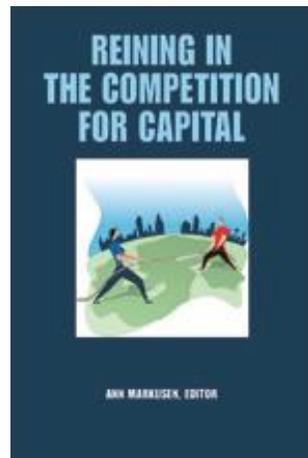

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European Commission



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When asked whether subsidies are good or bad, economists generally give so many different answers that the conclusion can only be: it depends. It depends on the objective, the type of subsidy, the beneficiary, the economic context, etc. Precisely because it depends on many factors, the European Union (EU) has set up a control mechanism for subsidies, or state aid, as the EU calls it, with a view to distinguish the “good” from the “bad” subsidies and make sure that only good subsidies are granted. This raises two questions: how to determine what a good subsidy is, and how to organize a functioning control mechanism.

The following contribution aims to explain in a nutshell how the EU system works, what its main features are, and what alternative approaches could be developed. (For a general overview of the EC State aid rules, see, for example, Bilal and Nicolaidis [1999]; Biondi, Eeckhout, and Flynn [2004]; D’Sa [1998]; Hancher, Ottervanger, and Slot [1999]; Heidenhain et al. [2003]; Nicolaidis, Kekelekis, and Buyskes [2005]; Quigley and Collins [2003]; Sinnaeve [2001].)

SYNOPSIS OF EU STATE AID CONTROL

Why State Aid Control?

State aid control in the EU has existed for almost half a century now. Its inclusion in the EC treaty was quite remarkable and novel as there were no other examples of comparable state aid disciplines at the time.

Among the reasons for introducing state aid control one could first refer to general economic arguments against subsidies: the risk of a subsidy race, where EC member states might outbid each other and transfer problems from one country to another. This would not only be a waste of public money, but in the long term, if companies rely too much on state intervention, it could weaken the competitive position of European industry.

The inclusion of state aid rules in the EC treaty is also closely linked to the establishment of a common market, where goods and services can circulate freely. After the gradual abolition of tariff and nontariff barriers to trade, the granting of state aid is one of the few remaining tools for national governments to protect their national industry. Barriers to trade that have been dismantled in the integration process should not be replaced by other barriers in the form of state aid. Therefore, strict control is necessary also from a common market perspective. At the same time, as markets become more integrated the distortive effects of state aid are more visible and more directly felt by competitors in other member states, thus requiring state aid disciplines.

Finally, it is important to underline that the state aid provisions were inserted in the competition chapter of the EC treaty. The logic of the treaty is to ensure undistorted competition regardless of whether distortions are caused by the behavior of businesses, for which the antitrust rules were adopted, or by the action of the state. State aid control should thus be seen in the light of its role to avoid unjustified distortions of competition. (For a comparison of EU and the United States in the application of competition policy against state intervention in the market, see Ichikawa [2004, p. 555].)

The Definition of State Aid

The treaty uses a rather wide definition of state aid. (For an overview of recent developments regarding the definition of state aid pursuant to Article 87 [1] EC Treaty, see Winter [2004, p. 475].) It includes all advantages selectively granted by the state or through state resources that distort competition or threaten to distort it and affect trade between member states, e.g., grants, loans at nonmarket conditions, state guarantees, all types of tax advantages, and the sale of land at nonmarket

conditions. This notion is broadly comparable, although not identical, with that of a subsidy under the WTO rules.

The selectivity criterion (i.e., whether an aid measure is specific or selective) is determined at the level of each member state. This implies that if member states apply different levels of taxes, this is not considered to be state aid. If, however, they lower the tax rate or grant other types of tax advantages only to certain sectors, certain types of enterprises (such as small and medium-sized enterprises [SME] or coordination centers for multinational companies), or enterprises located in a certain area within the territory of a member state, this would constitute state aid and must respect the relevant conditions.¹

The Substantive Rules of State Aid Control

What does the EU control mechanism look like? The treaty starts from the principle that state aid is incompatible with the common market, unless it falls under one of the exceptions of the treaty (Article 87). The Commission has the power to decide whether or not this is the case. The exceptions are formulated in a very general way (they refer, for example, to broad concepts such as the development of regions with an abnormally low living standard or serious underemployment, and the development of certain economic activities). As a result, the treaty gives the Commission wide discretion to develop criteria for the approval of certain types of aid and design a state aid policy. This policy will necessarily evolve in the same way as the common market and the EU objectives.

