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EC State aid rules applied to taxes –

An analysis of the selectivity criterion

derogation

Article 87 (1)

the nature or general scheme of the system

Article 88 (3)

norm

derogation method

Mona Aldestam

IUSTUS FÖRLAG

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SKRIFTER FRÅN
JURIDISKA FAKULTETEN I UPPSALA

95

Redaktör: Nils Jareborg

To grandfather

'The truth is that there is nothing simple and automatic about complex problems' (Surrey, in Hellmuth and Oldman)

EC State aid rules applied to taxes –

An analysis of the selectivity criterion

Mona Aldestam

IUSTUS FÖRLAG

Abstract

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The application of Art 87(1) EC to taxes above all is connected to the application of the derogation method, which appears to be part of the selectivity criterion.

This dissertation examines the application of the derogation method and the assessment of the selectivity criterion applied to taxes, primarily *de lege lata*, but also *de lege ferenda*. It begins with an analysis of the relationship among the criteria of Article 87(1) EC and continues with an analysis of the relationship between the derogation method and the assessment of the selectivity criterion applied to taxes. Several scholars have criticised the application of the derogation method because of the difficulty of identifying a derogation and of establishing the benchmark against which the derogation should be assessed. In this dissertation both the benchmark and the establishment of a derogation is analysed, partly with reference to the tax expenditure debate that occurred in the subject area of international taxation during the 1970s and 1980s. The selectivity criterion applied to taxes contains an assessment of justification, whereby the selective nature of a measure can be justified on the basis of the nature or general scheme of the system: Therefore the meaning and implications of this assessment are also examined.

After all these issues have been examined *de lege lata*, the extents to which the application of the derogation method and the assessment of the selectivity criterion follow a logical system are discussed and recommendations for eliminating the identified deficiencies are put forward.

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Uppsala, 18 October 2004

Mona Aldestam

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PART I

1 Introduction

1.1 The subject

In recent years there has been great progress in European integration. Although the integration process has touched upon the topic of taxation, the area of direct taxation has, to a large extent, been ignored, it might be assumed, therefore, that the Member States have retained the sovereign right to construct at least their direct tax systems as they pleased. The EC Treaty, however, contains several provisions that limit the sovereignty of Member States in the construction of taxation systems. To tax lawyers it is common knowledge that various rules in the EC Treaty prohibiting discrimination must be taken into account. Importantly, but less known, State aid rules must also be taken into account.

To State aid lawyers, it has been common knowledge since the early 1960s that the State aid rules apply also to taxes, an application encompassing its own particular problems – problems that have engendered little discussion in the literature. Therefore it seems particularly relevant to analyse the application of the EC State aid rules to taxes.

The State aid rules are laid down in Articles 87 to 89 of the EC Treaty. Article 87 EC contains three subparagraphs. Article 87(1) EC, which contains the criteria that a measure must meet in order to be classified as State aid, reads: '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'.

Thus aid in any form, which:

1. Has been granted by a Member State or through State resources,
2. distorts or threatens to distort competition,
3. favours certain undertakings or the production of certain goods (the selectivity criterion), and
4. affects trade between Member States

is considered to be incompatible with the common market.

However, Article 87 EC is not an absolute prohibition; its various exemptions are contained in Article 87(2) and (3), Article 88(2) subparagraph 3, Article 86(2), Article 296, and Article 120 EC.

Article 88 EC contains procedural rules, the most important of which is laid down in the first sentence of Article 88(3) and specifies the obligation of the Member States to notify the Commission in advance of any plans to introduce a measure classified as State aid according to Article 87(1) EC or to alter an aid measure that has already been notified. In addition, the obligation of the Member States to await the final decision of the Commission before the measure is put into effect is laid down in the last sentence of Article 88(3) (the stand still clause).

Article 89 EC, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, provides the Council with the power to make any appropriate regulations for the application of Articles 87 and 88. The Council may, in particular, determine the conditions in which Article 88(3) should apply and the categories of aid that should be exempted from this procedure.

As indicated, the obligation to notify the Commission is dependent upon the measure being classified as State aid according to Article 87(1) EC. Thus once the Member State has classified a measure as State aid, it is obliged to notify the Commission. It is then up to the Commission to determine if the measure actually constitutes State aid according to Article 87(1) EC and, if it does, if the measure can be exempted under any of the provisions provided for in Articles 87(2) or (3), Article 88 or in accordance with any other provision in the EC Treaty that provides for exemptions.

If a Member State deliberately or mistakenly neglects to notify the Commission, there is a risk that it will be required by the Commission to recover the aid if the measure is later perceived (due to information received in a complaint or as a result of the control exercised by the Commission *ex officio* to constitute incompatible State aid according to Article 87(1) EC. The obligation to await the final decision of the Commission has direct effect and thus it is possible, for example, for a competitor to approach a national court if it is of the opinion that another undertaking or group of undertakings has been granted aid unlawfully, i.e. without prior notification of the aid having been given to the Commission. It is then possible for the competitor to claim damages from the Member State under certain conditions. Thus in legal terms, the classification of a measure as State aid according to Article 87(1) EC has important implications.

In practice, however, the analysis of the application of Article 87(1) EC sometimes seems, in itself, to be of subordinate importance. Fre-

quently, it appears that measures taken by Member States, the Commission, and others are routinely classified as State aid and that the regulatory focus is placed instead on the possible exemption of the measure. As the possibilities of exemptions are relatively limited and connected to conditions and are, as a rule, accepted for only a limited period; and, as the notification requirement entails the expenditure of considerable resources from the Member States, the focus of this dissertation is the application of Article 87(1) EC to taxes. Procedural rules and possibilities of exemptions provided in the EC Treaty are required in order to illuminate how the notification routine requires resources and to place Article 87 EC in the State aid system.

Although it has been common knowledge since 1961 that the coverage of Article 87 EC includes taxes, only in the last few years has there been a growing interest in the application of Article 87(1) EC to taxes. This recent increase of interest in fiscal aid has likely resulted from the Council's (ECOFIN) adoption on 1 December 1997 of a resolution of a code of conduct for business taxation.[1] The agreement resulted from a wide-ranging discussion on the need for coordinated action at the Community level to tackle harmful tax competition. The application of State aid rules to taxes had been discussed as an important step in coming to grips with the problems of harmful tax competition, which was why the Commission undertook, on the same occasion, to draw up specific guidelines on the application of Articles 92 and 93 of the Treaty (Articles 87 and 88 EC) to measures relating to direct business taxation. Moreover, the Commission committed itself to a strict application of the relevant aid rules. Thus in 1998 the Commission issued a notice on the application of State aid rules to measures relating to direct business taxation (hereafter referred to as the Commission notice on tax measures). In paragraph 4 of its notice, the Commission particularly emphasised that it intended to examine or re-examine the tax arrangements in force in Member States on a case-by-case basis.[2]

Although the Commission's notice on tax measures was followed up in a report in November 2003,[3] the application of Article 87(1) EC to

[1] Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation, OJ C 2, 6.1.1998, p. 1.

[2] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9.

[3] Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C

taxes still appears to be vague and difficult to comprehend. The essential question is: When may a tax measure be classified as State aid? This question obviously presupposes a deeper knowledge of the application of Article 87(1) EC to taxes. It appears that one of the particular features of the application of Article 87(1) EC to taxes is the application of a "derogation method", according to which only derogations from a tax are considered to constitute State aid.

The application of the derogation method in and of itself triggers several questions. What is considered to be a derogation? To be able to talk about a derogation there must be a point of departure or a benchmark. Thus what is considered as the point of departure in the application of the derogation method? What is the relationship between the application of the derogation method and the assessment of the selectivity criterion applied to taxes? In general, the selectivity criterion requires that the measure at issue must favour a certain undertaking or the production of certain goods. It is often claimed that the aim of the selectivity criterion is to distinguish State aid measures from general measures. General measures are measures open to all firms on an equal access basis and are not considered to constitute State aid according to Article 87(1) EC. As the application of the derogation method aims to distinguish derogations from a tax system that is generally applicable to all firms on an equal access basis, and the aim of the selectivity criterion is claimed to distinguish between selective and general measures, it may be suggested that the application of the derogation method simultaneously fulfils the requirements of selectivity.

Furthermore, it follows from paragraph 12 of the Commission notice on tax measures that the selective nature of a measure may be *justified on the basis of the nature or general scheme of the system* and, if so, the measure would not be considered to be aid within the meaning of Article 87(1) EC. The possibility of having a measure justified on this ground first appeared in Case 173/73, Italy *v* Commission.[4] In the case at issue, the Italian Government had introduced a reduction of social charges pertaining to family allowances with regard to the Italian textile industry and small crafts. Previous systems for financing family allowances had placed sectors employing a high proportion of female employees in a disadvantageous position and it was argued that the aim of reducing social charges was simply to correct earlier disadvantages. In its judgment on this case, the Court of Justice (ECJ), among other things, held that: 'It must be concluded that the partial reduction of social charges pertaining

[4] Case 173/73 Italian Government *v* Commission [1974] ECR 709.

to family allowances devolving upon employers in the textile sector is a measure intended partially to exempt undertakings of a particular industrial sector from the financial charges arising from the normal application of the general social security system, without there being any justification for this exemption on the basis of the nature or general scheme of this system.' Several questions arise in this context: What does "justifications on the basis of the nature or general scheme" mean and under what circumstances may an aid measure be justified?

In analysing the derogation method, it is interesting to note that a similar method was and is applied to identify "tax expenditures": expenditures hidden in the tax system – losses of revenue realised through failure to impose taxes. The subject of tax expenditures was heavily debated in the area of international taxation during the 1970s and 1980s. In order to determine if a measure constituted a tax expenditure, deviations from a normative tax structure were identified. Thus it would appear that the method used in the tax expenditure context is similar to the application of the derogation method, which, in turn, suggests that an analysis of the tax expenditure debate may be useful in an analysis of the derogation method.

1.2 The aim and relevant questions

This is a legal dogmatic dissertation with the primary aim of identifying the application of Article 87(1) EC to taxes, with particular regard to the application of the derogation method and the assessment of the selectivity criterion, *de lege lata*, and with the secondary aim of exploring this application *de lege ferenda*.

More specifically, the aim of this dissertation is to examine the application of the derogation method by analysing what is currently considered to constitute a derogation from tax and what is currently considered to be the point of departure in the application of this method. Several other related questions are analysed and discussed: Are there any options to applying the derogation method? What is the relationship between the application of the derogation method and the selectivity criterion? Are they currently considered to be separate assessments or are they considered fulfilled simultaneously? Yet another aim is to examine the current possibilities for justifying the selective nature of the measure on the basis of the nature or general scheme of the tax system and to undertake an analysis of the logic of the current method of applying Article 87(1) EC to taxes, with regard to the application of the derogation method and the assessment of the selectivity criterion. Finally, a discussion of other

possible ways of viewing the application of the derogation method and the selectivity criterion in Article 87(1) EC to taxes that would cure this insufficiency is presented.

Needless to say, the EC State aid rules are of great political interest, and political pressure undoubtedly influences legal decision making.[5] The existence of political influences may make a legal analysis difficult; nonetheless, the aim of this dissertation is to pursue a legal analysis.

1.3 The scope

This dissertation focuses specifically on the application of the derogation method and the assessment of the selectivity criterion in Article 87(1) EC as applied to taxes. Thus neither the remaining criteria of Article 87(1) EC as applied to taxes nor Articles 87(2) and (3) EC are dealt with in this dissertation. Nonetheless, an account will be made for the remaining criteria of Article 87(1) EC in Sections 2.3–2.5. Such an account is necessary, partly for an examination of the relationships among the various criteria, which, in turn, is essential for the analysis in Chapters 4–7, and partly for placing the derogation method and the selectivity criterion in the proper context of Article 87(1) EC. Articles 87(2) and (3) EC are accounted for in Section 3.3 in order to place Article 87(1) EC into a larger State aid perspective. Although most of the tax measures classified as State aid are categorised as operating aid, it is also possible to categorise as investment aid some of the State aid measures that are in the form of taxes. For this reason, an account has been made not only for the most commonly applied exemptions for State aid measures that appear in the form of taxes but for all types of exemptions.

