

State aid and Competition

Speech at the seminar on

“STATE AID IN LAW AND PRACTICE IN THE EUROPEAN UNION”,

Warsaw 21 – 22 March 2005

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I would like to thank the organisers of this seminar and in particular the President of the Office for Competition and Consumer Protection, Mr Banasiński, for inviting me to speak at this seminar. I feel honoured in particular as my focus in my daily responsibilities is rather on competition and not on state aid. The Swedish Competition Authority which I am heading has no tasks on state aid assigned to it. However, as an authority responsible for competition, state aid is important for how competition works. Moreover, we often deal with competition problems related to state aid in our enforcement of the competition legislation as well as in our analyses and reports on the competition conditions in Sweden.

In my remarks today I would first like to briefly discuss why and how state aid may distort competition between companies

on the market. Second I will share with you some experience from a Swedish perspective including some comments on subsidies given by the state or municipalities from a local or small scale perspective.

Distortions on competition

No doubt public subsidies can be a powerful tool that can be used to achieve social objectives or to address market failures. However, subsidies also have an effect on competition. These effects are both short term and direct as well as structural and long term.

Competition is a process of rivalry between companies. Companies compete by offering lower prices, better quality or differently designed products. Consumers steer the market by their choices and efficient firms, that offer the products consumers want to buy, will prosper and others exit from the market. This mechanism will be distorted if one or some of the players on the market receive subsidies which alter their costs and revenues and change their behaviour on the market. Subsidies may lead to inefficiencies, as efficient firms may be forced to leave the market if they cannot compete with less efficient firms that receive subsidies.

Subsidies, regardless of their objective, always intervene in the functioning of a market. The extent of negative effects on competition depends, in general terms, on the nature of the subsidy and on the characteristics of the market concerned. Effects on competition should therefore in my view always be taken into account when the granting of any type of public subsidies is considered, not because competition is a goal in itself, but because competition is a means to achieve consumer welfare.

State aid provided to a sector of the economy

State subsidies are sometimes by governments given to a sector of the economy. The motive behind comprehensive support of this kind is often reduced competitiveness of the industry in question compared to the surrounding world. Competition from producers in other countries is seen as a threat to the industry, to employment and to prosperity of the region or regions where the industry is located. The objective of the state support might be to enable domestic producers to compete with foreign suppliers on conditions that are perceived as more fair. Sometimes the objective is more explicitly declared to allow modernisation and innovation in order to achieve sustainable competitiveness of the domestic industry.

The purpose of the sector aid can thus be very different. Generally speaking, the aid might be part of a *rescue operation* due to sudden changes with problematic consequences. It might also be a part of a long-term *restructuring operation* in order to preserve the viability of companies in the sector. In the extreme, governments can give *operational support* to industries. The assessment of the state aid depends on the type of state aid.

The process to reconstruct an industry is a long-term, costly and painful commitment. Sometimes the state aid successfully supports the reconstruction of the industry, but more often the outcome is negative, if all costs involved are taken into account. In the end, the costs are paid by the national tax payers. There are many examples worldwide of interventions by states that subsidize industries without any realistic possibilities to compete in the long run with products manufactured at much lower costs elsewhere. The state aid may in such cases even be

counterproductive in that it artificially prolongs the necessary reform process.

According to the European Commission State Aid Scoreboard from spring last year, Sweden is among the countries in the European Union with the lowest proportions of GDP spent on state aid. Arriving there has not been an easy process. I would like to give you two different examples from the previous decades of state support. The first example is the shipbuilding industry and the second an example from the financial sector.

The shipbuilding industry

The first example is the Swedish ship-building industry. Only some thirty years ago Swedish children were taught at school, and very correctly so, that Sweden was one of the leading ship-building nations in the world. Big shipyards on the west coast of Sweden had many thousands of employees and the industry accounted for an important part of the country's Gross Domestic Product. However, during the period 1975 to 1982 the Swedish competitiveness eroded rapidly due to competition from shipbuilders in countries with much lower production costs. These foreign competitors were furthermore often supported by state aid. Prices on the world market were also pressed down by the over-capacity produced by the expansion of this industry in many countries.

During this rather long period the Swedish shipbuilding industry became the by far largest recipient of state aid in Sweden. In spite of these efforts the industry failed to cope with the pressure from international competition. For example, the number of employees decreased, from 32.000 to 17.000. The decline in the shipbuilding industry also had big effects in other

industries that supplied products for the ships, such as the steel industry.

The costs for the taxpayers and the inefficiency of state aid in this situation became apparent. This led to the decision not to grant further state aid. Today, only some niche shipyards on a smaller scale exist in Sweden. This example shows that in spite of very large efforts from the state, it is very difficult to achieve positive results from state aid to a whole industry if the necessary conditions for sustainable international competitiveness do not exist. Reconstruction of the industry may even be unduly prolonged by the support. In situations of long periods of competitive problems of a structural nature, state aid can not only be costly for taxpayers but also inefficient.