The basic principles, however, remain the same: the aid should contribute to the achievement of EU objectives in such a way that the distortion of competition is justifiable. Aid by definition distorts competition. The reason why it can nevertheless be authorized lies in the fact that it promotes other EU objectives, such as regional development, R&D, employment, etc., which outweigh the distortion in a proportional way. In other words: if market forces alone are sufficient to attain the EU objective, no aid should be granted, but where the benefits to the EU as a whole exceed those that would result from undistorted competition, authorization is justified.

It is clear that these general principles need to be embodied in more operational criteria. The Commission has therefore translated the prin-

ciples into concrete assessment criteria, which are laid down in frameworks and guidelines.² These quasi-legislative texts define the conditions under which aid projects can be authorized for different types of aid, specifically aid for regional development, promotion of SME, employment, R&D, environmental protection, training of workers, restructuring of enterprises in difficulties, and provision of risk capital—to mention the most important objectives. They aim at ensuring greater legal certainty for member states and companies, predictability, and equal treatment.

For each of these horizontal objectives, a number of precise conditions define under which circumstances aid can be granted. Normally a maximum aid intensity will be determined. This is the maximum amount of aid, expressed as a percentage of the eligible costs. These percentages are further modulated according to the size of the aid beneficiaries (small enterprises can, as a rule, receive higher amounts of aid) and the region where they are located (higher aid is allowed in poorer regions). (On regional aid, see also Battista [2005]; Nicolaidis [2003, p. 543]; and Wishlade [2003].) For example, a company setting up a new plant in a poor Portuguese region can receive a higher aid amount than if it had established its new plant in the Netherlands. If the company is a small enterprise, it can also get an SME bonus. If, however, a member state wants to grant the company a straight tax break without any condition, this will normally not be authorized by the Commission because there is no direct counterpart for the aid (such as new investment or job creation).

State Aid Procedures

In procedural terms, Article 88 of the EC treaty establishes a mechanism of prior control, based on the notification obligation and the standstill clause. (On state aid procedures, see Sinnaeve and Slot [1999, p. 1153].) Member states have to notify in advance all their aid projects to the Commission and may only implement them after the Commission has given its green light.

Simple cases are decided after a preliminary examination within two months starting from the receipt of a complete notification. For more complex cases that raise doubts about their compatibility with the common market, the Commission will open a formal investigation after

the preliminary examination. In this second phase, all interested parties, in particular the aid beneficiary and its competitors, have the opportunity to present their comments on the aid project.

If member states do not respect these procedural obligations, the aid is granted unlawfully and the Commission can at any time start an investigation, e.g., following a complaint by a competitor or *ex officio*. If the Commission finds that the unlawful aid is incompatible with the common market, it will order its reimbursement, with interests. Aid grantors (and aid beneficiaries) thus run a serious risk if they do not follow the rules.

SOME REFLECTIONS BASED ON THE EU EXPERIENCE

Strengths of the EU System

One of the main strengths of the EU regime is obviously the fact that it has the legal and institutional framework for conducting state aid control; it has the following necessary means at its disposal to make the control system work:

- an independent authority (the Commission) to set and enforce the rules under the control of the EC Court of Justice.
- the legal and administrative mechanisms to organize the system of prior notification and authorization.
- flexibility, that is, the option to adapt the rules if changes in the economic environment or in the priorities of the EU require so. For example, if Europe underinvests in R&D, that will be taken into account when the rules on aid for R&D are revised; if on the other hand certain sectors suffer from overcapacity or serious structural problems, a more restrictive aid policy will be adopted (see, for example, European Commission [2002]). When member states recently started to use the provision of venture-capital as a tool to assist enterprises, the Commission adopted a communication in order to clarify in what circumstances such actions

would fall within the scope of the state aid rules and what conditions had to be respected (European Commission 2001).

- the necessary acceptance by all the actors involved (governments, industry, public at large) and the recognition that aid disciplines are needed in a common market like the EU. Of course, state aid control is also subject to criticism, but not more than any other policy. What contributes to this acceptance is the fact that the state aid regime still leaves sufficient room to member states for developing their economic policies including subsidies. There is no general interdiction of state aid; member states can still grant all types of aid (except export aid and local content aid, forbidden under the WTO rules), they only have to respect certain conditions. The more distortive the aid is, the stricter the conditions will be, but the approach is balanced and makes sense from a common market perspective.

Not all of these features of the EU regime are necessarily indispensable, but they certainly facilitate the functioning of the system.