Because the overriding aim of this dissertation is to identify the way in which Article 87(1) EC is applied to taxes with regard to the derogation method and the selectivity criterion, it is taxes on a general and abstract level that are of interest. In this context, social security charges are also treated as taxes. Furthermore, because the classification of a measure as State aid in accordance to Article 87(1) EC triggers several procedural rules, these rules are discussed in Section 3.2. It should be noted, however, that the discussion is brief and contains only the procedural rules that are most relevant to this dissertation.

[5] Cini, pp. 9–17.

1.4 Method and materials

1.4.1 Introduction

The analysis begins with an examination of two Commission documents: the Commission notice on tax measures issued in 1998; and the report on the implementation of this notice, published in November 2003 (the 2003 implementation report).[6] In cases in which the two documents provide insufficient or unsatisfactory information, the analysis shifts to an examination of case law of the ECJ and the Court of First Instance (CFI) and Commission decision practice. The decision to use the Commission notice on tax measures and the 2003 implementing report as the point of departure in the analysis could be questioned: What type of documents are they? Are they legally binding documents? Is it appropriate to use them as a point of departure in the analysis pursued here? In order to answer these questions, it is necessary to place Article 87(1) EC into the context of the State aid system as a whole and to examine the manner in which the State aid rules have developed as well as the role of the Commission in the State aid system.

1.4.2 The State aid control system

1.4.2.1 The long delay in reaching political agreements

The State aid system is based on Articles 87 to 89 of the EC Treaty. Although, the rules have been in the Treaty since 1957 and there has been a dramatic increase in interest and in importance attributed to the State aid rules in general over the past 15 to 20 years, it was not until 1998 that the Council adopted a regulation on the general application of Articles 87 and 88, based on Article 89 EC. Article 89 EC reads: 'The Council, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, may make any appropriate regulations for the application of Articles 87 and 88 and may in particular determine the conditions in which Article 88(3) shall apply and the categories of aid exempted from this procedure'.

[6] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9; Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C

[7] Council Regulation (EC) No 994/98.

Thus in 1998 the Council adopted Council Regulation No 994/98.[7] This action was closely followed in 1999 by the adoption of another regulation (Council Regulation No 659/1999).[8] In April 2004 the Council adopted yet another regulation (Council Regulation No 794/2004).[9]

Prior to 1998, Article 89 EC had been used as a legal basis, but only in regulations with a limited scope of application, such as regulations providing for the conditions to aid shipbuilding and to exempt major categories of aid to inland transport from notification requirements.[10] Thus the adoption of Council Regulation No 994/98 and Council Regulation No 659/1999 were the first regulations of more general application that were adopted with Article 89 EC as legal basis.

The Commission had submitted legislative proposals on two occasions – once in the mid 1960s concerning procedural matters and once in early 1970s when the Commission produced a draft regulation to control regional aid in the central regions.[11] Neither of these regulations succeeded in securing the Council's approval, however, and it appears that, in principle, the Commission had since abandoned its efforts to regulate State aid through the use of formal legislation. In fact, these failed efforts were followed by a period characterised by the Commission's outspoken unwillingness to formalise its powers.[12] Apparently, former Commissioner, Sir Leon Brittan, did not find regulations necessary;[13] others referred to the bad experiences of ineffective legislation in the case of shipbuilding prior to the issuing of the 7th Directive of 1987.[14] Perhaps the Commission, as Evans has suggested, preferred to maintain a clear separation between its power and that of the Council, and to rely on dialogue and consultation with Member States.[15]

Thus for various reasons, legal acts were in principle not pursued under Article 89 EC until 1998. As decision making on a case-by-case basis was not and is not considered to be satisfactory for reasons of transparency

[8] Council Regulation (EC) No 659/1999.

[9] Council Regulation (EC) No 794/2004.

[10] Evans, p. 407.

[11] A first proposal on the basis of Article 94 was submitted to the Council in 1966. It concerned, in particular, the exemption of certain categories of aid from the notification requirements. This proposal was subsequently withdrawn in 1975. The second proposal, based on Article 94, was submitted in 1972 and concerned rules for the supervision by the Commission of regional aid. This proposal was withdrawn in 1976. For further details see Sinnaeve and Slot, p. 1153; Evans, p. 406; Cini, p. 18 and Cananea, p. 62.

[12] Evans, p. 407.

[13] Slot, pp. 742–743.

[14] Rawlinson, p. 60.

[15] Evans, p. 407.

and legal certainty, the need for rules arose. In the absence of formal rules, other methods of regulating the State aid area began to appear in the early 1970s.

The first example of this informal regulation appeared in 1971, when a letter was sent from the Commission to the Member States dealing with aid within the textile and clothing industries. Since then, the Commission has issued letters, communications, guidelines, recommendations, and notices containing information of how the State aid rules should be applied. The group term, "policy frameworks", is used to refer to these instruments. Although the instruments vary in form and content, they share the common feature of having been issued by the Commission alone.

For several years the Member States have had the opportunity to air their views on policy frameworks at multilateral meetings that precede the issuing of the policy framework at issue. Multilateral meetings are held approximately four times a year at the initiative of the Commission. A draft of the relevant policy framework is usually sent to the national authorities a few days or weeks in advance of multilateral meetings in order for the national experts to prepare their questions or comments. However, it is important to emphasise that none of the Member States has the right of veto. So although the Member States can issue strong criticism, the Commission is free to issue the frameworks as it sees fit. It has been suggested, however, that the Commission should attempt to reach consensus for practical reasons, because the Commission is never 'so free of pressures from national governments as to be able to completely ignore strong opposition to its proposal'.[16] At least the smaller Member States may not agree that the Commission generally considers the comments of the Member States before issuing their policy frameworks. It is not far-fetched to assume that many Member States feel neglected and overlooked in this process.

Cananea points out that these policy frameworks are not easily categorised. However, she suggests that it is appropriate to distinguish between frameworks that deal with procedural questions and those that contain criteria under which the Commission will or may accept different aid measures, usually on the basis of Article 87(3) EC.[17]

For the most part, procedural policy frameworks have been integrated into Council Regulation No 659/1999.[18] And, to this extent, the policy frameworks have been replaced by the regulation.

[16] Rawlinson, p. 60.

[17] Cananea, p. 63.

[18] Council Regulation (EC) No 659/1999.

However, the second group of policy frameworks containing criteria under which the Commission will or may accept different aid measures, usually on the basis of Article 87(3) EC, contains, in itself, various categories of policy frameworks. There are policy frameworks dealing with financial transfers and transactions (of which the Commission notice on tax measures is an example), the assessment for approval of State aid with horizontal objectives (such as research and development, environmental protection, and rescue and restructuring of firms encountering difficulties), assessment of services of general economic interest, assessment for approval of regional aid, and frameworks dealing with the assessment for approval of aid to particular sectors (such as ground transport and air transport).

These frameworks may be published in the Official Journal (C Series), may be attached to letters addressed to the Member States, or may remain internal to the Commission's administrative organisation.[19] According to Rawlinson, the aims of the Commission's policy frameworks are to save time for the officials working with State aid control, to increase transparency, to create legal certainty, and to uphold the credibility of enforcement.[20] Moreover, according to the Commission notice on tax measure, the aim of policy frameworks may also be to ensure the consistency and equality of treatment among Member States.[21]

Most policy frameworks appear to lack legally binding force over the Member States but to legally bind the Commission.[22] However, it is not far-fetched to assume that several Member States consider themselves to be politically bound by these policy frameworks because of the extraordinary powers entrusted in the Commission by the EC Treaty.

[19] Cananea, p. 63.

[20] Rawlinson, pp. 56–57.

[21] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9, paragraph 4.

[22] It has been suggested that the principle of legal expectation renders the State aid policy frameworks legally binding on the Commission (Cananea, pp. 71–72). Moreover, Case C –313/90, Comité International de la Rayonne et des Fibres Synthétiques (CIRFS) and Others *v* Commission [1993] ECR I-1125, provides an example illuminating the Commission's inability to depart from its policy frameworks without the confirmation of the Member States. For further reading on the legally binding character of State aid policy frameworks, see for example Aldestam.

1.4.2.2 The role of the Commission in the State aid system

The State aid system is based on a control system in which the Commission has been granted extraordinary powers. One of the essential elements in the Commission's State aid control machinery is the Member States' obligation to notify it of any plans to alter existing aid or to introduce new aid measures. Thus whenever a Member State considers that an aid measure fulfils the criteria in Article 87(1) EC, it is obliged to notify the Commission according to the first sentence of Article 88(3) EC. It is then up to the Commission to decide if the measure at issue constitutes State aid according to Article 87(1) EC and, if so, if the measure is compatible with the common market, with reference to the conditions for exemptions provided for in Article 87(2) or (3) or in accordance with any other provision in the Treaty.

If after having investigated the aid measure, the Commission is still hesitant to decide if the aid measure can be considered compatible with the common market, it should initiate the procedure provided for in Article 88(2) EC. Under this procedure, all concerned parties are invited to submit their comments, thereby gaining additional decision making time for the Commission. If, after having completed this deeper investigation, the Commission concludes that the aid measure is incompatible with the common market or that the aid is being misused, it should decide that the State concerned must abolish or alter the aid measure within a period to be determined by the Commission. The Member States are obliged, under the third sentence of Article 88(3), to await the final decision of the Commission.

It may seem reasonable to assume that the procedure referred to in Article 88(2) EC is applicable only to existing aid, because Article 88(1) EC refers only to existing aid. The definition of existing aid according to Council Regulation No. 659/1999 is:

> For the purpose of this Regulation: ...
> (b) "existing aid" shall mean:
> (i) without prejudice to Articles 144 and 172 of the Act of Accession of Austria, Finland and Sweden, all aid which existed prior to the entry into force of the Treaty in the respective Member States, that is to say, aid schemes and individual aid which were put into effect before, and are still applicable after, the entry into force of the Treaty;
> (ii) authorised aid, that is to say, aid schemes and individual aid which have been authorised by the Commission or by the Council;
> (iii) aid which is deemed to have been authorised pursuant to Article 4(6) of this Regulation or prior to this Regulation but in accordance with this procedure;
> (iv) aid which is deemed to be existing aid pursuant to Article 15;

(v) aid which is deemed to be an existing aid because it can be established that at the time it was put into effect it did not constitute an aid, and subsequently became an aid due to the evolution of the common market and without having been altered by the Member State. Where certain measures become aid following the liberalisation of an activity by Community law, such measures shall not be considered as existing aid after the date fixed for liberalisation;[23]

In Case 173/73, Italy *v* Commission, which was referred to in Section 1.1 of this thesis, the ECJ held, however, that the Commission was empowered to apply the procedure provided for in Article 93(2) of the Treaty (Article 88(2) EC) to non-notified aid as well.[24] Consequently, the Commission's power referred to in Article 88(2) EC not only covers existing aid but also unlawful aid – that is, aid that has been put into effect in contravention of Article 88(3) EC.[25] "New aid" refers to aid schemes or individual aid, which is not existing aid, including alterations to existing aid.[26]

If a Member State decides to grant or alter aid or to enforce the aid measure in contravention to the standstill clause, the Commission may adopt a decision to suspend or, under certain circumstances, to recover provisionally any unlawful aid until the Commission has made a decision about the compatibility or non-compatibility of the aid with the common market.[27] If a Member State fails to comply with a suspension injunction or a recovery injunction, the Commission, while conducting the examination on the substance of the matter on the basis of the information available, is entitled to refer the matter directly to the Court of Justice and to apply for a declaration that the failure to comply constitutes an infringement of the Treaty.[28] In the event of a negative decision in a case of unlawful aid, the Commission should decide that the Member State concerned must take all necessary measures to recover the aid from the beneficiary under the condition that a recovery would not be contrary to general principles of Community law.[29] Moreover, Article 88(1) EC grants the Commission strong powers. According to Article 88(1) EC: 'The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States. It

[23] Article 1 of Council Regulation (EC) No 659/1999.
[24] Case 173/73 Italian Government *v* Commission [1974] ECR 709.
[25] Article 1(f) of Council Regulation (EC) No 659/1999.
[26] Article 1(c) of Council Regulation (EC) No 659/1999.
[27] Article 11 of Council Regulation (EC) No 659/1999.
[28] Article 12 of Council Regulation (EC) No 659/1999.
[29] Article 14 of Council Regulation (EC) No 659/1999.

shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the common market.'