Although the support to the Swedish shipbuilding industry did not distort relations between different domestic shipyards, it clearly distorted competition with foreign shipyards. Furthermore it locked in resources in an industry that was not viable in the long run.

The Swedish bank crisis

Another example of government financial intervention is the support given to the financial sector. The first signs of the impending crisis in the Swedish financial system emerged during the autumn of 1990, when finance companies began to have difficulties. The background to and causes of the problems were a sustained period of economic growth in the mid and late 1980s, in conjunction with perverse tax incentives and a deregulation of credit markets, generated a hothouse climate in which loan and real-estate markets became unbalanced. The level of indebtedness rose and real-estate prices climbed to unreasonable heights.

The real-estate crisis hit specialised finance companies first but it was soon clear that the extent of the decline in prices would also lead to substantial losses for the banks.

Banks are more exposed than most other companies since a bank's survival will be threatened by the mere suspicion that it may be in difficulties. Expectations of losses and future insolvency may thus be self-fulfilling. Problems for a particular bank may therefore start a chain reaction where real or supposed difficulties for one bank bring down other banks, too.

Such a course of events would have extremely serious consequences for individuals and firms, as well as for the economy in general. In the extreme case the payment systems would collapse and with it the possibility of executing payments via bank transfers. Furthermore, extensive losses among banks and other credit institutions lead to a decreased overall supply of credits and poorer terms for borrowers. With less possibility of financing consumption and investment with loans, demand will fall from households as well as firms. The economic outlook then becomes still bleaker, business profitability falls and unemployment rises, leading to even larger loan losses. The economy is liable to enter a downward spiral where financial problems weaken real activity and this in turn accentuates the financial crisis.

State support

In September 1991 it was evident that some banks had suffered extensive credit losses with the possibility of a risk of insolvency. The banks turned to the government for help. The State deemed it necessary to cooperate and the Parliament decided in December 1992 to guarantee that the banks would be able to fulfil their obligations in a timely manner by granting an

implicit general commitment and by providing direct state aid. The purpose was to safeguard the stability of the payment systems and secure the credit supply.

On 1 May 1993, the Bank Support Authority was established for the purpose of managing the government's support and restructuring of the problem banks. The support was provided primarily in the form of loans, guarantees and capital contributions. The support measures were provided on commercial terms in order to minimize the state's long-term expenses for such support. The intention was that the costs, to the greatest possible extent, should be refunded to the state. The general support was to be abolished as soon as this was possible without risking the creditors' interest.

Institutions applying for support had to undergo a thorough evaluation which provides a foundation for assessing whether any support is needed and, if so, the form of such support. If the State guaranteed certain assets, these were to be transferred to a separate entity within the institution, or to a separate company, which the Bank Support Authority controlled.

In certain cases the institution had to undertake to produce plans for and implement a rationalization of its operations. These plans had to be reported to the State. By these strict measures the distortions of the rescue operation was sought to be minimized.

Support provided

The State's total commitment for the support amounted to SEK 90.5 billion. Payments were made equal to SEK 65 billion.

Of the total of SEK 65 billion paid out, an important part was expended for share subscription, share purchases and capital contributions to the state-owned bank Nordbanken and Gota Bank. Extensive reconstruction was undertaken at both banks and finally the Bank Support Authority decided to transfer Gota Bank to Nordbanken.

The support was not given to all banks. Two of the four major banks, together with the smaller banks and the independent savings banks were not given any direct government support. Other parts of the banking system did not need government aid.

The effects of the support

The costs incurred through the bank support must be evaluated against the background of the values at risk. At the time when the government commitment was made the situation in major parts of the credit market was regarded as extremely unstable. Serious losses had already been incurred by a couple of major credit institutions. The exchange and interest rate turbulence in the autumn 1992 resulted in a marked increase of the uncertainty regarding the power of the institutions to resist different financial strains and the risk of new insolvency rapidly developing. The consequences for the payment system and the credit supply of such a development were deemed to be unacceptable; unforeseeable losses to the national economy were at risk.

In parallel to the banking crisis, the Government carried out a strict monetary policy regime with high interest rates. In order to be able to reach the monetary policy objectives, the banking crisis had to be taken care of.

When analysing the outcome it is clear that the support achieved its objective in stabilizing the banking system. With regard to the bank structure, a major structural change at institutional level was that after being restructured, one bank was incorporated into the state-owned Nordbanken group. This meant that an independent medium-sized bank disappeared. Furthermore, the strict conditions for support lead to a packaging of assets and the creation of a number of new real estate companies.