Can the EU system then be called a success? Probably, since it has fulfilled the objectives rather well. The most distortive types of aid are under control. Very strict conditions are applied to

- operating aid, i.e., aid typically granted without any condition or counterpart, which relieves an enterprise of the expenses it would itself normally have to bear in its day-to-day management or its usual activities (*Siemens v. Commission* 1997).
- aid to large enterprises in rich areas of the EU.
- sectoral aid. The Commission's policy favors aid with horizontal objectives (e.g., SME development, R&D, and worker training) and takes a strict approach on sectoral aid, limited to particular sectors of the economy, such as steel.
- aid to enterprises in difficulty. While it used to be normal for the state to intervene in order to save jobs, such intervention now is only allowed under very strict conditions. The company must first provide a viable restructuring plan, and it must make a significant contribution and reduce its capacity on the market in order to compensate for the distortion. Furthermore, the one-time last-time principle applies according to which restructuring aid

is allowed only once. These conditions are important because restructuring aid is one of the most distortive types of state aid. The fact that both the Commission's decision and/or its nonimplementation can be challenged before the Court offers an additional guarantee in order to ensure that the said conditions are respected and enforced.

In brief, the most distortive types of aid are under control, and in addition, the rules normally also ensure that aid is not the main reason for a company to make certain decisions. For example, the aid allowed can rarely be so substantial that a company would decide to delocate merely because of that aid. Other factors, such as infrastructure, presence of trained workforce, general tax levels, and administrative procedures to be complied with, are more decisive. But if a company considers several alternative locations for a new plant, all of which meet its specific investment requirements, it may choose the site in a disadvantaged area, because it can get a comparatively higher aid amount there. This is fully in line with the EU's "cohesion policy."

Weaknesses of the EU System

Like any system, EU state aid control also has its weaknesses, some of which have been tackled already, others would require further reform action.

A first problem is the high administrative burden that results from the notification obligation. If the Commission had to assess every single measure, however small and unimportant, this would be unfeasible and an inefficient use of resources. Therefore, the obligation of prior notification has been softened. Member states can notify so-called aid schemes, which define the general conditions under which a certain type of aid will be granted. If the scheme complies with the rules, it will be approved for a certain number of years and the individual applications of the scheme do not need to be notified anymore. Furthermore, in recent years a number of block exemption regulations have been adopted for certain less distortive types of aid. (On the block exemptions, see Sinnaeve [2001, p. 1479].) They exempt, for example, aid for SME, and aid for employment or training of workers under well-defined conditions from the notification obligation. Block exemptions liberate the Commission from a number of routine cases, so that the Commission

can concentrate on the more problematic cases. However, they also shift part of the responsibility to the aid grantors, which now have to control themselves whether their aid projects fulfill the conditions of the block exemption. Therefore, in order to avoid a weakening of the control system, increased ex-post monitoring, as well as the vigilance of competitors, who can complain to the Commission or go to national courts if the conditions of a block exemption are infringed is of utmost importance.

Block exemptions are also a good illustration of a second difficulty, that is, finding the right balance between the need for legal certainty, with simple and predictable rules, and the risk that such predefined rules leave no room to take account of the merits of each individual case. In theory the Commission has a wide discretion to decide in every case whether a subsidy is good or bad. However, member states and enterprises call for clear and transparent assessment criteria, which also ensure equal treatment. The Commission has over the years replied to this justified request by establishing rather precise rules for most types of aid. Once established, these rules bind the Commission and thus in practice considerably reduce its discretionary power. This leads to a situation where member states feel obliged to consider only aid measures fitting within the established criteria, even if other creative new projects might be equally defensible or even more efficient to achieve the objectives. Vice versa, the Commission cannot prohibit measures that fulfill the criteria of its block exemptions or guidelines, even if a particular case does not seem very convincing. This permanent tension between individual discretion and legal certainty is, however, inherent to all legislation and unavoidable. Like any legislator, the Commission is challenged to find the right balance in this respect.

A third difficulty worth mentioning is the fact that the EU control mechanism is not designed to ensure that aid measures are economically efficient. This fact should probably not be called a weakness, as it is simply the consequence of how the system was conceived: State aid policy is part of competition policy and its first aim is to limit distortions of competition. The paradox is that the most distortive aid may also be the most efficient in terms of achieving the goal of the aid provider. For example, tax holidays are likely to attract investments, but they distort both competition and the level playing field between enterprises too much to be acceptable in a common market. Conversely, aid

schemes that do not create significant distortions might get a Commission approval, even if they are not so efficient, such as because the aid is too small to have an effect (a small tax advantage for the recruitment of new workers may not create any jobs which would not have been created anyhow). The Commission is reluctant to take a position on the efficiency of a proposed aid measure, also in view of the division of powers between member states and the Commission. Ultimately it is up to member states to decide how they pursue an economic policy adapted to their own situations and spend—or waste—money.

