.a.	n.a.	n.a.
GR		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
E	1987	25	0,1	5	0,0	65	0,1	135	0,3
	1988	115	0,3	43	0,1	226	0,4	203	0,3
	1989	367	1,0	345	0,6	1 001	1,3	729	0,9
	Jan.-Sept. 1990	346	1,2	478	1,0	1 378	2,4	1 050	1,6
F	1986	480	0,4	1 220	1,0	2 139	1,0	3 164	1,5
	1987	420	0,4	730	0,6	2 070	1,0	2 620	1,2
	1988	540	0,4	570	0,4	2 110	0,9	2 610	1,1
	1989	685	0,4	1 190	0,6	2 385	0,9	3 287	1,2
	Jan.-July 1990	375	0,4	710	0,7	1 654	1,2	2 001	1,3
IRL		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
I	1986	721	0,9	312	0,4	n.a.	n.a.	n.a.	n.a.
	1987	998	1,1	305	0,3	n.a.	n.a.	n.a.	n.a.
	1988	659	0,8	359	0,4	n.a.	n.a.	n.a.	n.a.
	1989	854	0,8	485	0,4	n.a.	n.a.	n.a.	n.a.
NL	1986	1 025	1,3	5	—	1 500	1,5	238	0,2
	1987	405	0,5	19	0,0	854	0,8	207	0,2
	1988	468	0,6	52	0,1	972	0,8	232	0,2
	1989	859	0,9	517	0,6	1 607	1,3	902	0,7
	Jan.-Oct. 1990	525	0,7	441	0,6	1 296	1,2	624	0,8
P	1986	33	0,4	11	0,1	56	0,4	100	0,9
	1987	58	0,7	18	0,2	107	0,7	97	0,8
	1988	285	2,6	70	0,5	397	2,1	177	1,0
	1989	532	3,0	356	1,7	782	2,9	523	2,5
UK		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[1] Ecu-denominated current account flows mainly consist of interest receipts and payments.
n.a. = not available.
Source: EC central banks.

In 1990, 18 European railroad companies adopted the ecu as the currency in which their reciprocal claims and liabilities are periodically (every fortnight) netted and as the currency in which the balance due is paid. A step further has recently been taken by expressing the freight tariffs in ecus, but without imposing the ecu as the payment currency.

The ecu is also used by some European multinationals as their internal accounting unit and, in some cases, as the common currency in which the intra-company trade is invoiced and paid. So far, however, few companies invoice their outside customers in ecus.

3. The market ecu and its use by central banks

Central banks are increasingly using the market ecu for the placement of their exchange reserves. At the end of 1990, ecu reserves held by the central banks of the industrialized countries (i.e. central banks reporting to the BIS) amounted to ECU 27 billion. This represented an increase of 60 % over 1989. The actual figure for all central banks is not known but is likely to be significantly higher. An important factor behind this development is the borrowing activity of the national authorities in the ecu market. To a large extent, they sell the proceeds of their bond and other note issues to their central banks.

Ecu reserve holdings of central banks also vary according to their intervention policy on their exchange markets. This is particularly the case for the central banks that participate in the exchange-rate mechanism of the EMS. Indeed, next to the dollar and the Deutschmark, the ecu has become an important intervention instrument which ERM participants buy or sell against their own currency in view of the latter's stabilization within its fluctuation band.

Another important development is the choice of the ecu as the exchange-rate 'peg' for the currencies of non-EC countries. In October 1990, Norway linked itself to the exchange-rate mechanism of the EMS and pegged the krone to the ecu. It fixed the parity of the krone at NKR 7,994 for ECU 1 and established fluctuation limits of + and − 2,25 % around that rate. These limits represent compulsory intervention rates for the Norwegian central bank. In other words, short of a parity change, the central bank is obliged to ensure that the exchange rate of the krone is kept within the fixed limits. In May and June of 1991 respectively, Sweden and Finland took the same step. There was a difference though : Sweden fixed its fluctuation limits against the ecu at + and − 1,5 % around the ecu parity of the krone, Finland chose + and − 3 % for the markka.

Three important aspects of this linkage should be stressed. In the first place, it is not construed as membership of the European Monetary System as such. Indeed, since July 1990, the EMS has become the first stage in the Community's monetary integration process. Consequently, only Member States can be institutionally part of the System and of its decision-making bodies.

In the second place, in joining the exchange-rate mechanism of the EMS, these countries have done so by pegging their currency to the ecu. Apart from the political significance of opting for a pegging method that has a pronounced Community character, this decision also indicates that they view the ecu as a satisfactory anchor for their stability-oriented monetary and exchange-rate policies.

Finally, by becoming the exchange-rate anchor of an increasing number of currencies, the role of the market ecu as an international reserve and intervention currency is being strongly stimulated.

4. The use of the ecu by Community institutions

The ecu has an important share in the financial transactions of the Community institutions.

(a) Borrowing and lending activities

The Commission, for account of the Community, is active on the international financial markets in back-to-back operations : borrowing funds for onlending to support development programmes in Member States, or to Member States directly when they face balance of payments problems. For a growing part, these transactions are ecu-based. Moreover, the Commission is becoming increasingly involved in securing financial assistance to governments in Eastern Europe. These loans are denominated in ecus and generally disbursed in ecus. This was the case, for example, for the first tranches of the loans to Hungary, Czechoslovakia and Bulgaria.

The Commission has also increased its presence on the ecu money market. The ceiling for total ecu holdings in the treasury of the European Coal and Steel Community is now 1,5 billion.