In order for the Commission to keep all existing aid under constant review, it decided several years ago to use the powers provided to it in Article 88(1) EC to request all Member States to furnish certain basic data in the form of an annual report on all current aid schemes. The obligation to provide the Commission with an annual report currently follows from Article 17 of Council Regulation 659/1999.[30]

The purpose of the procedure provided under Article 88(1) EC is to give the Commission the means to control existing aid as well. Article 88(1) EC is designed to enable the Commission to secure the abolition or adaptation of old or pre-accession aid that is incompatible with the common market and to review aid schemes or certain provisions that were authorised in the past but are no longer considered compatible with the common market.

The Commission also uses the procedure provided for in Article 88(1) EC to secure changes to existing aid schemes in all Member States at the same time. As is the case when reviewing individual schemes, the Commission recommends the proposed changes to the Member States as "appropriate measures". If Member States consent, the new rules are considered binding.[31] But, if a Member State declines, the Commission may use procedures contained in Article 88(2) EC to make the rules binding on the Member State.[32] In this context, it is of interest to question when a Member State may be considered to have consented and what the consequences are of it declining to accept a policy framework.[33]

1.4.2.3 Value of policy frameworks

It follows from the previous section that the cornerstones of the control system on which the State aid system rests with regard to new aid is the Member States' obligation to notify the Commission under the first sentence of Article 88(3) EC, and with regard to existing aid, the powers conferred on the Commission under Article 88(1) EC to keep all systems of existing aid under constant review. These cornerstones, together with the Member States' obligation to await the final decision of the Commission, create a system in which the decisions of the Commission are of

[30] Council Regulation (EC) No 659/1999.

[31] Competition law in the European Communities, Volume IIA, Situation at 30 June 1998, p. 40.

[32] Competition law in the European Communities, Volume IIA, Situation at 30 June 1998, p. 41.

[33] For further reading with regard to these questions see Aldestam.

essential importance in an analysis of the State aid rules. All types of Commission decisions on State aid may be appealed, within the limits of procedural law of the EC Treaty and the Statute of the Court of Justice. The appeal can be made either to the CFI or to the ECJ, depending on the reason for the appeal and the party appealing.

Without any ambitions to provide an exhaustive picture of the CFI's and ECJ's jurisdiction regarding Commission decisions in matters of State aid, the CFI under Article 225 EC has jurisdiction to hear and to determine, in the first instance, actions and proceedings referred to in Articles 230, 232, 235, 236 and 238 EC. Within the area of State aid, it is proceedings under Articles 230 and 232 EC that may be of relevance. Accordingly, the CFI has the jurisdiction to review the legality of an act adopted by the Commission and the review can be on grounds of lack of competence, infringement of an essential procedural requirement, infringement of the EC Treaty or of any rule of law relating to its application, or misuse of law. Requests to review the legality of an act may be brought forward by Member States or by a natural or legal person. In the latter case, the act or subject focus of the requested review may include Commission decisions addressed to another person but that are of direct and individual concern to the person requesting the review.

Moreover, the CFI has jurisdiction to review complaints brought forward by any natural and legal person alleging that the Commission has failed to act. In this case, the action is admissible only if the Commission has first been called upon to act. An example of the latter would be a competitor complaining about a Commission decision not to classify a measure as State aid. Rulings by the CFI according to Article 225 (1) subparagraph 2 may be appealed to the ECJ under the conditions and within the limits laid down in the Statute of the Court of Justice.[34]

It follows from the wording of Article 225 EC *é contrario*, that the ECJ has retained jurisdiction with regard to actions taken in accordance with Articles 226 and 227, articles that also are relevant to matters of State aid. Thus the ECJ has retained jurisdiction over proceedings initiated by the Commission against a Member State, or by a Member State against another Member State, for introducing unlawful State aid or for maintaining State aid measures that is incompatible with the common market and which the Commission has said must be abolished. Similarly, the ECJ has jurisdiction with regard to actions initiated by the Commission in accordance with Article 88(2) subparagraph 2. A case in point would be a Member State's noncompliance with a decision taken by the Commission under Article 88(1) EC.

[34] Statute of the Court of Justice, available at http://curia.eu.int/en/instit/txtdocfr/txtsenvigueur/statut.pdf

1.4.2.4 Summary

Because of the control system upon which the State aid system rests, the Commission's decisions are an important source of law within the area of State aid. These decisions are based on Commission case practice and on the case law of the ECJ and CFI, as well as on policy frameworks. The Commission's policy frameworks are the result of the long absence of more formal regulatory instruments. Although policy frameworks are not formally legally binding, they are rules of crucial importance to everyone concerned with EC's State aid rules. Against this background, it is appropriate to use the Commission notice on tax measures and the 2003 implementation report as a point of departure in the analysis pursued in this dissertation.

1.4.3 Further remarks on method and material

The title of the Commission's notice on tax measures implies that it covers only the application of State aid rules to measures relating to direct business taxation. Thus it presents the appearance of not covering the application of State aid rules to measures relating to indirect taxation. However, in its 2003 implementing report the Commission commented on the direct versus indirect taxation issue and held that: 'Although the Commission notice in principle covers only direct taxation, it has provided a basis for analysing certain cases in the filed of indirect taxation.'[35] The Commission mentioned that it had referred to the notice in a number of decisions relating to indirect taxation measures, 'particularly as regards the principle of a measure being justified by the nature and general scheme of the system.'[36] Accordingly, it appears that the Commission notice on tax measures can be used as a basis for the analysis of the application of Article 87(1) EC to taxes on a general and abstract level, at least with regard to the analysis of the possibilities of justifying the selective nature of a measure on the basis of the nature or general scheme of the system.

The main problem seems to concern VAT and the concept of State aid, as VAT reductions are subject to strict Community rules and conform to the principle of equality of taxation for similar products. Thus in

[35] Paragraph 71 of the report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C

[36] Ibid.

paragraph 72 of the 2003 implementing report, it is stated that: 'Such reductions are therefore not usually caught by Article 87(1) EC.'[37] However, this fact does not render it inappropriate to use the Commission's notice on tax measures as a basis for analysing the application of Article 87(1) EC to taxes on a general and abstract level. Nor is it inappropriate to extend the analysis to include the derogation method, at least on the question of what constitutes the point of departure in the application of the derogation method. However, due to the particular conditions mentioned regarding VAT, it is possible to assert that the discussion held in Section 4.2.2 is not altogether valid for VAT.

Because policy frameworks are, as a rule, based on the most recent case law and on Commission case practice, it has been assumed that the Commission's notice on tax measures is based on judgments of the ECJ and the CFI, as well as Commission decisions prior to 1998 – the date of the Commission notice on tax measures. Accordingly, the 2003 implementing report is based on judgments of the CFI and the ECJ and Commission decisions prior to November 2003, when the report was published. In order to analyse the Commission's notice on tax measures and the 2003 implementing report, some of the relevant judgments and decisions on which these documents were based are analysed. However, in situations in which this method has not proved to be sufficient to clarify the issue being discussed, other judgments of the ECJ and the CFI and Commission decisions (published between 1 January 1998 and 1 July 2004) are analysed.

It is important to note that there is little case law of the ECJ and the CFI that relates to the possibility of justifying a measure on the basis of the nature or general scheme of the system. Moreover, it is not easy to analyse Commission decisions dealing with the possibility of justifications on the basis of the nature or general scheme of the system, because prior to and following the adoption of Council Regulation No 659/1999, the Commission need only publish its decision that a measure is not classified as aid or that it can be approved (a decision not to raise objections) in a short summary notice.[38]

If, after a preliminary examination of an aid measure, the Commission has doubt as to the measure's compatibility with the common market, it should initiate proceedings according to Article 88(2) EC. Between

[37] Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C

[38] Competition Law in the European Communities, Vol. IIB, Situation in December 1996, p. 37; Article 26(1) of Council Regulation No 659/1999.

1 July 1989 and the adoption of Council Regulation No 659/1999 the Commission's decision to initiate the Article 88(2) procedure had to be published in the Official Journal the letter to the Member State, in which the Member State was informed of the decision to initiate the Article 88(2) procedure. The final decision closing a procedure according to Article 88(2) EC (former Article 93(2)) had to be published as a notice if the decision was positive; however, if the decision was negative or if it was positive but had certain conditions imposed upon it, the full text had to be published.[39] Since the adoption of Council Regulation No 659/1999, the Commission's decision to initiate Article 88(2) procedure is published in full text form but only in the language of the country concerned, and is accompanied by a meaningful summary written in all the official languages. All decisions to close the procedure provided for in Article 88(2) EC should be published in the Official Journal.[40]

Given the political interest in State aid matters and these procedural rules the possibility of analysing Commission decisions with regard to assessments pursued in the application of Article 87(1) EC no doubt are reduced, unless the Commission has not initiated the procedure provided for in Article 88(2) EC. In these situations the decision to close the procedure is published in full text, but only in the language of the country concerned. Moreover, the effect of these publication rules, in respect of the assessment of the possibility of having measures justified on the basis of the nature and general scheme of the system, is that only those decisions involving case decisions in which the aid measures have *not* been considered justified are published in full text. Thus it is difficult to identify the Commission's reasoning in cases in which the aid measure has been considered justified. As the Commission has made several decisions in which it has concluded that the measure in question cannot be justified on the basis of the nature or general scheme of the system, only some decisions are accounted for in Chapter 5.

1.4.4 The analysis in a norm-perspective

As mentioned in Section 1.1, a method similar to the derogation method appears to have been, and still is, applied to identify tax expenditures. The tax expenditure era began in Germany in 1959 when Germany started to account for what was later to be referred to as tax expendi-

[39] Competition Law in the European Communities, Vol. IIB, Situation in December 1996, pp. 37–38.

[40] Article 26(2) of Council Regulation No 659/1999.

tures.[41] However, the concept of "tax expenditure" first appeared in a speech by Stanley S. Surrey,[42] entitled 'The United States Income Tax System ... The Need for Full Accounting'. In his speech, he said that: '... Through deliberate departures from accepted concepts of net income and through various special exemptions, deductions and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures – in effect to produce an expenditure system described in tax language'.[43] He further claimed that when Congressional talks and public opinion turned to reduction and control of Federal expenditures, these tax expenditures were never mentioned. Because these expenditures were not listed in a visible way, he added, they were not scrutinised by the Congress or by the Budget Bureau.[44]

For this reason, Surrey called for a full accounting for the effects of expenditures hidden in the tax system. He advocated an approach that would explore the possibility of describing the expenditure equivalents of tax benefit provisions in the Federal Budget. Conscious of the fact that such a task would inevitably lead to difficulties of interpretation or measurement, he said that the task was a question of determining '... which tax rules are integral to a tax system in order to provide a balanced tax structure and a proper measurement of net income, and which tax rules represent departures from that net income concept and balanced structure to provide relief, assistance, incentive or what you will for a particular group or activity?'.[45]

Once these tax items had been identified, the next step was to compute their expenditure and, finally, to classify these costs by budget definitions. The goal of developing a description and analysis of tax expenditures was reached in the 1968 Annual Report of the Secretary of the United States Treasury.[46] It was also in this Annual Report that the concept of "tax expenditure" was used formally for the first time. Thus a list of tax expenditures was presented in the 1968 Annual Report, and the list was identified as containing deviations from widely accepted definitions of income and standards of business accounting and departures from the generally accepted structure of an income tax.[47]

[41] Ds 1992:6, p. 14.