Clearly, the Government had to balance between different conflicting goals. Effects on economic growth in the short and in the long term had to be balanced. Despite the tragedy of having to use tax money to assist the banking sector, there are four conditions that helped easing the distortions of competition.

- The problem was a sudden collapse of confidence in markets with potential external effects. In those cases markets may not internalize the subsidies in the same way.
- The support given was selective and targeted.
- The Government set criteria for the support that lead to a pay-back and restructuring of the industry on market conditions.
- The support was limited in time.

Although the distortion on competition was thus eased one distortion still linger: the memory of the intervention as such.

State aid and municipalities/ subsidies granted by municipalities

Let me now turn from issues related to macro-oriented problems involving large volumes of state aid to a more micro-oriented

question that is different in scope and nature to the above: namely subsidies granted by municipalities. Municipal subsidies differ in that the number of cases where aid is granted is large, but that the money granted in each case is fairly moderate. If considered separately, these cases may therefore be of little interest. The sum of these subsidies may, however, be considerable.

In Sweden, like most other European countries, state aid is only controlled under the EC legal framework. Although there are notifications to the Commission of state aid granted by municipalities, the focus here today will be on subsidies that, for one reason or other, do not qualify as state aid but may nevertheless distort competition.

De minimis aid and cross-subsidisation

The subsidies at issue can broadly be put into two categories that I will refer to as *de minimis aid* and *cross-subsidisation*. Let me explain the two categories by giving you an example that is not uncommon in Sweden: subsidies to conference centres.

Conference centres may bring with them positive effects on the local business life. They may also offer job opportunities. It may therefore be in a municipality's interest to see to that conference facilities are offered within the municipality. This could be done in two ways:

1. The first is by *offering incentives* to a private company to run a conference centre. Incentives could be, for instance, to let property below market price. If the difference between market rent and rent charged is less than 100.000 euro over three years, i.e. *de minimis aid*, the subsidy would probably fall outside the scope of Article 87 EC.

2. The second possibility is that the municipality chooses to *run the facilities* itself. It may then directly, or indirectly, subsidise these activities. This latter type of subsidy generally does not include a *transfer of state resources*. It therefore does not qualify as state aid.

What effects could subsidies have on the market?

Could these types of subsidies that are not covered by state aid legislation have an effect on competition? The number of complaints concerning subsidies lodged with the Swedish Competition Authority indicates that quite a number of companies believe so.

I would argue that the effects of cross-subsidisation or de minimis aid on the local or regional market could potentially be the same as state aid would have on a national or international market. The extent of the detrimental effect, however, vary according to the amount of aid granted - especially in relation to the costs for supplying the good or service - the competitors position and how many competitors there are.

No controlling mechanism

The next question is, if these subsidies cannot be challenged under EC competition law, can they be challenged under national competition law? In Sweden, the answer is most often no.

As mentioned above, we receive quite a few complaints concerning subsidies that do not qualify as state aid. Among the most common complaints concerning public actors are those of cross-subsidisation and predatory pricing due to subsidies. In most cases, the Competition Authority can do very little to

remedy the situation. For the Competition Act to apply the municipality must be an undertaking. Granting subsidies is generally an exercise of public authority. Should the municipality or recipient of de minimis aid be an undertaking, we need to prove an abuse of dominant position. The dominance criterion is rarely satisfied. Should it be satisfied, the price charged may be low, but not below cost and therefore not qualifying as predatory.

However, we inform the public authorities and the Government about these problems in our reports and publications in order to raise their knowledge and awareness.

The aim for policy of non-state aid subsidies?

As stated above, subsidies granted by municipalities may detrimentally affect the market. At least in Sweden, there is no legal recourse to challenge the inequalities in competitive conditions. In absence of a legal framework, what policy should guide municipalities when granting de minimis aid and cross-subsidizing?

It seems clear that aid could have a detrimental impact on the competitive conditions on local and regional markets. Municipalities should therefore be cautious when granting subsidies. A minimum requirement should be that an analysis of the effect on competition on local and regional markets should be done. When a subsidy is deemed necessary, steps should be taken to ensure that the aid is granted in a way that minimizes the negative impact of it. This could include inviting possible recipients to tender for the subsidy.

Conclusions

I have tried to show that state aid nearly by definition distorts competition in some way and often does not achieve its objective. The effects on competition should in my view always be taken into account before any type of public subsidy is granted, even if it may well fall under the thresholds for EU notification.

As state aid means intervention in the market mechanisms it is important to limit the detrimental effects on competition. Strict application of state aid rules, transparency and considerations of alternative use of the money spent on state aid are some ways to achieve this. Here I fully agree with the direction for the state aid policy in the European Union outlined by Ms Nellie Kroes, the EU Commissioner for competition: Less and better aid! I sincerely hope this message will penetrate decision makers at all levels. In the end, all subsidies are paid by all of us, the tax payers!

Thank you for your attention.