The European Investment Bank (EIB) has played a major role in the birth and the growth of the ecu's financial markets. Its capital is denominated in ecus and a majority of the Member States who are the shareholders of the Bank have chosen to pay in their capital share in ecus. The EIB borrows from the market to re-lend for development projects within the Community and in associated countries. At the end of October 1990 outstanding loans disbursed in ecu totalled ECU 8 billion, or 16,2 % of the total loan portfolio of the EIB, which operates in 17 different currencies. The ecu holds a similar share on the other side of the EIB's balance sheet where the outstanding amount of ecu-denominated issues came to ECU 6,5 billion or 14,3 % of the portfolio.

In addition, the Bank has raised the ceiling of its commercial paper programme from ECU 200 million to ECU 700 million. This programme was initiated last year to meet the Bank's needs for the financing of its ecu loans that are made on a floating interest rate basis.

Finally, the ecu is an important component of the EIB's liquid resources. The volume of these resources has been fluctuating between ECU 150 and 700 million and includes the proceeds of short-term paper placed on the ecu money market with maturities of one, two, three or six months, the paper being constantly renewed on maturity.

(b) The ecu in the Community budget

The general budget of the Community is denominated in ecus. However, according to the present rules, the Member States discharge their contributions to the budget in their national currencies. Most budget outlays are still made in national currencies as well.

An exception is the European Development Fund (EDF) which is not included in the general budget of the European Communities. Here Member States have the option to pay either in ecus or in their national currency. The majority pays in ecus.

But in specific sectors of the general budget, progress is being achieved as well. Thus, following partial changes in the existing budget legislation, the share of the ecu in Community expenditures is increasing fast. Thus ecu payments related to the structural Funds' programmes (Regional Fund, Social Fund, Guidance Section of the Agricultural Guidance and Guarantee Fund) are now being made in ecus. These payments amounted to about ECU 5 billion in 1990 and are expected to reach ECU 10 billion in 1991.

In late 1989, the Commission proposed to the Council to pay the Community staff salaries in ecus. This proposal is still under consideration. A decision is expected by the end of the year.

V — The role of the ecu in the transition period towards economic and monetary union (EMU)

1. The Community and EMU : a brief progress report

For a long time already the European Community has been attracted by the idea of transforming the Common Market into an economic and monetary union.

The first attempt goes back to December 1969 when the European Council (i.e. the Community's Heads of State or Government) decided to embark on the road towards economic and monetary union with the aim of achieving it by the end of the 1970s. A committee was set up, the 'Werner Committee', named after the then Prime Minister of Luxembourg, to draft a blueprint. A stage-by-stage approach was proposed and the first stage — a reduction in the margins of fluctuation against the dollar (the 'snake') — started in 1971. Moreover, the European Monetary Cooperation Fund (EMCF) was created as a forerunner of the future European central bank.

This first attempt was short-lived. The oil crisis of 1973 and the differences in policy response by the Member States provoked the demise of the system which lost most of its major participants. It ended up being a Deutschmark zone composed, besides the Deutschmark, of the Benelux currencies and the Danish krone.

With the setting up of the European Monetary System (EMS) at the end of 1978 a new attempt was launched. This system started with a transitional stage that was to be superseded, two years later, by an institutional stage which would grant increased monetary powers to the EMCF and set the Community back on the road towards economic and monetary union. This institutional stage never took shape.

In 1988, the European Council relaunched the process and instructed a committee presided over by Jacques Delors, President of the Commission, to study and propose the ways and means to realize, in stages, a European economic and monetary union (EMU).

This third attempt is set to succeed. Indeed, an Intergovernmental Conference is presently under way to draft the amendments that must be made to the founding text (Rome Treaty) of the Community so as to incorporate in this text the provisions for economic and monetary union. After being adopted by the 12 governments and parliaments, the amended text will become the new Charter of the Community. The Conference is scheduled to finalize its work by the end of the year and the voting procedures in the various Member States will take another year. In short, by the end of 1992, the Community should be firmly and irrevocably embarked on the road towards EMU.

Considering the past, why should the prospects for a successful outcome look bright this time?

Basically there are three reasons for optimism:

(i) A first reason is the implementation of the single market. This means that by the end of 1992, when all intra-Community frontier formalities, non-tariff barriers and tax barriers will have been eliminated, trade in goods, services and capital between Member States should be put on the same footing as similar transactions within each of these Member States.

However, such a market will fall short of being a truly single market as long as national currencies continue to exist. In that case, there will not be a single price for the consumer; nor will there be a single market for the producer. The uncertainties generated by possible exchange-rate fluctuations will interfere with the consumer's choice and with the producer's investment decisions. And for all involved, significant costs will arise from the continued need to trade and deal in the Community currencies. All these factors will create obstacles to transactions between the Member States as compared to transactions within each Member State. In short, in order to have a truly single market of 340 million people — comparable to but larger than the US market — a single currency is necessary. It is the perception, at the highest political level, of the need to add a monetary dimension to the single market that has given renewed impetus to the process of economic and monetary union.

(ii) A second factor is the success of the European Monetary System. Since January 1987, the System has functioned without any realignment of parities, apart from a minor adjustment to the Italian lira's central rate when it reduced its fluctuation margin from +/− 6 % to +/− 2,25 %. Proof has been administered that policy coordination works among countries who agree on the principle that price stability is an essential precondition for sustained and lasting economic growth.

(iii) Finally, all national authorities (except the British so far) have become increasingly convinced that, in a closely integrated market, national monetary independence is more an illusion than a reality. Collective decision-making is therefore increasingly viewed as the only possibility to retain a say in the management of a Community which Europeans accept as a 'must' in an ever-growing number of areas of private and public life. It is, moreover, the only way to secure the interests of the Community, and consequently of its members, in the world at large.