[42] Stanley S. Surrey who was Assistant Secretary for Tax Policy, US Treasury Department from 1961 to 1969, was Professor of Law at Harvard Law School.

[43] Hellmuth and Oldman, pp. 576–577.

[44] Ibid, p. 578.

[45] Ibid.

[46] Surrey, p. 4; McDaniel and Surrey, p. 3.

[47] Surrey and Hellmuth, pp. 528–29.

According to Surrey and Hellmuth, the aim of the tax expenditure approach was to present the revenue costs of the special tax provisions in the Federal budget in such a way that these special tax provisions would be comparable to the expenditure and loan programmes to which they were alternatives. According to these authors, such a presentation would encourage a broad approach to the analysis and evaluation of the expenditure, loan, and special tax provision under each function, all of which aim to achieve the same purpose. The government and the public would then be in a position to decide if it would be desirable to uphold particular government assistance and, if so, the form of assistance that should be provided.[48]

This US project was not without its critics. Bittker, who was particularly critical,[49] pointed to difficulties in determining which items should rightfully be included in the tax expenditure lists, and addressed other problems related to estimation. Furthermore, tax expenditures are usually defined in relation to a normal tax structure or a benchmark and, as stated in a report from the House of Representatives Standing Committee on Expenditure, because benchmarking is an abstraction, there will always be room for legitimate disagreement about its nature and whether or not certain tax provisions are properly characterised as tax expenditures.[50] These difficulties led the Australian Treasury to state that the aim of identifying tax expenditures should be to include the cost of special tax provisions in the budget-making process and documentation. Such provisions can, in most cases, be considered as alternatives to direct expenditure programs rather than an attempt to define some ideal taxation system and to demonstrate deviation from it.[51]

In the 1970s, the interest in tax expenditure started to spread beyond the United States and the international aspects of this issue seemed to have reached a peak in the 1980s. As a result, a number of countries started to account for tax expenditures in their yearly budgets. Several major reports and publications appeared: In 1984, the OECD Committee on Fiscal Affairs presented a report in which issues of the measurement and use of tax expenditure accounts were examined; in 1985, McDaniel and Surrey published the book *International Aspects of Tax Expenditures: A Comparative Study*; in 1987, the Nordic Council of Ministers reported the results of a working group established to develop guidelines for identi-

[48] Surrey and Hellmuth, p. 530.

[49] Bittker, (1969) I, p. 244; Bittker, (1967), pp. 925–985.

[50] Taxation Expenditures, 1982, p. 5, citing the Canadian Department of Finance.

[51] Ibid.

fying tax expenditures; and in 1996, the OECD published an update of its report from 1984.

It follows that the main challenge in establishing tax expenditures is to determine deviations from some norm and to identify the norm itself. Because the method of establishing and classifying tax expenditures appears to be similar to the method used in the classification of tax measures as State aid, and because part of the purpose of this dissertation is to determine the point of departure in the application of the derogation method and to analyse what constitutes a derogation from this norm or benchmark, it seems fruitful to analyse the tax expenditure debate as part of the analysis of the derogation method. Thus the tax expenditure debate is discussed in Section 4.3 and in Chapter 6. In Section 4.3, the aim is to determine if the tax expenditure debate improves the understanding of the conditions under which a measure constitutes a derogation from tax. In Chapter 6, the aim is to determine if the tax expenditure debate can contribute to understanding what constitutes the benchmark in the application of the derogation method. Therefore, the tax expenditure debate is examined in both chapters, but from different angles.

The main part of the tax expenditure discussion deals with problems relating to income tax and, especially, to income tax for individuals. The tax expenditure discussion may, therefore, appear to be of limited interest in an analysis of the application of the selectivity criterion in Article 87(1) EC as it is applied to taxes. In this context, it must first be noted that the tax expenditure discussion also covers the matter of income tax for corporations: issues relating to the depreciation of assets, for example. Second, it should be emphasised that, for the purpose of this dissertation, it is the general discussion concerning the identification or construction of a norm and deviations from the norm that is of primary interest.

1.5 Relevant research

The application of Article 87(1) EC to taxes is a broad subject and few authors appear to have considered it in depth. In 1997, Wishlade focused on this subject in a paper concerning the question of when tax advantages are State aid and when they are general measures.[52] Schön has elaborated on the subject of Article 87 EC applied to taxes,[53] Bacon has

[52] Wishlade, *When are tax advantages state aids and when are they general measures?* European Policies Research Centre, University of Strathclyde, Glasgow, 1997.

[53] Schön, (1999), "Taxation and State Aid Law in the European Union", Common Market Law Review, 36: pp. 911–936.

addressed the subject of State aid and general measures,[54] and Kube has dealt with problems relating to the application of Article 87(1) EC to taxes.[55] Moreover, Nicolaides has criticised the current application of Article 87(1) EC to taxes.[56] Both Luja and Pinto address the application of Article 87(1) EC to taxes in their dissertations; Luja's dissertation focus on the assessment and recovery of tax incentives in the EC and the WTO[57] and Pinto's dissertation addresses tax competition and EU law.[58]

This dissertation is a contribution to the general discussion surrounding the application of Article 87(1) EC to taxes, in particular with regard to the application of the derogation method and the assessment of the selectivity criterion to taxes. One novel feature of this dissertation is its discussion in Chapter 4, of the relationship between the derogation method and the selectivity criterion, which, in turn, presupposes a discussion of the relationships among the general criteria of Article 87(1) EC presented in Section 2.6. Another innovative feature, in Section 4.3 and in Chapter 6, is the use of literature and arguments concerning the method applied to establish and classify tax expenditures, in an attempt to improve the understanding of the application of the derogation method. Another contribution is the analysis of the possibility of justifying the selective nature of an aid measure on the basis of the nature or general system, a topic pursued in Chapter 5.

1.6 Structure

This dissertation has seven chapters divided in two parts. The first part, comprising Chapters 1–3 presents a more general description of the State aid rules, and the second part, comprising Chapters 4–7, a more specific treatment of Article 87(1) EC applied to taxes. Chapter 2 provides an overview of Article 87(1) EC. As the main aim of this dissertation is to analyse the selectivity criterion applied to taxes, Chapter 2 also

[54] Bacon, (1998), "State Aids and General Measures", YEL 1997, Vol. 17, (ed. Barav and Wyatt) Clarendon Press, Oxford, pp. 269–321.

[55] Kube, National Tax Law and the Transnational Control of State Aids *On the need for a Further Reconciliation of Economic and Social Policy Concerns in Transnational Law*, EUI Working Paper Law No. 2001/9, Badia Fiesolana, San Domenico, 2001.

[56] Nicolaides, (2001), "Fiscal Aid in the EC *A Critical Review of Current Practice*", World Competition 24(3), pp. 319–342.

[57] Luja, *Assessment and Recovery of Tax Incentives in the EC and the WTO: A View on State Aids, Trade subsidies and Direct Taxation*, Intersentia, 2003.

[58] Pinto, *Tax Competition and EU Law*, Kluwer Law International, 2003.

deals with the relationship between the various criteria of Article 87(1) EC. Chapter 3 places Article 87(1) EC into a somewhat larger perspective and provides an account for relevant procedural rules and the possibilities of having measures exempted according to various provisions in the EC Treaty. In this context it should be mentioned that the treatment of in particular Articles 120 EC and Article 296 EC could have been placed in Section 2.2 dealing with the scope of Article 87(1) EC, but because these Articles are used also to exempt aid measures that although they might fall outside the scope of Article 87(1) EC has been notified to the Commission, these Articles are treated in Section 3.3.2.3 dealing with exemptions provided for elsewhere in the Treaty.

Chapter 4, which is the first chapter in the second, more specialised part of the dissertation, contains a description of the derogation method and how it was established. This chapter also contains an analysis of what is currently considered a derogation and examines the contribution of the tax expenditure debate on an improved understanding of circumstances under which a measure is considered to be a derogation. Furthermore, Chapter 4 includes an analysis of some of the criticisms that have been articulated against the application of the derogation method and a discussion of possible alternatives to this method. The last issue covered in Chapter 4 is the relationship between the derogation method and the selectivity criterion.

The focus in Chapter 5 is an examination of the justifications on the basis of which the derogating measure can be justified with reference to the nature or general scheme of the system, with the aim of establishing the current practice and of examining the possibility of justifying measures on this ground.

Chapter 6 illuminates the fact that the Commission seems to have been influenced by the tax expenditure debate in its assessments of justifying State aid measures on the basis of the nature or general scheme of the system, at least to some extent. It examines the current view of what is considered to be the point of departure in the application of the derogation method: if it is a norm corresponding to what was considered a norm in the tax expenditure debate or something else. The question of when a measure is considered to constitute a "true" derogation for the purpose of the application of Article 87(1) EC applied to taxes is also dealt with. In this context the logic of the system in which Article 87(1) EC is applied to taxes is discussed. Is there an alternative way to view the application of the derogation method and the assessment of the selectivity criterion that would cure this insufficiency? Chapter 7 contains the concluding comments of this dissertation.

1.7 The reader

This dissertation is written from a State aid perspective, in that the departure of the analysis is taken from the State aid rules. Thus readers knowledgeble in State aid law may find Chapters 2 and 3 superfluous or too detailed. It should be noted, however, that the discussion regarding the relationship between the criteria of Article 87(1) EC in Section 2.6 is essential for the analysis in Chapters 4–7. In order to make the dissertation accessible to less informed readers, the content of court cases and Commission decisions in general are described in greater detail than is the typical case in State aid literature.

Some readers may however also be of the opinion that chapters 2 and 3 are to shallow. In this context it should be remembered that the main aim of the dissertation is to examine the selectivity criterion applied to taxes.

2 Article 87(1) EC – a general overview

2.1 Introduction

As mentioned in the introduction, Article 87(1) EC reads '[s]ave 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.'

The first subordinated clause of Article 87(1) EC provides for a saving clause. According to Evans, this saving clause incorporates the *lex specialis* principle:[1] If there are other Treaty rules regarding State aid, they overrule Article 87 EC. Consequently, in order to establish the scope of Article 87(1) EC, it is necessary to examine other parts of the EC Treaty. For example, the Treaty provides for particular aid rules in the area of agriculture and transport. Moreover, the Treaty provides for several exemptions; accordingly, Article 87(1) EC does not provide an absolute prohibition. The scope of Article 87(1) EC is dealt with in this chapter, whereas the exemptions are further examined in Chapter 3. In addition to the saving clause in the first subordinated clause, Article 87(1) EC provides for several criteria which, if fulfilled, mean that the measure at issue constitutes State aid and that there is a requirement to notify the Commission in advance. Accordingly, any aid measure of any form whatsoever constitutes incompatible State aid, if the aid measure:

- Has been granted by a Member State or through State resources, distorts or threatens to distort competition,
- by favouring certain undertakings or the production of certain goods and,
- affects trade between Member States.

[1] Evans, p. 1.

In addition to these four criteria, the Commission and the ECJ and the CFI frequently emphasise the requirement of an advantage – the measure must provide the recipient with an advantage. Because these criteria are cumulative they must all be fulfilled in order for the measure to be classified as State aid according to Article 87(1) EC.

In my view, these criteria could be divided into three categories: One category of criteria would thus be concerned with the requirements placed on the donor; another category would contain the required character and effect of the measure; and yet another category would focus on the requirements placed on the recipient or recipients. In this chapter, a general assessment of the criteria of Article 87(1) EC is provided for.

Before examining these categories, it should be mentioned that the application of Article 87(1) EC is governed by several principles. Moreover, the scope of Article 87(1) EC is addressed before the various categories of criteria of Article 87(1) EC are examined.