This does not mean, however, that efficiency plays no role in the assessment of state aid. If aid were completely inefficient it would not normally be authorizable, as it could hardly be considered to be in the interest of the EU. To some extent efficiency requirements are thus incorporated in the conditions for authorization. They ensure, for example, that 1) for any aid there must be a significant counterpart from the company, such as job creation; 2) the enterprise must make a substantial own contribution (aid can never finance the whole project); and 3) if aid is granted for investment or job creation, the investment or the jobs must effectively be maintained for a certain number of years. But these criteria are defined at a general level and are not conceived to select the most efficient measure in a particular case. The Commission thus will not analyze whether other measures might be more appropriate and more efficient than state aid. That is left to member states.

In this respect the question may be raised whether more prior and ex post assessment should be done before and after aid is granted. For example, member states should more often make a study concerning what type of economic measures would be most appropriate before having recourse to state aid. Currently this indispensable preliminary question is often ignored. Similarly, during the operation of an aid scheme, a study of its impact could be useful so that adjustments could be made in case the objectives are not reached. But here a time problem exists: aid schemes have a limited duration of normally five years. Before the effects can be seen and a study can be completed, the scheme often already comes to an end. In any event, it could be argued that, as a minimum, some kind of ex post assessment on the effects of aid measures should be required. That way, aid grantors could benefit from the experience when considering new aid measures or the extension of existing ones. At the same time the Commission would be better equipped to

evaluate and adapt its own policy. The Commission has recently made attempts to encourage member states to carry out such assessments, as with the “Scoreboard project,” which is published online.³ The Commission also is reflecting on how to introduce more economic analysis in its assessment of state aid (Hancher 2005, p. 425). However, leaving aside some ad hoc initiatives, it can be argued that so far, not enough emphasis is put on this aspect.

A final problem is the volume of illegal aid. It must be recognized that a significant number of aid measures is still granted without authorization (Nicolaidis 2002, p. 249). This is explained partially by the fact that local and regional aid providers especially lack awareness of the rules or infringed the notification obligation because they believed that their measure did not constitute state aid—given the relative unclarity left by the state aid definition it is often far from obvious what is aid and what is not. It may also be the result of a deliberate decision of the granting authority to take the risk.

Many of these cases are discovered by the Commission, either because competitors complain or because politicians publicly announce what action they took to stimulate the local industry. But certainly a number of aid measures will always remain unknown. Is this a real problem? One should not overestimate it. First, if there is a big distortion and a real competition problem, this cannot be hidden. Competitors will know and will complain to the Commission. Secondly, there is a powerful remedy: if the illegal aid does not fulfill the conditions for ex post authorization, the Commission will order its recovery, with interests. And reimbursement can go back for 10 years. The recovery procedure may be long and cumbersome, because it is the member state who has to recover from the beneficiary and the latter may exhaust all remedies under national law against the reimbursement. But the jurisprudence of the EU is such that ultimately reimbursement will have to take place. And although repayment can, of course, not always fully redress the distortion of competition, especially after several years, the recovery rules are an important deterrent to prevent the granting of clearly incompatible aid. Moreover, compared to the WTO rules, for example, they definitely increase the efficiency of the EU system. The recovery tool is therefore, despite some weak points, a strength of the EU state aid policy.

THE EU SYSTEM AS A MODEL?

Since the EU experience is overall quite positive, the question arises of whether and how it could be a model for other jurisdictions. Again, the answer should probably be: it depends. One has to recognize that EU state aid control is linked to the common market and competition policy. The system as such can therefore probably only be successfully transposed to groups of countries or regions with a comparable level of economic integration and also the political will to entrust an independent authority with the power to determine the common interest of all members, with all the repercussions this may have on economic, social, environmental, and other policy areas.

Such groups of countries exist. For example, the EFTA Surveillance Authority fulfills the same role as the European Commission for Norway, Iceland and Liechtenstein (in the past also for Austria, Finland, and Sweden) (Antoniadis 2002, p. 157). This example proves that EU state aid control is not unique.