On the ecu's role in EMU important decisions have already been taken even before the outcome of the Intergovernmental Conference. Indeed, at their Rome meeting, in October 1990, the European Council agreed (except for one dissenting opinion) that EMU should have a single currency ('a strong and stable ecu') and that in the transition period towards EMU, the present ecu should be reinforced and further developed.

2. An outline of the ecu's development in the transition period

The ecu has become an important international currency. However, its breakthrough has mainly been in the area of financial transactions: Euro-issues, international bank credits, national ecu bond issues in Italy, France, Ireland, Spain and Greece, issues of ecu treasury bills in the United Kingdom and treasury notes in Italy, futures contracts, etc.

The financial success of the ecu among European operators lies for many in its characteristics as a relatively stable currency with an 'average' interest rate. This makes it an attractive currency to borrow by residents of high-interest-rate countries and an equally attractive investment currency for residents of low-interest-rate countries.

However, most ecu bond issues and other borrowings are 'swap-driven', i.e. the borrowed ecus are exchanged for other currencies. In other words, the ecu is not directly used as a means of payment for the commercial transactions (purchase of equipment, imports, etc.) that the borrowings are supposed to finance.

Here we touch on a crucial point: the ecu is rarely used as the currency for pricing, invoicing and payment in transborder trade within the Community. In fact, as mentioned before, in most Member States invoicing in ecus is less than 1 % of the total value of their foreign trade.

A take-off in the trade area is important for two main reasons:

(i) When the single market becomes a reality, competition between the various Community currencies will quite naturally increase. On the other hand, business firms for reasons of convenience and cost will reduce as much as they can the number of currencies used in their transborder transactions within that market. The emergence of a currency of a Member State as the dominant currency in the Community would not be a welcome development, neither from a political nor from a monetary point of view. In order to preserve the balanced character of the integration process and to avoid complicating monetary policy coordination between the Member States, the ecu should become the major currency used for pricing, invoicing and payment in the transborder trade within the Community.

(ii) National currencies are not easily uprooted. By using the ecu alongside their national currency, European operators would familiarize themselves with the ecu's use and with the prospect that it will eventually replace the national currencies. In doing so, they would, for an increasing range of transactions, already benefit from the advantages of the ecu as the Community's common currency.

A reciprocal link exists (see Section 3 below) between these two developments which would greatly help the introduction, in the final stage, of the Community's single currency: an ecu which would have smoothly evolved from a common currency into the single currency.

3. Action programme in support of the ecu's development

Up to now, the ecu's use in transborder trade has not really taken off. It is, however, the domain in which the ecu should increasingly be used during the transition period in order to become Europe's common currency. This raises the question of how this development will actually be achieved.

One option must be firmly ruled out: imposing the ecu. Apart from being politically unpalatable, this approach would also be operationally inefficient as reluctant recipients would surely dump the 'market' ecu onto the market.

On the contrary, the aim should be to generate a spontaneous market response in favour of the ecu by reinforcing its qualities and by eliminating the obstacles that prevent the ecu from competing on equal terms with other foreign currencies and with its component currencies.

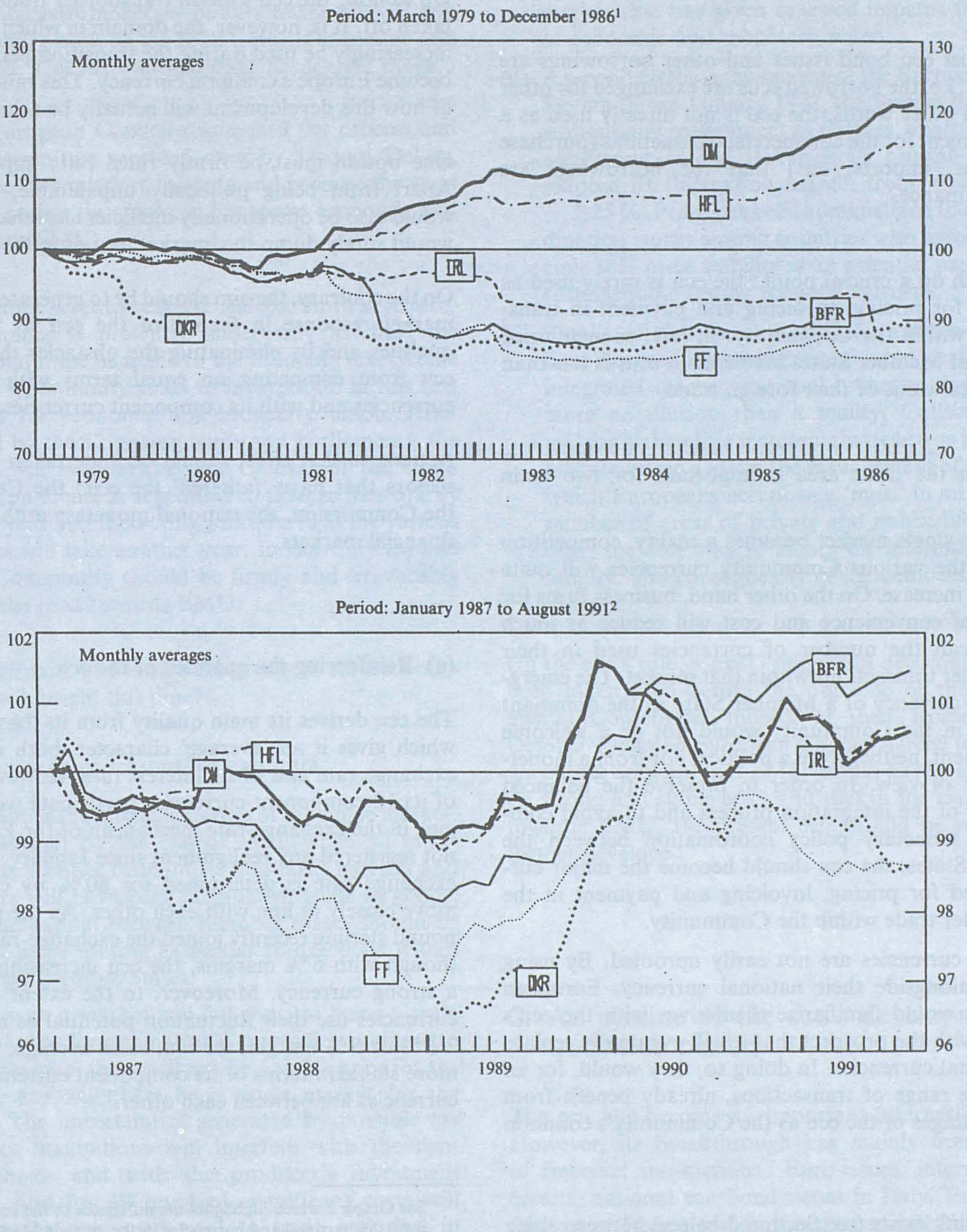
Actions to that effect should be undertaken by the various sectors that have 'fathered' the ecu: the Community and the Commission, the national monetary authorities and the financial markets.