2.1.1 The effect principle

The effect principle is one of the most important principles governing the application of Article 87(1) EC. This principle originates from Case 173/73, Italy *v* Commission, mentioned in Section 1.1. In this case, the Italian Government claimed that the reduction at issue should be considered as a measure of a social nature which, accordingly, did not fall under Article 92 of the Treaty (Article 87 EC). Against this background, the Court stated that: '... Article 92 does not distinguish between the measures of State intervention concerned by reference to their causes or aims but defines them in relation to their effects'.[2]

2.1.2 The market investor's principle

Another principle of importance is the market investor's principle. This principle was illuminated by the ECJ in paragraph 60 in the judgment of Case C-39/94 SFEI and Others *v* La Poste and Others, in which the Court held that: '... In order to determine whether a State measure constitutes aid, it is necessary to establish whether the recipient undertaking receives an economic advantage which it would not have obtained under normal market conditions.' Consequently, if the question is whether or not a certain transaction could be classified as State aid, an examination

[2] Case 173/73 Italian Government *v* Commission [1974] ECR 709, paragraph 13.

would have to take place to determine if the transaction would have been pursued in a similar manner had the provider been a commercial actor. In the latter case, the measure would probably not be considered to be State aid according to Article 87(1) EC. If, on the other hand, it is not considered plausible that a commercial actor would have pursued a similar transaction, the measure most probably would be considered as constituting State aid.[3]

2.2 The scope of Article 87(1) EC

2.2.1 Introduction

As mentioned in Section 2.1, the first subordinated clause of Article 87(1) EC provides for a saving clause and Articles 70 to 80 of the EC Treaty provide for particular rules for transport and Articles 32 to 38 provide particular rules for agriculture. Does this mean that aid to the transport and agricultural sector fall outside the scope of Article 87(1) EC?

2.2.2 Transport

In Article 70 EC, it is stated '[T]he objectives of this Treaty shall, in matters governed by this title, be pursued by Member States within the framework of a common transport policy'. Moreover, it follows from Article 71 EC that for the purposes of implementing Article 70 EC and accounting for the distinctive features of transport, the Council shall act in accordance with certain prescribed procedures and lay down:

a) common rules applicable to international transport to or from the territory of a Member State or passing across the territory of one or more Member States;
b) the conditions under which non-resident carriers may operate transport services within a Member State;
c) measures to improve transport safety;
d) any other appropriate provisions.

[3] Case C-39/94 Syndicat Français de l'Express International (SFEI) and Others *v* La Poste and Others [1996] ECR I-3547, paragraph 60. For further reading, see Quigley and Collins, pp. 29–37.

Article 73 EC provides that: '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'. Furthermore, Article 76 EC states that: 'The imposition by a Member State, in respect of transport operations carried out within the Community, of rates and conditions involving any element of support or protection in the interest of one or more particular undertakings or industries shall be prohibited, unless authorised by the Commission'. The second paragraph of Article 76 EC provides for procedural as well as substantive rules with regard to the application of these rates or conditions. The third paragraph of this Article states that the prohibition in the first paragraph shall not apply to tariffs fixed to meet competition. Finally, it follows from Article 80 EC that the provisions for transport apply to transport by rail, road, and inland waterway. The question is, of course, what all this mean in relation to the application of Articles 87 to 89 EC.

First, it implies that aid to all types of transport other than rail, road, and inland waterways, fall within the scope of Articles 87 to 89 EC. But, what is the relationship between Articles 87 to 89 EC and aid to transport by rail, road, and inland waterways? According to Evans, the Council had concluded by 1965 that Article 92 (Article 87 EC) applied to transport by rail, road, and inland waterways.[4] This interpretation was later codified in Article 2 of Council Regulation (EEC) No 1107/70 and confirmed by the ECJ in Case 156/77, Commission *v* Belgium.[5]

2.2.3 Agriculture and fisheries

2.2.3.1 Agriculture

Determining the scope of Article 87(1) EC with regard to agricultural products is dependent upon several factors. The first sentence of Article 32(1) EC states that the common market shall extend to agriculture and trade in agricultural products, and the second sentence defines agricultural products as products of the soil, of stock-farming, and of fishing and products of first-stage processing directly related to these products.

[4] Evans, pp. 264–265; Council Decision 65/271/EEC of 13 May 1965 on the harmonization of certain provisions affecting competition in transport by rail, road, and inland waterways, OJ 88, 24.5.65, pp. 1500–1503.

[5] Case 156/77 Commission *v* Kingdom of Belgium [1978] ECR 1881, paragraphs 11–13.

It follows from the second paragraph of Article 32 EC that the rules laid down for the establishment of the common market should apply to agricultural products, save as otherwise provided in Articles 33 to 38 EC. Paragraph 3 of Article 32 refers to Annex I (formerly Annex II) to the Treaty that lists the products that are subject to the provisions of Articles 33 to 38. With regard to the application of the State aid rules to agriculture, it is stated in Article 36 EC that the chapter relating to the rules on competition should apply to the production of and trade in agricultural products only to the extent determined by the Council within the framework of Article 37(2) and (3) and in accordance with the procedure laid down therein.

Consequently, it seems that Articles 87 to 89 EC are applicable to agricultural products that are not listed in Annex I. However, for products that are listed in Annex I, State aid rules apply only to the extent determined by the Council. In 1961, the Council enacted Regulation No 26/62 in order to determine the applicability of the competition rules to the agricultural sector.[6] According to Article 4 of Regulation 26/62, only Article 93(1) (Article 88(1) EC), and the first sentence of Article 93(3) (Article 88(3) EC) are to be applied to the agricultural sector. As a result, the Commission's authority has been circumscribed with regard to State aid control in the agricultural sector. Accordingly, the Commission has authority only to require information about aid measures in order to review existing aid.

The authority of the Commission does not extend to initiating the procedure provided for in Article 88(2) EC in order to force the Member State to abolish or alter aid which the Commission considers to be incompatible with the common market. This lack of authority to apply Article 88(2) EC also has consequences for the procedure regarding new aid measures. Furthermore, the obligation for a state to provide notification about plans to grant new aid or to alter existing aid also applies to aid to the agricultural sector. The third sentence of Article 88(3) EC states that the Member States must await the final decision of the Commission; but this obligation does not apply to aid measures directed at the agricultural sector. Furthermore, and of the greatest importance for purposes of this dissertation, Article 87(1) EC is not applicable.

In effect, however, the rules in Regulation 26/62 are of limited application because the Council has adopted regulations establishing common market organisations for specific agricultural products (that is to say,

[6] Council Regulation (EEC) No 26.

a certain set of rules for a certain type of agricultural product). Apparently, this action has been taken for approximately 90 % of all products listed in Annex I.[7] Aid to products falling within the scope of a common market organisation must usually be assessed in accordance with the relevant regulation because these aid rules constitute *lex specialis* in relation to Articles 87 to 89 EC.[8] It appears that some of these regulations specifically mention that Articles 87 to 89 EC should be applied, whereas other regulations explicitly provide for particular aid measures or schemes.[9] Whenever an agricultural product is covered by a common market organisation regulation, Regulation 26/62 is not applicable. Consequently, Regulation 26/62 is applicable only to those agricultural products listed in Annex I that are not covered by a common market organisation regulation.

2.2.3.2 Fisheries

According to Article 32 EC, fishery products are included in the agricultural products classification and the same principles apply. In 1992, the Council established a common market organisation for fisheries through the adoption of Council Regulation (EEC) No 3759/92,[10] which includes a specification of the products covered. The Regulation provides for specific aid measures for these products. This Regulation was replaced in 2000 by Council Regulation (EC) No 104/2000.[11]

2.2.3.3 Summary

In summary, it seems that the scope of Article 87(1) EC covers aid measures for agricultural products that are beyond the products listed in Annex I. The scope also appears to include aid to products which are governed by a common market organisation regulation specifying the application of Articles 87 to 89 EC, but the scope does not include aid to fisheries.

[7] Hancher, Ottervanger and Slot, p. 178.
[8] Ibid, p. 179.
[9] Ibid, pp. 56–57 and p. 179.
[10] Council Regulation (EEC) No 3759/92. Regulation as last amended by Council Regulation (EC) No 3318/94.
[11] Council Regulation (EC) No 104/2000.

2.3 The donor

According to Article 87(1) EC, there are two options for the granting of aid: An aid measure must be granted by a Member State or through State resources.

2.3.1 The concept of "Member State"

The notion of "Member State" in Article 87(1) EC has been interpreted widely. The ECJ held in Case 78/76, Steinike and Weinlig, that it was not necessary to distinguish between aid that was granted directly by the State or indirectly by public or private bodies established or appointed by the State to administer the aid. The Court argued that in applying Article 92 (Article 87 EC), the primary concern must be the effect of the aid on the recipients and not the status of the institution entrusted with the distribution and administration of the aid.[12] The Court, in Case 323/82, Intermills, considered that State aid granted by a public authority constituted State aid. In the case at issue, the public authorities, as a result of economic difficulties, acquired a holding in Intermills SA, and it was this action that was considered to constitute a State aid measure that was incompatible with the common market.[13] Moreover, the ECJ, in Case 248/84, Germany *v* Commission, held that aid granted by regional and local bodies of the Member States, whatever their status and description, are embraced by this notion.[14]

The concept of "Member State" has since been broadened even further to embrace undertakings acting under the influence of the State. Such influence may result from the fact that, for example, the State owns a majority of the shares of the undertaking or organisation entrusted with the administration and distribution of the aid; that more than half the members of any of the boards of the organisation are appointed by the State; or that the responsible auditor is appointed by the State. In accordance with this reasoning, Gasunie was considered to constitute the "Member State" within the meaning of Article 87(1) EC by the ECJ in joined Cases 67, 68 and 70/85, Gebroeders van der Kooy *v* Commission.[15]

[12] Case 78/76 Firma Steinike und Weinlig *v* Federal Republic of Germany [1977] ECR 595, paragraph 21.

[13] Case 323/82 SA Intermills *v* Commission [1984] ECR 3809, paragraph 32.

[14] Case 248/84 Federal Republic of Germany *v* Commission [1987] ECR 4013, paragraph 17.

[15] Case 67, 68 and 70/85 Kwekerij Gebroeders van der Kooy BV and Others *v* Commission [1988] ECR 219.

In this case, the Dutch company, Gasunie, transported, imported, and exported natural gas in the Netherlands and distributed natural gas to Dutch horticultural operations at prices that were lower than those applied to other industries. At that time natural gas accounted for 95 % of the energy consumption of Dutch horticultural producers. Gasunie, a company governed by private law, was owned by 40 % by Staatsmijnen (which, in turn, was wholly owned by the Government of the Netherlands), 10 % by the Government of the Netherlands, and 50 % by two private oil companies. Gasunie was administrated by a board consisting of eight members, one of which was appointed by the Minister for Economic Affairs, three by the Staatsmijnen, and two by each of the private oil companies. The board of directors, acting on a three-quarter majority, set the gas prices. Since 1963, however, by agreement with Gasunie, prices and delivery conditions for the supply of gas were subject to the approval of the Minister for Economic Affairs.

The ECJ considered that Gasunie constituted the State for the purposes of Article 92 (Article 87 EC), although the Dutch Government held only 50 % of the shares, rather than 51 % or more, and it appointed only half the members of the supervisory board. The deciding factor for the Court seems to have been the fact that the Dutch Government had the ability to veto the tariff adopted by Gasunie. The various circumstances, taken as a whole, resulted in the Court concluding that: '... Gasunie in no way enjoys full autonomy in the fixing of gas tariffs; rather it acts under the control and on the instructions of the public authorities. It is clear, therefore, that Gasunie could not fix the tariff without taking into account of the requirements of the public authorities.'[16]

In Case C-303/88, Italy *v* Commission, a State holding company, Ente Nazionale Idrocarburi (ENI), which had been established by legislation to operate as an independent economic entity dependent on private capital markets for funding, had taken over Lanerossi in 1962. Four of Lanerossi's subsidiaries in the men's outer wear sector had suffered losses for several years. The Commission, in 1988 held in a decision that capital injections from ENI-Lanerossi into its men's outer wear subsidiaries between 1983 and 1987 constituted State aid according to Article 92 of the Treaty (Article 87 EC). It was further considered to be unlawful, as the Commission had not been notified properly according to Article 93(3) of the Treaty (Article 88(3) EC)).