Another interesting, somewhat different example of subsidy control is that, of the 14 accession candidates, 10 meanwhile became members of the EU on May 1, 2004.⁴ In view of the importance attached to state aid policy, the EU concluded with these countries, well before accession, bilateral agreements on the basis of which they were required to respect the State aid regime of the EU, as a kind of preparation for accession. The practical implementation of this obligation was not easy, since none of the accession candidates had any experience with State aid control. They all set up separate State aid authorities from scratch and created the necessary legislative framework to comply with this new task. Obviously this process was not completely successful for all countries, but it proved its value, not only as a transitional solution in the run up to EU accession, but also as a model for state aid control at the national level. It has shown that state aid control, not by a supranational authority but at the national level, can work, provided the state aid authority has the necessary legal framework, administrative capacity and functional independence from the grantors of state aid. The state aid authorities should function in a comparable way as competition authorities. In federal states, such a system might be an option in order to avoid interstate or even intercity bidding wars.

Organizing state aid control by an independent state aid authority does not necessarily mean that the system must be a copy of the EU, which is admittedly rather heavy. Both in terms of procedural enforcement and of substance, a “light” version can be imagined. For example, procedurally one could exempt all the less-important cases and set such a threshold that only the big cases are subject to control, in order not to overload the system. One could also replace the general prohibition with exceptions after prior authorization by its opposite: all aid is allowed unless it is forbidden. Or one could replace it by a system where enterprises or other regions have a right to complain if they suffer from subsidies granted elsewhere (a sort of actionable subsidies within a certain jurisdiction). In regard to the substantive rules, one could envisage only some basic, minimum criteria (e.g., define specific objectives for which aid can be granted and the conditions which the recipient must achieve, put a cap on the aid amount, etc.), or detailed rules for the most problematic types of aid.

The alternative to organize state aid control without a separate state aid authority, for example, through legislation by which all aid grantors are bound, is probably more difficult. In such regime, the rules would have to be agreed by national, regional, or local governments, which would weaken the whole mechanism and in practice be very difficult if the rules should go beyond some minimum conditions. Furthermore, in a system without independent authority to apply, with a certain margin of discretion, the predefined rules to a concrete case, there would be no flexibility. The rules would have to be exhaustive, and their regular update in function of economic developments would be cumbersome. Moreover, the question arises as to who would control and enforce the rules? Presumably, in the absence of a central state aid authority, the rules should be enforceable through the courts, but that would again create problems. Therefore, this alternative seems to be less promising.

Ultimately, to what extent the EU system can be a model depends thus on the situation and the objectives one pursues. Creating an independent authority to set and enforce the rules is certainly a big step but an easier starting point for a well-functioning system. However, other less ambitious options should not be disregarded, even if they would just consist of some general minimum requirements, as that would still be better than having no rules at all.

CONCLUSION

To make a proper evaluation of the EU system, one would in fact have to compare the current regime with a situation without any state aid control. Only such a hypothetical comparison would demonstrate the full impact of the system.

While it is obviously not possible within the scope of this chapter to go through this exercise, it may be expected that, in broad terms, it would reveal that:

- The EU system strikes a reasonable balance between limiting distortions of competition caused by aid, and allowing measures that promote EU objectives; since all aid, and especially the most distortive types of aid, are subject to conditions, the distortions are kept to an acceptable level.
- Since the rules are rather precise and transparent, many cases will never be proposed in the first place. Member states are generally well aware of the basic principles; therefore, they will plan their interventions accordingly and not propose any “unworthy” projects. Any discussion with the Commission will then more be on the details of the project than on the broad characteristics. An important part of the impact of the EU system therefore lies in all the potentially distortive measures that were never even considered, or were withdrawn when it became apparent that no approval could be expected.

To conclude, the EU regime perhaps is not perfect, but it works well and there seems to be no reason why many elements of it would not be useful also in a different context.

Notes

The views expressed in this article are the author’s own and should not be attributed to the European Commission.

1. For the definition of an SME, see European Commission (2003). On the application of the definition of state aid to tax measures, see Luja (2003) and Rossi-Maccanico (2004, p. 229).

2. An overview of the currently applicable rules can be found at http://europa.eu.int/comm/competition/state_aid/legislation (accessed August 9, 2006).
3. http://europa.eu.int/comm/competition/state_aid/scoreboard/ (accessed August 9, 2006).
4. On May 1, 2004, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia joined the EU. Bulgaria and Romania are expected to join in 2007. Turkey and Croatia are also candidate countries. See Schütterle (2002, p. 79; 2005, p. 255).

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