(a) Reinforcing the qualities of the ecu

The ecu derives its main quality from its 'basket' definition which gives it an 'average' character, both in terms of its exchange rate and of its interest rate. However, since eight of its 12 component currencies participate with 2 ¼ % margins in the exchange-rate mechanism of the EMS which has not registered any realignment since January 1987, the ecu's exchange rate is determined for 80 % by currencies that move closely in line with each other. As the peseta and the pound sterling recently joined the exchange-rate mechanism, though with 6 % margins, the ecu increasingly qualifies as a strong currency. Moreover, to the extent that the EMS currencies use their fluctuation potential as allowed by the 2 ¼ % or 6 % margin, the ecu, as an average, will tend to be more stable in terms of its component currencies than these currencies are between each other.[1]

[1] See Graph 2 which highlights the difference in the ecu's behaviour *vis-à-vis* the narrow-band currencies in the periods March 1979 to end of 1986 and January 1987 to June 1991. In the first period, the DM appreciated by more than 20 % against the ecu while the FF devalued by more than 15 %. In the second period, the highest appreciation against the ecu was 1,4 % registered by the BFR and LFR, the highest depreciation was 1,3 % by the FF.

GRAPH 2: Evolution of the narrow-band currencies of the EMS *vis-à-vis* the ecu



[1] March 1979 = 100.
[2] January 1987 = 100.
NB: Note difference in scale between the two graphs.

The ecu's qualities as a strong and stable currency would be further enhanced by:

(i) global progress in the convergence of policies and policy results within the Community. This would allow the EMS to enlarge participation in the exchange rate mechanism to all the Member States, to generalize the 2 ¼ % margins (or even reduce them) and to effectively phase out realignments;

(ii) abandoning the revision of the ecu's composition. By doing so, a factor of uncertainty would be removed for market operators and the ecu would reinforce its strong currency bias as the weight gains of its stronger components would no longer be scaled down.

This solution to 'strengthen' the ecu is to be preferred to the 'hard ecu' proposals made by the British and Spanish authorities. The first one involves the creation of ecu money by a European Monetary Fund. This has been opposed, in particular by most central banks, because it amounts to the creation of a parallel currency. The second one, while maintaining the 'basket' definition of the ecu, introduces an additional, non-compatible determinant in the valuation of the ecu's exchange and interest rates and empowers the European central bank to manage these rates. This is likely to disturb the markets and the monetary policies of the Member States.

Moreover, besides confirming in the new Treaty the ecu's vocation to become Europe's single currency, the Community authorities should also reassure the markets that the transition from the 'basket' ecu to an 'abstract' ecu issued by a European central bank will be smooth and without disrupting the continuity of the ecu's exchange and interest rates.

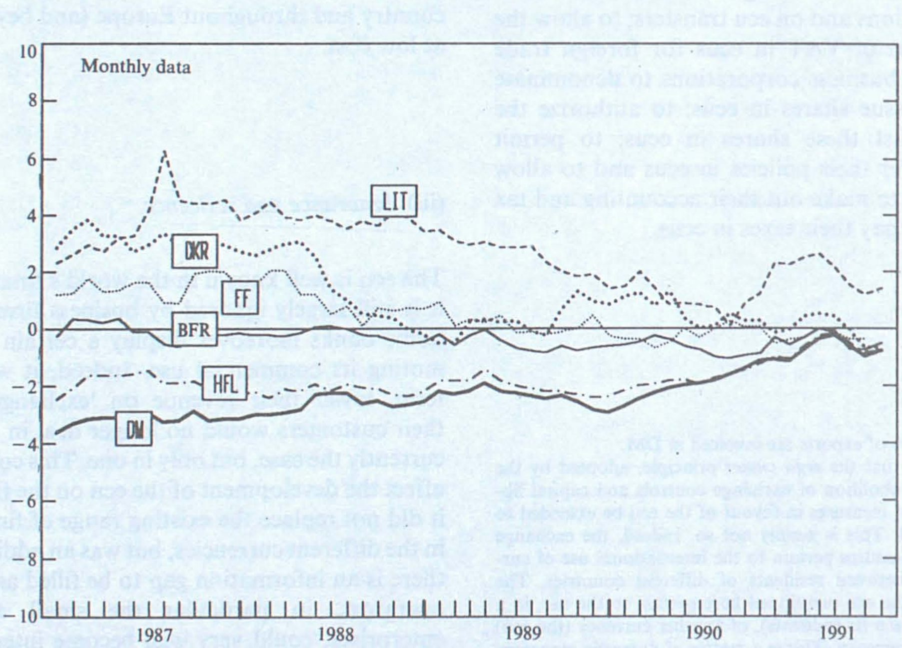
(b) Eliminating the obstacles to the ecu's development

The ecu is saddled with several handicaps that hamper its commercial development. They mainly relate to the following.