As one of its arguments, the Italian Government stressed that the Commission had not established that the amount of ILT used to make

[16] Case 67, 68 and 70/85 Kwekerij Gebroeders van der Kooy BV and Others *v* Commission [1988] ECR 219, paragraph 37.

up for the operating losses suffered by the subsidiaries between 1983 and 1987 came from State funds and, consequently, that those injections of capital fell within the concept of State aid. However, the ECJ referred to joined Cases 67, 68 and 70/85, Van der Kooy *v* Commission, and held that no distinction should be drawn between cases in which aid is granted directly by the State and cases in which it is granted by public or private bodies established or appointed by the State to administer the aid. For several reasons ENI was considered to operate under the control of the Italian State. ENI was a public corporation controlled by the Italian State, the members of the board of directors and management board of the corporation were appointed by a decree of the Prime Minister, and ENI did not enjoy full freedom of action because it had to account for directives issued by the Interministerial Committee for Economic Planning. Moreover, the ECJ held that ENI had the power, backed by the authorisation of the Minister of State Holdings, to issue bonds guaranteed as to capital and interest by the State. Thus the Commission was entitled to regard the funds provided by ENI through Lanerossi to the four subsidiaries as State interventions which could constitute aid.[17]

Thus it is evident that the determination of whether or not an undertaking is to be considered as acting under the direct or indirect influence of the State must proceed on a case-by-case basis.

2.3.2 State resources

In order for a measure to be considered as State aid according to Article 87(1) of the EC Treaty, the aid must have been granted by a Member State or through State resources. The meaning of this criterion has been subject to various interpretations, and, depending on the interpretation, it has been considered to mean that a measure is:

1) granted by the State but financed by private means;
2) granted by the State and financed by public means; or
3) granted by non-public bodies but financed by public means.

Although the Court appears to have taken contradictory positions in different judgments with regard to this issue, it seems that it has finally come to a conclusion. For example, in Case 290/83, Commission *v* French Republic,[18] in Case 57/86, Hellenic Republic *v* Commission,[19] and in

[17] Case C-303/88 Italian Republic *v* Commission [1991] ECR I-1433.
[18] Case 290/83 Commission *v* French Republic [1985] ECR 439, paragraph 14.
[19] Case 57/86 Hellenic Republic *v* Commission [1988] ECR 2855, paragraph 12.

Case C-387/92, Banco de Crédito Industrial,[20] the Court held that a measure may constitute aid in the meaning of Article 87 EC although it did not involve a transfer of State resources. This view can, however, no longer be considered valid, as the Court, in a series of recent judgments, has concluded that State aid must entail some form of financial burden on public funds.[21] The Court's approach in this context has been criticised by several authors.[22]

One of the consequences of the Court's conclusions is that measures characterised by fixing minimum retail prices, even in cases in which the objective is to favour distributors of a certain product at the exclusive expense of consumers, cannot constitute State aid according to Article 87(1) EC.[23] In Case C-379/98, Preussen Elektra, for example, German electricity supply undertakings were obliged to purchase the electricity produced in their area of supply from renewable energy sources (the eligible renewable sources were articulated explicitly in the German legislation) and to pay for it in accordance with regulated rules. As the obligation imposed on the private electricity supply undertakings to purchase electricity from renewable energy sources at a fixed minimum price did not involve any direct or indirect transfer of State resources to them, the measure was not considered to constitute State aid.[24]

[20] Case C-387/92 Banco de Crédito Industrial SA, now Banco Exterior de España SA *v* Ayuntamiento de Valencia [1994] ECR I-877, paragraph 14.

[21] In Case 82/77 Openbaar Ministerie of the Kingdom of the Netherlands *v* Jacobus Philippus van Tiggele [1978] ECR 25, paragraph 24, followed by joined Cases C-72 and 73/91 Sloman Neptun Schiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887, paragraph 19 and Case C-189/91 Petra Kirshammer-Hack *v* Nurhan Sidal [1993] ECR I-6185, paragraph 16, the Court concluded that the measure in question did not constitute aid according to Article 87 because none of the measures at issue was financed by public means. This view has been confirmed in a line of cases: for example, joined Cases C-52/97, C-53/97 and C-54/97 Epifanio Viscido and Others *v* Ente Poste Italiane [1998] ECR I-2629, paragraph 13, Case C-200/97 Ecotrade Srl *v* Altiforni e Ferriere di Servola SpA (AFS) [1998] ECR I-7907, paragraph 35, Case C-295/97 Industrie Aeronautische e Meccaniche Rinaldo Piaggio SpA *v* International Factors Italia SpA (Ifitalia) and Others [1999] ECR I-3735, paragraph 35 and Case-C-379/98 Preussen Elektra AG *v* Schleswag [2001] ECR I-2099, paragraphs 58–60.

[22] See Slotboom, p. 289. For further reading see, for example, Bacon, pp. 279–290.

[23] Case 82/77 Openbaar Ministerie of the Kingdom of the Netherlands *v* Jacobus Philippus van Tiggele [1978] ECR 25, paragraph 24 and Case C-379/98 Preussen Elektra AG *v* Schleswag [2001] ECR I-2099, paragraphs 58–60. Quigley, however, seems to be of a different opinion (see Quigley, 1993, pp. 26–29).

[24] Case C-379/98 Preussen Elektra AG *v* Schleswag [2001] ECR I-2099, paragraphs 58–60.

Furthermore, in situations in which a private body such as a trade association raises funds from their members and uses these funds to finance aid to their members without any intervention by or direction from the State, the measure is not considered to constitute State aid.[25]

Moreover, the ECJ and the CFI have consistently held that the criterion that the aid must be granted by the State or through State resources is fulfilled when the recipient is relieved from charges normally borne by the undertaking in its daily activities. Thus the criterion that the measure must be granted by the State or through State resources also covers the situation in which public income is, in fact, reduced or potentially reduced.[26] Accordingly, a loss of tax revenue is synonymous with public spending in the form of tax expenditures.[27]

What would have been the judgment had the recipient contributed to the aid it had been granted? Would this circumstance change the view that the aid constituted State aid? In Case 78/76, Steinike and Weinlig, the Court held that: 'A measure adopted by the public authority and favouring certain undertakings or products does not lose the character of gratuitous advantage by the fact that it is wholly or partially financed by contributions imposed by the public authority and levied on the undertakings concerned'.[28] Thus the fact that the recipient has contributed to the grant itself does not change the fact that the measure could be considered to constitute State aid.

Aid measures financed by Community resources are usually not covered by Article 87 of the EC Treaty. However, when the granting of aid financed by Community resources has been entrusted to national public or private bodies and the bodies are left with some discretion over the granting of aid, it appears that Article 87 may be applicable after all.

2.3.3 Summary

The concept of Member State is a broad one, and embraces not only the Member State but all authorities at the central, regional, and local level as well as undertakings considered to be acting under the direct or indirect influence of the State. The requirement that the aid be granted

[25] Quigley and Collins, p. 9.

[26] Hancher, Ottervanger and Slot, p. 24.

[27] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9, paragraph 10.

[28] Case 78/76 Firma Steinike und Weinlig *v* Federal Republic of Germany [1977] ECR 595, paragraph 22.

through State resources means that the aid can be granted by the State or by a private body, but that it must be financed by public means. Moreover, the aid must involve a transfer of State resources. Finally, the criterion that the measure must be granted by the State or through State resources also covers the situation in which public income is reduced, in fact or even potentially. Accordingly, a loss of tax revenue is synonymous with public spending in the form of tax expenditures.

2.4 The aid measure

2.4.1 Introduction

According to the suggested categorisation, one category of criteria in Article 87(1) EC refers to the aid measure itself. In this case, the category would consist of the requirements for form and effect that the aid measure would have to meet.

2.4.2 Aid in any form whatsoever

One of the first questions that comes to mind in examining Article 87(1) EC relates to the concept of aid. What is the definition of aid? The fact is that there is no definition provided in either the EC Treaty or the ECSC Treaty. According to Schina, definitions may have been intentionally omitted to reduce the risk of circumvention and increase the ECJ's and CFI's flexibility to interpret the conditions under which a measure constitutes aid.[29] Furthermore, without a settled definition the word "aid" embraces all aid, including new forms of aid that were unimaginable at the moment of the signing of the Treaty of Rome.

Thus the concept of aid is a dynamic one. In Case 30/59, Steenkolenmijnen *v* High Authority, which occurred soon after the treaties had been signed, the ECJ emphasised the breadth of the aid concept. In this case, the Court had to interpret Article 4c) of the ECSC Treaty in relation to a miner's bonus that had been introduced in Germany.[30] According to this system, all miners working underground were granted a tax-free shift bonus, paid by the undertakings through deductions from taxes paid on wages. The Court concluded that the miners' bonus constituted

[29] Schina, p. 13.

[30] Case 30/59 De Gezamenlijke Steenkolenmijnen in Limburg *v* High Authority of the ECSC [1961] ECR 1.

a subsidy or aid that was incompatible with the common market. The Court further stated that:

> A subsidy is normally defined as a payment in cash or in kind made in support of an undertaking other than the payment by the purchaser or consumer for the goods or services which it produces. An aid is a very similar concept, which, however, places emphasis on its purpose and seems especially devised for a particular objective which cannot normally be achieved without outside help. The concept of aid is nevertheless wider than that of a subsidy because it embraces not only positive benefits, such as subsidies themselves, but also interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without, therefore, being subsidies in the strict meaning of the word, are similar in character and have the same effect.[31]

Consequently, the concept of aid also embraces indirect forms of aid such as a tax that is not fully collected, not collected in due time, or not collected at all.

The statement by the Court that an aid measure will be judged by emphasising its purpose may seem contradictory to the statement mentioned in Section 2.1.1 concerning the application of the effect principle. One possibility is, however, that a distinction is drawn between a subsidy and an aid measure; the aid measure is characterised by the fact that the measure aims to achieve a certain goal or objective, whereas a subsidy does not. In establishing whether or not an aid measure is incompatible with the common market, the message seems to be that the effect on the recipients is the important variable rather than the aim of the body granting the aid.

It follows from the wording of Article 87(1) that the aid may be of any form whatsoever. It was mentioned previously in this section that the concept of aid also includes indirect forms of aid. Consequently, direct subsidies, tax exemptions, and exemptions from duties or parafiscal charges, preferential interest rates, guarantees of loans on especially favourable conditions, the provision of land or buildings at no cost or on especially favourable terms, provision of goods or services under preferential conditions, indemnities against operating losses, or any other State aid measures with equivalent effects have been considered to be covered by the concept of aid.[32]

[31] Case 30/59 De Gezamenlijke Steenkolenmijnen in Limburg *v* High Authority of the ECSC [1961] ECR 1, p. 19.

[32] Reply to a written question, OJ (Special ed.) 1963, 2235, cited in Wyatt and Dashwood, p. 682.

This list has been further elaborated upon in order to include reimbursement of costs in the event of success, State guarantees (directly or indirectly), preferential rediscount rates, dividend guarantees, preferential public ordering, deferred collection of fiscal or social contribution, direct and indirect State participation in share capital and logistical or commercial assistance provided for unusually low consideration.[33] These forms of aid are merely examples of some of the forms of measures that may be considered to constitute aid according to Article 87(1). New forms of aid arise continually.

The advantage of a broad, all-embracing definition has already been mentioned. One of the drawbacks, however, is the extraordinary difficulties Member States have in foreseeing what measures will be considered to constitute State aid according to Article 87(1) EC.

2.4.3 Distortion of competition and intra-Community trade

2.4.3.1 Introduction

Another criterion of Article 87(1) EC is used to assess whether or not an aid measure distorts or threatens to distort competition. The fact that existing distortions of competition and the threat of distortion of competition is covered in the article, is a necessary consequence of the obligation of Member States to provide advance notification of aid measures. At the time of providing notification, the aid measure's effects on competition can only be guessed. Moreover, it is actual competition as well as potential competition that Article 87(1) EC aims to protect. Thus aid that is expected to prevent or hinder the entry of new competitors into the market is covered by Article 87(1) EC.[34]

2.4.3.2 State aid – automatic distortion of competition?

At one point it was considered that the object or effect of State aid always was to distort competition and, consequently, an assessment of the effects on competition was not considered to be necessary. According to Advocate General (AG) Capotorti, who first articulated this view in Case 730/79, Philip Morris, State aid was considered to distort competition unless exceptional circumstances existed. Among the examples of excep-

[33] Document 20.502/IV/68 from December 1968, referred to in D'Sa p. 56; Seventh Survey on State Aid in the European Union in the manufacturing sector and certain other sectors, 1999, referred to in Wyatt and Dashwood, p. 682.