(i) *The absence of a national base*

The ecu is nowhere a national currency. This has two consequences. Firstly, the ecu does not benefit, for the development of its international commercial use, from the support

GRAPH 3: Euro-market interest-rate differentials *vis-à-vis* the ecu



that other currencies derive from the existence of a large national market. The development of the dollar as a pricing, invoicing and payment currency for international trade (not only its own foreign trade but also trade between third countries) was based on the importance of the American market for the rest of the world. Another contributing factor was the choice, by a large number of countries, of the dollar as the exchange-rate peg for their currencies. The same factors have backed a similar development of the Deutschmark at the European level.

Secondly, the ecu is more expensive to use than a national currency. Indeed, where an exporter manages to invoice in his own currency,[1] it is the importer alone who assumes the cost of converting his currency into the exporter's currency. In choosing the ecu they both bear these costs to the full extent.

The national authorities could remedy the ecu's competitive disadvantage by gradually opening their own national base to the ecu.

In other words, they should progressively extend to the ecu — and to the ecu alone — the privileges that their own currency enjoys within the national boundaries.[2]

For example, the national authorities should envisage, where appropriate, to eliminate VAT charges on ecu/national currency exchange operations and on ecu transfers; to allow the charging and payment of VAT in ecus for foreign trade invoices; to authorize business corporations to denominate their capital and to issue shares in ecus; to authorize the stock exchanges to list these shares in ecus; to permit insurance firms to offer their policies in ecus and to allow business corporations to make out their accounting and tax returns in ecus and to pay their taxes in ecus.

The effect of these and other measures would be threefold. Firstly, the ecu would acquire a share of the 'national base' in the countries involved. This would contribute to the ecu's development as an invoicing and payment currency in intra-Community trade. Indeed, ecu receipts by exporters of these countries could now directly be used domestically (i.e. without conversion in the national currency). Secondly, initiatives taken by one country would have a spill-over effect in other countries as operators there will be faced with stepped-up demands to invoice or be invoiced in ecus. And thirdly, these initiatives would also give the residents of the countries involved the possibility to use the ecu between themselves. The ecu would become part of the national monetary landscape.

(ii) *Obstacles within the payment systems*

The existing ecu clearing system is a 'wholesale' system (low numbers, high value) that fits the international financial uses of the ecu. However, with the ecu's prospective development in the international commercial area and its increasing use within individual Member States, the need arises to 'regionalize' the existing ecu clearing system by establishing links with the various national payment systems. Moreover, the 'retail' clearing systems (cheques, eurocheques, bank and credit cards) should be adapted so as to enable the residents of all EC countries to make ecu payments in their own country and throughout Europe (and beyond), speedily and at low cost.

(iii) *Ignorance and reticence*

The ecu is well known in the world's financial markets. But, it is still largely ignored by business firms, even in Europe. Some banks moreover display a certain reluctance in promoting its commercial use. Indeed, it would, in the short term, lower their revenue on 'exchange' commissions as their customers would no longer deal in 12 currencies, as is currently the case, but only in one. This consideration did not affect the development of the ecu on the financial markets as it did not replace the existing range of financial instruments in the different currencies, but was an addition to it. All in all, there is an information gap to be filled as many commercial operators, in particular the small and medium-sized enterprises, could very well become interested in the ecu if only they were made to know it better.

1 In Germany, about 80 % of exports are invoiced in DM.
2 It is sometimes argued that the *erga omnes* principle, adopted by the Member States for the abolition of exchange controls and capital liberalization, imposes that measures in favour of the ecu be extended to other currencies as well. This is simply not so. Indeed, the exchange control liberalization measures pertain to the international use of currencies, i.e. their use between residents of different countries. The measures in favour of the ecu mentioned here pertain to the use, in a given country (i.e. between its residents), of another currency (the ecu) alongside the national currency. This is a matter of domestic monetary order.

VI — Conclusions

The European Community is firmly set on the road towards economic and monetary union and the introduction in the end stage of a strong and stable ecu as the union's single currency. In the transition period towards EMU, the present market ecu should be further developed with particular emphasis on its role as a pricing, invoicing and payment currency for transborder commercial transactions.

The ecu's development is necessary to ensure the neutrality of the monetary integration process and to familiarize the markets with the ecu and with its advantages as a common currency. It would facilitate and possibly speed up the implementation of the final stage of EMU.

In order to secure the ecu's development, its present definition should be reinforced and the obstacles progressively eliminated that prevent the ecu from competing on equal terms with the currencies that it is to replace at the end of the transition period.

The decision-making power to make the appropriate amendments to the ecu's legislative and regulatory framework rests plainly with the Community authorities, the Commission and the national authorities.

In acting along these lines, an interplay between market forces and decisions by the authorities could be generated and a momentum created similar to the one that is proving so helpful in implementing the single market.

Annex 1

Council Regulation (EEC) No 3180/78 of 18 December 1978 changing the value of the unit of account used by the European Monetary Cooperation Fund[1]

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Regulation (EEC) No 907/73 of 3 April 1973 establishing a European Monetary Cooperation Fund,[2] and in particular the last paragraph of Article 5 of the Statutes of the Fund,

Having regard to the proposal from the Commission,

Having regard to the opinion of the Monetary Committee,

Having regard to the opinion of the Board of Governors of the European Monetary Cooperation Fund,

Whereas Regulation (EEC) No 907/73, in Article 5 of the Statutes of the Fund, requires the latter's operations in the currencies of the Member States to be expressed in a European monetary unit of account of a value of 0,88867088 grams of fine gold;

Whereas this definition no longer conforms with the rules in force in the international monetary system;

Whereas, apart from cases in which the value of the European monetary unit of account is changed automatically, the past paragraph of the said Article 5 provides that any other changes shall be decided on by the Council, acting unanimously on a proposal from the Commission, after consulting the Monetary Committee and the Board of Governors of the Fund;

Whereas the establishment of a new European Monetary System, which was the subject of the resolution of the European Council meeting in Brussels on 4 and 5 December 1978, provides for the use of an 'ecu' defined as a basket of Member States' currencies,

HAS ADOPTED THIS REGULATION:

Article 1

With effect from 1 January 1979, the Fund's operations shall be expressed in a unit of account known as the ecu which is defined as the sum of the following amounts of the currencies of the Member States

German mark:	0,828
Pound sterling:	0,0885
French franc:	1,15
Italian lira:	109,00
Dutch guilder:	0,286
Belgian franc:	3,66
Luxembourg franc:	0,14
Danish krone:	0,217
Irish pound:	0,00759

Article 2

The Council, acting unanimously on a proposal from the Commission after consulting the Monetary Committee and the Board of Governors of the Fund, shall determine the conditions under which the composition of the ecu may be changed.

Article 3

This Regulation shall enter into force on 1 January 1979.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 18 December 1978.

For the Council
The President
H. MATTHÖFER

[1] OJ L 379, 30.12.1978, p. 1.
[2] OJ L 89, 5.4.1973, p. 2.

Annex 2

Council Regulation (EEC) No 2626/84 of 15 September 1984 amending Article 1 of Council Regulation (EEC) No 3180/78 changing the value of the unit of account used by the European Monetary Cooperation Fund

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to the Act concerning the conditions of accession of the Hellenic Republic and to the adjustments to the Treaties of 28 May 1979,[1] and in particular Annex VIII thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the Monetary Committee,

Having regard to the opinion of the Board of Governors of the European Monetary Cooperation Fund,

Whereas Article 1 of Council Regulation (EEC) No 3180/78 of 18 December 1978[2] defines the ecu as the sum of amounts of currencies of the Member States;

Whereas Article 2(3) of the resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System stipulates that the weights of the currencies in the ecu shall be re-examined and if necessary revised within six months of the entry into force of the System and thereafter every five years or, on request, if the weight of any currency has changed by 25%;

Whereas a re-examination has been carried out and the results indicate that a revision is appropriate;

Whereas in accordance with Article 2(3) of the resolution of the European Council of 5 December 1978, the revision should be made in line with underlying economic criteria and should not, by itself, modify the external value of the ecu;

Whereas Annex VIII of the Act annexed to the Treaty of Accession of the Hellenic Republic to the European Communities specifies that the drachma shall be included in the ecu before 31 December 1985 if, before that date, a revision of the ecu is undertaken;

Whereas the Greek authorities have taken the necessary measures to ensure that the inclusion of the drachma in the ecu will take place in conditions which ensure the smooth functioning of the ecu market,

HAS ADOPTED THIS REGULATION:

Article 1

With effect from 17 September 1984 the composition of the ecu as laid down in Article 1 of Council Regulation (EEC) No 3180/78 of 18 December 1978 is amended as follows:

German mark:	0,719
Pound sterling:	0,0878
French franc:	1,31
Italian lire:	140,00
Dutch guilder:	0,256
Belgian Franc:	3,71
Luxembourg franc:	0,14
Danish krone:	0,219
Irish pound:	0,00871
Greek drachma:	1,15

Article 2

This Regulation shall enter into force on 17 September 1984.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Dromoland Castle, 15 September 1984.

For the Council
The President
A. DUKES

[1] OJ L 291, 19.11.1979, p. 17.
[2] OJ L 379, 30.12.1978, p. 1.

Annex 3a

I

(Acts whose publication is obligatory)

Council Regulation (EEC) No 1971/89 of 19 June 1989 amending Article 1 of Regulation (EEC) No 3180/78 amending the value of the unit of account used by the European Monetary Cooperation Fund

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Regulation (EEC) No 3180/78,[1] and in particular Article 2 thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the Monetary Committee,

Having regard to the opinion of the Board of Governors of the European Monetary Cooperation Fund,

Whereas Article 1 of Regulation (EEC) No 3180/78, as amended by Regulation (EEC) No 2626/84,[2] defines the ecu as the sum of amounts of currencies of the Member States;

Whereas Article 2(3) of the resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System stipulates that the weights of the currencies in the ecu shall be re-examined and if necessary revised within six months of the entry into force of the System and thereafter every five years or, on request, if the weight of any currency has changed by 25%;

Whereas a re-examination has been carried out and indicates that a revision is appropriate;

Whereas, in accordance with Article 2(3) of the said resolution, the revision should be made in line with underlying economic criteria and will not, by itself, modify the external value of the ecu;

Whereas the Joint Declaration on the inclusion of the peseta and the escudo in the ecu,[3] annexed to the Treaty of Accession of Spain and Portugal, states that the decisions to include the peseta and the escudo must take into account the necessity of ensuring a stable development of the functions and uses of the ecu and that either of these decisions could be made at the request of the new Member State concerned, after consultation with the Monetary Committee, on the occasion on the first five-year review of the weighting of the currencies within the ecu;

Whereas the Spanish and Portuguese authorities have requested that their respective currencies be included in the ecu;