[34] Schina, p. 24.

tional circumstances was the absence of a common market of products identical to or substitutable for those manufactured by the recipient of the aid.[35] The Commission appears to have shared this view, at least at the beginning of the 1980s. According to the 11th report on competition policy, the Commission stated that:

> Moreover, the effect of the use of aids within the Member State should not be overlooked. While the recipient of aid receives a positive advantage, there are *automatic disadvantages* for those who do not receive aid. Not only do they have to compete, but the very fact of the granting of subsidies may have wider economic effects in terms of higher tax, budget deficits and higher rates of interest which further heighten the disadvantage of the non-recipient of aid. It is possible to envisage a situation where efforts to ameliorate the social consequences of the adaptation of crisis sectors can and do lead to the result that potential growth in newer industries, which provide the real future, is retarded if not made impossible.[36] (Emphasis added)

However, the ECJ did not agree with AG Capotorti.

In the case in question, the Netherlands Government had informed the Commission of its intention to grant aid to the Netherlands subsidiary of Philip Morris. The aid consisted of promotion and guidance of investments of HFL 30.000.000. The amount of aid granted depended on the number of jobs created, and was limited to 4 % of the investment. The aim of the aid was to help the Netherlands' subsidiary of Philip Morris to reorganise and expand its Netherlands-based production of cigarettes by closing one of its two factories and by raising the annual production capacity of the second to 16.000 cigarettes. The net effect was an increase in the capacity of the subsidiary by 40 % and an increase in total production in the Netherlands by about 13 %. The Commission decided that the Netherlands should refrain from implementing its proposal. This Commission Decision was appealed to the ECJ and resulted in Case 730/79, Philip Morris.[37]

The applicant's appeal to the EJC contained two grounds for declaring that the decision in question should be voided. The first ground was that the decision was in breach of: 1) Article 92(1) of the Treaty (Article 87(1) EC),

2) one or more general principles of Community law, in particular the principles of good administration, the protection of legitimate expectation and of proportionality, or at least one or more principles of the

[35] AG Capotorti in Case 730/79 Philip Morris Holland B.V. *v* Commission [1980] ECR 2671, at 2698.

[36] 11th report on competition policy, 1981, point 176.

[37] Case 730/79 Philip Morris Holland B.V. *v* Commission [1980] ECR 2671.

Commission's competition policy, and 3) Article 190 of the Treaty (Article 253 EC) in that the Commission's statement of reasons on which the decision was based was incomprehensible or contradictory. The second ground was that the Commission's decision that the derogation provisions of Article 92 (3) of the Treaty (Article 87(3) EC) was not considered applicable in the circumstances of this case, was in breach of Article 92(3) of the Treaty (Article 87(3) EC) and of the above-mentioned principles.

In this ruling the ECJ laid down several important principles. In this context however it is the view of AG Capotorti, mentioned previously, that the object or effect of State aid is always to distort competition and, consequently, an assessment of the effects on the competition was, therefore, considered unnecessary, that is of interest. Although the ECJ did not agree with AG Capotorti, it nevertheless seemed satisfied with a market analysis far less extensive than would normally be required with regard to Article 81 and 82 EC (former 85 and 86 of the Treaty) on concerted practices and abuse of dominant position.

According to Schina, the Court's message that a market analysis is indeed necessary for assessing the effects of an aid measure on competition and intra-Community trade apparently failed to induce the Commission to adopt clearer and more detailed reasoning when formulating decisions under Article 93(2) of the Treaty (Article 88(2) EC).

2.4.3.3 A trend towards better reasoned decisions?

The Commission's habit of not reasoning its decisions carefully has, according to Schina,[38] changed as a result of the Court's judgment in joined Cases 296 and 318/82, Leeuwarder Papierwarenfabriek. In this case the Court held that the Commission had failed to present any reasons for deciding that the State aid in question affected or could affect competition and intra-Community trade. More particularly, the Court said that the Commission had not specified the situation of the relevant market, the place of Leeuwarder in that market, and the pattern of trade between Member States in the product in question or in the undertaking's exports.[39] According to Schina, in all decisions on State aid published in the Official Journal after the Court's judgment in joined Cases 296 and 318/82, Leeuwarder Papierwarenfabriek, the Commission takes much greater care to provide economic data and arguments to support its

[38] Schina, p. 25.

[39] Case 296 and 318/82 Kingdom of the Netherlands and Leeuwarder Papierwarenfabriek BV *v* Commission [1985] ECR 809, paragraph 24.

contention that the aid in question affects competition and intra-Community trade.[40] Another trend seems to be that the competition criterion and the intra-Community trade criterion are treated as one. Therefore, it seems appropriate at this point to consider the intra-Community trade criterion.

2.4.4 The intra-Community trade criterion

2.4.4.1 Introduction

Yet another criterion of Article 87(1) EC that has to be met in order for an aid measure to be considered as incompatible State aid is that the aid measure must affect trade between Member States. This criterion has been satisfied relatively easily in the past as the ECJ concluded in abovementioned Case 730/79, Philip Morris: If an aid measure granted by a Member State strengthens the position of one or more undertakings, in comparison with other undertakings competing in intra-Community trade, the competing undertakings must be regarded as being affected by the aid measure.[41] According to this view, it seems to have been sufficient that the recipient undertaking was active on a market in which there was competition among producers from various Member States.[42] The interpretation of the criterion of intra-Community trade has been further developed by the ECJ and the CFI.

2.4.4.2 The intra-Community trade criterion treated together with the competition criterion

As mentioned, it seems to be a trend that the intra-Community trade criterion is treated together with the criterion of distorted competition. The ECJ's judgment in Case C-305/89, Alfa Romeo, is one example. Alfa Romeo, the second-largest Italian car manufacturer at the time, and one that formed part of the public holding company Istituto per la Ricostruzione Industriale (IRI), had steadily accumulated losses over the 14 years following the first oil crisis of 1973/74. The 10-year strategic plan adopted in 1980 had proved inefficient and had been revised in 1983 and again in 1984. The financial results of Alfa Romeo neverthe-

[40] Schina, pp. 25–26.

[41] Case 730/79 Philip Morris Holland B.V. *v* Commission [1980] ECR 2671, paragraph 11.

[42] Case 730/79 Philip Morris Holland B.V. *v* Commission [1980] ECR 2671, paragraphs 11–12.

less deteriorated during 1984 and 1985 and a new three-year investment plan was adopted.

In 1985, Alfa Romeo received a capital contribution from the IRI and from Finmeccanica, which was controlled by the IRI, for the purpose of covering losses incurred in 1984. The funds came from budgetary allocations made to the bodies administering State share holdings – including IRI. In 1986, an additional capital provision had been granted to Alfa Romeo by Finmeccanica and generated by bonds issued by IRI. In 1986, an agreement of sale was settled between Finmeccanica and Fiat, according to which all the assets of Alfa Romeo were to be transferred to Fiat for a total amount of ITL 1024.6 thousand million. Through a new subsidiary, Alfa Lancia, Fiat assumed the financial liabilities of the former Alfa Romeo up to an amount of ITL 700 thousand million. The remaining assets and liabilities that were not assumed by Fiat were transferred to Finmeccanica.

In a decision from 1989, the Commission considered that aid in the form of capital contributions amounting to ITL 615.1 thousand million had been granted unlawfully by the Italian Government through the public holding companies IRI and Finmeccanica to Alfa Romeo, as it had been provided in contravention to Article 93(3) of the Treaty (Article 88(3) EC). The Italian Government brought the matter to the ECJ for the annulment of the decision, arguing that the provision of capital did not adversely affect competition within the Community. It claimed that the market share of Alfa Romeo was marginal and that the intervention did not lead to any reduction of market share for competing undertakings.[43]

In paragraph 26 of its ruling, the Court held that:

> In that connection it should be observed that where an undertaking operates in a sector in which there is surplus production capacity and producers from various Member States compete, any aid which it may receive from the public authorities is liable to affect trade between the Member States and impair competition, inasmuch as its continuing presence on the market prevents competitors from increasing their market share and reduces their chances of increasing exports. It is sufficient to note that, on the Italian market alone, Alfa Romeo's share was 14.6 % in 1986.

In paragraph 27, therefore, the Court concluded that the contested injection of capital was liable to affect competition within the Community.

Another example in which the competition criterion and the intra-Community trade criterion are treated together is the Court's judgment

[43] Case C-305/89 Italian Republic *v* Commission [1991] ECR I-1603, paragraph 25.

in Case C-142/87, Tubemeuse, a Belgian undertaking manufacturing seamless steel tubes for the oil industry. The undertaking had encountered difficulties in the 1970s and, as a result of a critical situation in 1979, a number of private shareholders sold the Belgian State their shares, which amounted to 72 % of the capital. The new shareholders of Tubemeuse decided to restructure the undertaking and to modernise its production plant. Accordingly, in 1982 the Commission authorised a grant of a series of aid measures by the Belgian State for the purpose of implementing an investment programme which was to ensure the undertaking's future within the context of two medium- and long-term contracts with the Soviet Union.

Efforts to modernise Tubemeuse did not have the anticipated effects. The situation deteriorated, resulting in almost complete withdrawal of the private shareholders and the acquisition by the Belgian State of most of Tubemeuse's share capital. At this point, the Belgian State granted aid to Tubemeuse in the form of a capital injection, a subscription to an issue of conditional participating convertible bonds, the conversion of guaranteed loans to Tubemeuse into capital, and some other forms of public support.

In a 1987 decision, the Commission found that the different forms of aid granted by the Belgian State to Tubemeuse were unlawful because the procedure laid down in Article 93(3) of the Treaty (Article 88(3) EC) had not been observed and because the aid was considered incompatible with the common market according to Article 92 of the Treaty (Article 87 EC). Therefore, the Commission ruled that the aid should be recovered.[44] In response, the Belgian State argued that the measures could not affect trade between the Member States or distort competition in the common market because 90 % of Tubemeuse's production was exported outside the Community, although the State agreed that Tubemeuse's production of seamless tubes would represent 17 % of the Community production as claimed by the Commission.

In response, the ECJ argued that given the interdependence between the markets on which Community undertakings operate, it is possible that aid might distort competition within the Community, even though the undertaking that receives the aid exports almost all its production outside the Community. The Court continued to hold that the exportation of part of the undertaking's production to non-member countries is only one of a number of factors that must be taken into account. According to D'Sa, the criterion of intra-Community trade may also be fulfilled when the whole of an undertaking's production is exported outside the

[44] Case C-142/87 Kingdom of Belgium *v* Commission [1990] ECR I-959.

Community.[45] As D'Sa further states, this conclusion is presumably based on the view that exports to countries outside the Community may also affect trade inside the Community.[46]

The fact that Tubemeuse exported 90 % of its production was, according to the ECJ, only one among several factors that has to be taken into account in deciding if a measure can be considered to affect trade between Member States. To the ECJ, it followed from the Commission Decision that there was a world-wide crisis – a recession – and an increase in competition in the seamless tubes sector marked by substantial surplus capacity in the producer countries and by price instability. Moreover, it followed that this situation was accentuated by the import restrictions imposed by the United States and by the new production capacity in the developing and State-trading countries.

Against this background, the Court concluded that: '... Any advantage accorded to an undertaking in this sector is therefore likely to improve its competitive position in regard to other undertakings'.[47] Furthermore, the Court confirmed that it had been reasonable for the Commission to expect Tubemeuse to redirect its activities toward the internal Community market after the withdrawal from the Soviet market. Thus in paragraph 40 the Court held that in the light of those considerations, the Commission's assessment in the contested decision – that the aid granted to Tubemeuse was 'likely to affect the competitive position of the Community undertakings in the sector concerned and, therefore, to affect trade and distort competition within the meaning of Article 92(1)' – (Article 87(1) EC), was adequately reasoned and did not appear to be erroneous.