Whereas the inclusion of the peseta and the escudo, in particular following the steps taken by the issuing authorities for these currencies, is compatible with the need to ensure a stable development of the functions and uses of the ecu;

Whereas it is desirable that an interval of time should elapse between the decision on the new weights of the currencies in the ecu and the date on which this decision takes effect,

HAS ADOPTED THIS REGULATION:

Article 1

With effect from 21 September 1989, the composition of the ecu as laid down in Article 1 of Regulation (EEC) No 3180/78 will be determined by:

(i) firstly, the following weights:

	%
German mark:	30,1
Pound sterling:	13,0
French franc:	19,0
Italian lira:	10,15
Dutch guilder:	9,4
Belgian franc:	7,6
Luxembourg franc:	0,3
Danish krone:	2,45
Irish pound:	1,1
Greek drachma:	0,8
Spanish peseta:	5,3
Portuguese escudo:	0,8

1 OJ L 379, 30.12.1978, p. 1.
2 OJ L 247, 16.9.1984, p. 1.
3 OJ L 302, 15.11.1985, p. 484.

(ii) secondly, the rates for the ecu derived by the Commission from the rates of the dollar recorded by the central banks of the Member States on their respective exchange markets, on Wednesday 20 September 1989 at 14.15.

The Commission shall be responsible for carrying out, on 20 September 1989, the calculations required to determine the new national currency amounts corresponding to the weights set out in this Regulation. It shall ensure that the new composition is communicated to the monetary authorities and published in the *Official Journal of the European Communities.*

Article 2

This Regulation shall enter into force on 20 June 1989.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Luxembourg, 19 June 1989.

For the Council
The President
C. SOLCHAGA CATALAN

Annex 3b

I

Press release issued by the Commission on 20 September 1989 and published in the Official Journal of the European Communities *(OJ C 241, 20.9.1989, p. 1)*

New composition of the ecu

In accordance with Council Regulation (EEC) No 1971/89 amending the composition of the ecu, and based on the weights announced therein, the Commission hereby announces the new national currency amounts composing the ecu, to take effect from 21 September 1989, as follows:

German mark:	0,6242
French franc:	1,332
Pound sterling:	0,08784
Italian lira:	151,8
Dutch guilder:	0,2198
Belgian franc:	3,301
Luxembourg franc:	0,130
Spanish peseta:	6,885
Danish krone:	0,1976
Irish pound:	0,008552
Greek drachma:	1,440
Portuguese escudo:	1,393

Annex 4

Procedure followed for calculating the ecu's exchange rates in terms of its component currencies and of other currencies

The central banks of the Member States whose currencies are in the ecu record, at 2.15 p.m. each day, the rate of the United States dollar against their own currency on their respective currency markets. The dollar rate was chosen as being the most representative currency rate in all financial centres. These rates are then forwarded through the National Bank of Belgium to the Commission, which uses them to calculate the 'official' ecu rate of the day, first in dollars and then in each of the currencies of the Member States. If an exchange market is closed, the central banks agree on a representative rate of the dollar against that currency.

Example: Calculation of ecu rates for 22 October 1990.

	USD rates on 22.10.1990 (USD 1 = ...)	Currency components of the ecu	USD value of the currency components of the ecu	Ecu rate in each component currency (ECU 1 = ...)[2]
	(1)	(2)	(3) = (2) : (1)	(4) = (Sum 3) × (1)
BFR/LFR	31,0675	3,431[1]	0,1104369518	42,4015
DKR	5,7575	0,1976	0,03432045158	7,85794
DM	1,5090	0,6242	0,4136514248	2,05951
DR	152,0600	1,440	0,009469946074	207,534
ESC	133,2000	1,393	0,01045795796	181,794
FF	5,0530	1,332	0,2636057787	6,89642
HFL	1,7009	0,2198	0,129225704	2,32142
IRL	1,7767	0,008552	0,0151943384	0,768176
LIT	1130,5000	151,8	0,1342768686	1 542,93
PTA	94,8000	6,885	0,07262658228	129,385
UKL	1,9530	0,08784	0,17155152	0,698831

Ecu rate in dollars: ECU 1 = USD 1,364817524 (Sum 3).

[1] Belgian and Luxembourg francs are taken together.

[2] Ecu rates are given with six significant figures.

The Commission also calculates the rate of the ecu in a dozen other currencies, using for each of these their dollar rate at 2.15 p.m.

The ecu rates calculated by the Commission are published daily, correct to six significant figures, in the 'C' edition of the *Official Journal of the European Communities*.

They are put on the Reuters (FXEZ, FXEY) and Telerate (3285) screens.

They are also made available through an automatic telex answering service. This service can be used as follows:

call telex number Brussels 23789 or 23794;

give own telex code;

type four times the letter C, which triggers the automatic answering system into operation.

The ecu rates of the day are available from 3.30 p.m. onwards (Brussels time).

Finally, the Statistical Office of the EC publishes them, together with other ecu statistics, in its monthly publication *Ecu-EMS information*.

Annex 5

Rules on changes in the ecu's composition

(a) Re-examination and revision of the currency amounts in the ecu

The procedure for re-examining the weights of the currencies in the ecu and, if necessary, to proceed with a revision of the ecu's composition is outlined in the resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System.[1]

(i) The weights of the currencies in the ecu:

are re-examined every five years. The first five-yearly re-examination took place in September 1984 and led to a revision of the ecu's composition. The next re-examination was scheduled in September 1989;

are re-examined, on request, if the weight of a component currency has changed by 25 % or more.

(ii) A re-examination is not necessarily followed by an actual revision. Its purpose is to assess whether or not a revision is needed, considering the size of the discrepancy between the weights of the currencies in the ecu and the relative economic importance of the Member States. Indeed, economic criteria (relative GNP and intra-European trade, shares in the financial support mechanism) have been at the basis of the fixing of the initial as well as the new compositions of the ecu. In the course of time, exchange-rate developments may change the currencies' weights out of proportion to what might be indicated by the underlying economic criteria. An excessive discrepancy, diagnosed at a re-examination exercise, will therefore trigger a revision procedure of the ecu's composition.

(iii) An actual revision has to be mutually accepted, which means: a unanimous decision by the Council of Ministers of the Community, on a proposal by the Commission and after consultation of the Monetary Committee and the Board of Governors of the European Monetary Cooperation Fund. A revision aims at re-establishing a satisfactory balance between the weight of the currencies in the ecu and the economic weight of the issuing countries, as indicated by the economic criteria. New weights are not automatically determined as the 'arithmetical' average of the different percentages supplied by these criteria; they result from an 'agreed' average. In this way, the primary aim of a revision, i.e. maintaining the ecu's representative character, does not preclude that consideration is also given to the need to avoid large-sized changes that could be detrimental to the development of the ecu on the markets.

(iv) A revision of the ecu's composition is not to be compared to a currency devaluation or revaluation that results in a sudden 'kink' in the market exchange rate of the currency involved. On the contrary, a revision is implemented in such a way that, on the day of the change, the value of the 'new' ecu is identical to that of the 'old' one. This is done by applying, on the day of the change, to the rates of the old ecu in terms of each of its component currencies, the new weights chosen for each of them in order to determine the new specific amounts of these currencies in the revised ecu. Any 'kink' in ecu rates is thus avoided,[2] though from the moment of revision onwards, the ecu's exchange rates will tend to differ over time from what they would have been under the old composition.

(b) Incorporation of the currencies of new members

Apart from being triggered by a re-examination, the ecu's composition will also change as the currencies of new members of the Community are incorporated. Being both symbol and instrument of Europe's monetary integration process, each new Member State has the right to have its currency in the ecu. However, this right is not to be exercised automatically; its timing and modalities are to be negotiated and are spelled out in the Accession Treaties.

Thus for the Greek drachma, it was agreed in the Treaty to proceed with incorporation at the latest by 31 December 1985 or, before that date, if the weights of the currencies in the ecu were to be revised. Such revision took place in September 1984 and, consequently, the drachma became a component of the ecu on that occasion.

For the peseta and escudo, the Accession Treaties[3] stated that the decision to incorporate the peseta and/ or escudo

[1] Article 2(3) of the Resolution states that 'The weights of currencies in the ecu will be re-examined and if necessary revised within six months of the entry into force of the System and thereafter every five years or, on request, if the weight of any currency has changed by 25 %'. Revisions have to be mutually accepted: they will, by themselves, not modify the external value of the ecu. They will be made in line with underlying economic criteria.

[2] In the official texts, this is referred to as 'maintaining the external value of the ecu'.

[3] OJ L 484, 15.11.1985.

could be taken on the occasion of the next five-yearly re-examination of the ecu, i.e. September 1989.

Contrary to the Treaty with Greece, which was negotiated before the EMS and the ecu became operational, no firm commitment was entered into with Spain and Portugal to proceed with incorporation in September 1989 when the matter was due to come up for consideration. This explains also the legal format of these provisions: a joint declaration annexed to, but not part of, the Treaty itself.

The change in approach reflects the growing awareness of the need to avoid disturbances on the market. This being so, the peseta and escudo were actually introduced in the ecu basket on the occasion of the 1989 revision.

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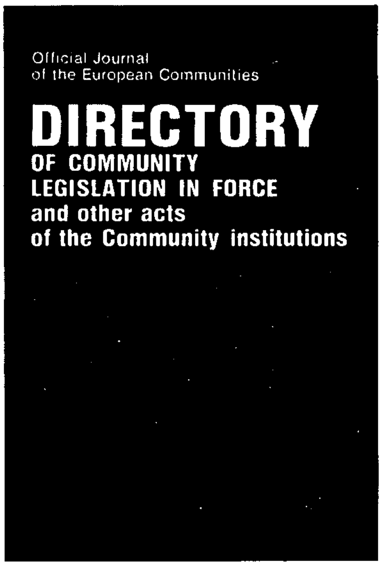

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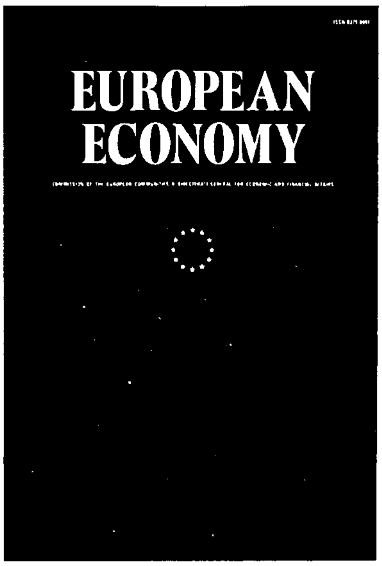

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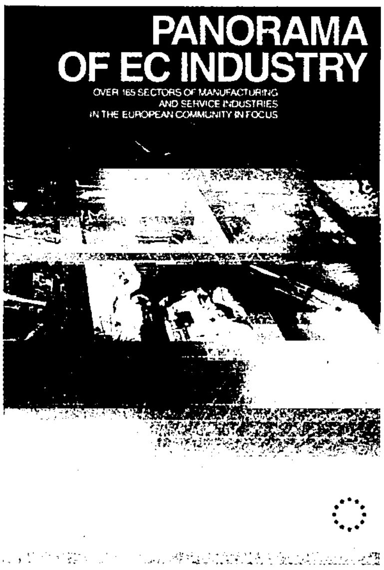

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