Another argument advanced by the Belgian State was that, as there was no rule with respect to State aid that defined the threshold above which it would be concluded that intra-Community trade was affected, reference should have been made to the level of 5 % of the market usually adopted by the Commission in competition matters. To this claim the Court responded that the Court in Case 730/79, Philip Morris, and in Case 259/85, France *v* Commission had held that the relatively small amount of aid or the relatively small size of the undertaking which receives it does not, in itself, exclude the possibility that intra-Community trade might be affected.[48]

[45] D'Sa, p. 99.

[46] Ibid.

[47] Case C-142/87 Kingdom of Belgium *v* Commission [1990] ECR I-959, paragraph 37.

[48] Case C-142/87 Kingdom of Belgium *v* Commission [1990] ECR I-959, paragraphs 42–43.

Moreover, the Court has considered that an aid measure may affect trade between Member States and distort competition even if the beneficiary that is in competition with undertakings from other Member States does not itself participate in cross-border activities. It reasoned that when a Member State grants aid to an undertaking, internal supply may be maintained or increased, with the consequence that the opportunities are reduced for undertakings established in other Member States to offer their services to the market of that Member State.[49]

In Case C-280/00, Altmark, the statement was repeated that a public subsidy granted to an undertaking not participating in cross-border trade or cross-border services may lead to the maintenance of or an increase in the beneficiary's supply, with the result that undertakings established in other Member States have less chance of providing their products or services in the market of that Member State.[50] In this particular case the Regierungspräsidium had granted Altmark Trans a licence for scheduled bus transport services in the Landkreis of Stendahl for the period 25 September 1990 to 19 September 1994.

This period was subsequently extended – first to 31 October 1996 and then to 31 October 2002. In making the decision to extend the license to 31 October 1996, the Regierungspräsidium simultaneously rejected the application of Nahverkehrsgesellschaft for licenses to operate those services. Nahverkehrsgesellschaft brought a complaint against the decision to extend the license to 31 October 1996, submitting that Altmark did not satisfy the requirements of the national legislation used as the legal basis for the decision at issue. The case was dismissed by the Verwaltungsgericht Magdeburg. On appeal, however, the Oberverwaltungsgericht Sachsen-Anhalt allowed the application of Nahverkehrsgesellschaft and set aside the issue of licences to Altmark. Altmark, in turn, appealed to the Bundesverwaltungsgericht, which stayed the proceedings and posed one question containing three parts to the ECJ.

In answering the question about the possible application of Article 92(1) (Article 87(1) EC), the Court held that it is not impossible that a public subsidy granted to an undertaking which provides only local or regional transport services and does not provide any transport services outside its State of origin may nonetheless affect trade between Member States, because the supply of transport services by the recipient may, for

[49] Case T-55/99 Confederación Española de Transporte de Mercancías (CETM) *v* Commission [2000] ECR II-3207, paragraph 86.

[50] Case C-280/00 Altmark Trans GmbH and Regierungspräsidium Magdeburg *v* Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747.

that reason, be maintained or increased with the result that undertakings established in other Member States have less chance of providing their transport services in the market in that Member State. The ECJ continued to argue that, in the present case, this finding is not merely hypothetical because, since 1995, several Member States have started to open certain transport markets for competition from undertakings established in other Member States. Therefore, a number of undertakings are already offering their urban, suburban, or regional transport service in Member States other than their State of origin.[51]

All these judgments illuminate the fact that the intra-Community trade criterion and the competition criterion are treated as one.

2.4.4.3 The character of the market

All the judgments reported in Section 2.4.4.2 have a common feature other than the fact that the intra-Community trade criterion and the competition criterion are treated as one: The character of the market in which the recipient undertaking is acting is the determining factor in the assessment of the competition criterion and the intra-Community trade criterion. In two cases – Case C-305/89, Alfa Romeo; and Case C-142/87, Tubemeuse – the market was marked by surplus capacity and increasing competition from competitors in different Member States. In the last case, the market of providing urban, suburban, or regional transport services was at issue.

In another judgment, in joined Cases 62 and 72/87, Glaverbel, the ECJ not only considered the aid in the context of the particular market, which in the case at issue was also a market of surplus capacity, but also considered if the applicant had been able to identify a separate market. The Belgian Government had notified the Commission of its intention to grant aid to investments by a flat-glass producer based at Moustier in the province of Namur. The investments were for the renovation of one of two float-glass production lines and for the modernisation of the other, thereby improving energy use and working conditions and enabling tinted glass and pyrolytically coated glass to be produced in addition to clear glass. The aid was to take the form of an interest subsidy of a certain size for six years, a capital grant of a certain size for six years, and exemption from land tax for five years on the whole investment. In 1986, the Commission ruled that the Belgian Government was to refrain

[51] Case C-280/00 Altmark Trans GmbH and Regierungspräsidium Magdeburg *v* Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747, paragraphs 77–79.

from implementing its proposal to grant aid. The Exécutif Régional Wallon and Glaverbel SA brought the matter to the ECJ, seeking an annulment of the Commission's decision.

After having discussed the situation on the flat-glass market, the ECJ dealt with the applicants' claim that the investments in question were intended to promote the production and marketing of a new product designed according to a new technology developed by Glaverbel, enabling the pyrolytic coating to be applied to the sheets of glass whilst they remain, to use the technical term, "on line" or "floated". According to the applicants, the new products competed with only a limited number of existing products. The ECJ did not agree that the applicant had managed to demonstrate the existence of two separate markets – one for the new product and one for traditional products.

Moreover, the Court held that the new product represented only about 30 % of the total output of Glaverbel; whereas Glaverbel, as an undertaking that produced a variety of products, received financial advantages from the aid.[52] The applicants claimed that the Commission had not shown how the proposed aid could have affected trade between Member States or distorted competition in the common market. According to the applicants, the Commission had merely established general considerations and statistics relating to the situation in the market for glass, without giving any specific indications enabling its reasoning to be understood.

In response to this claim, the ECJ noted in paragraph 17 that it had mentioned three different considerations in its decision. First, it had cited the vulnerability of the flat glass market, which was due, in particular, to stagnant demand, unused production capacity, and a steady decline in employment. Second, it had provided figures on trade between the Belgo-Luxembourg economic union and the other Member States, concluding that the volume of trade was large and noting that Glaverbel exported about 50 % of its flat-glass production to other Member States. Third, according to the Court, the Commission had explained that in 1984 and 1986 three decisions had been adopted whereby aid to the flat-glass industry had been declared incompatible with the common market according to Article 92 of the Treaty (Article 87 EC).

In paragraph 18 the Court concluded that these considerations taken together provided, for the purpose of Article 190 of the Treaty (Article 253 EC), an adequate statement of reasons in support of the Commis-

[52] Joined Cases 62/87 and 72/87 Exécutif régional wallon and SA Glaverbel *v* Commission [1988] ECR 1573, paragraphs 11–15.

sion's finding that the proposed aid was likely to affect trade between Member States and could distort or threaten to distort competition by favouring certain undertakings in relation to others.[53]

2.4.4.4 De minimis aid measures

According to Article 2 of Commission Regulation (EC) No 69/2001, *de minimis* aid measures should be deemed not to meet all the criteria of Article 87(1) EC.[54] According to the Commission notice on *de minimis* aid in force prior to the adoption of the Commission Regulation (EC) No 69/2001, it is the intra-Community trade criterion that is not considered to be met in cases of *de minimis* aid.[55] According to Article 2 subparagraph 2 of Commission Regulation (EC) No 69/2001 *de minimis* aid is aid granted to one undertaking with an amount not exceeding 100.000 EUR over a period of three years. Moreover, it follows from Article 2 subparagraph 1 that the effect of being categorised as a *de minimis* aid measure is that the aid measure does not fall under the notification requirement of Article 88(3) EC. However, it must be remembered that, at least at present, Commission Regulation (EC) No 69/2001 does not apply to:

a) The transport sector and the activities linked to the production, processing or marketing of products listed in Annex I to the Treaty;
b) aid to export-related activities, namely aid directly linked to the quantities exported, to the establishment and operation of a distribution network or to other current expenditure linked to the export activity; or
c) aid contingent upon the use of domestic over imported goods.

2.4.5 Advantage

Although it could be questioned whether or not the requirement of an advantage follows from the wording of Article 87(1) EC (perhaps it follows from the wording "favouring"?), it is nonetheless a requirement articulated by both the Commission and the ECJ. Because the meaning of this requirement seems to vary from case to case, this matter is further explored in Section 2.6.2.

[53] Joined Cases 62/87 and 72/87 Exécutif régional wallon and SA Glaverbel *v* Commission [1988] ECR 1573, paragraphs 16–18.

[54] Commission Regulation (EC) No 69/2001.

[55] Commission notice on the *de minimis* rules for State aid, OJ C 68, 6.3.96, pp. 9–10.

2.4.6 Summary

The fact that Article 87(1) EC covers aid in any form whatsoever means that Articles 87(1) EC is applicable to a wide range of measures. With regard to the requirement of distorted competition, it follows that the granting of State aid is no longer automatically considered to distort competition. However, it appears that the Court, in Case 730/79, Philip Morris, is satisfied with a market analysis of the application of Article 87(1) EC that is far less extensive than would normally be required by Articles 81 and 82 EC (formerly Articles 85 and 86 of the Treaty) dealing with concerted practices and abuse of dominant position.

Moreover, the Court's judgment in joined Cases 296 and 318/82, Leeuwarder Papierwarenfabriek, appears to have moved away from the trend of insufficiently reasoned decisions. Another trend seems to be that the intra-Community trade criterion is treated together with the criterion of distorted competition. Although the assessment of the competition criteria and the intra-Community trade criteria may not require a market analysis comparable to the one required with regard to Articles 81 and 82 EC (formerly Articles 85 and 86 of the Treaty) dealing with concerted practices and abuse of dominant position, it follows from the case law cited above that the character of the market is of vital importance. *De minimis* aid is not considered to fulfil the intra-Community trade criterion, however, and is not, therefore, classified as aid according to Article 87(1) EC.

2.5 The recipient

2.5.1 Introduction

The third suggested category of criteria of Article 87(1) EC discussed in this thesis concerns the requirements of the recipient or recipients; their character and the situations in which they are placed. The selectivity criterion – that the measure must favour a certain undertaking or a certain production of goods – is addressed in Section 2.5.3. It could perhaps be considered as part of the category of criteria discussed in Section 2.4. But, as it is the effect of an aid measure that is determinant, it appears to be more appropriate to place the selectivity criterion in the third category of criteria.

2.5.2 The character of the recipient or recipients

In order for a measure to be classified as State aid, it must distort or threaten to distort competition, and this criterion contains the requirement that aid recipients must be engaged in economic activities in competition with other actors. According to paragraph 11 of the Commission notice on tax measures, this fact applies regardless of the beneficiary's legal status or means of financing.[56] Thus the expression "undertaking" in Article 87(1) of the Treaty covers both private and public undertakings. The term also applies to public bodies, even if they do not enjoy a separate legal personality. It embraces all gainful activity, whether the activity is of a commercial, cultural, or other nature or if it involves production, services, or distribution.[57] Taking into account the effect-principle, it appears that even recipients who do not aim to make a profit and who pursue activities of more voluntary character ought to be covered by Article 87 (1) if the recipient's activities are, in fact, gainful. Also, the term "undertaking" ought to cover activities with a gainful aim but which, in fact, do not end up being gainful, as may well be the case for undertakings aimed at entering a competitive market. Whether the recipient fails or succeeds is not known when the aid is granted.

2.5.3 The selectivity criterion

The requirement in Article 87(1) EC that a measure has to favour "certain undertakings or the production of certain goods", is commonly referred to as the "selectivity criterion". It is often perceived that the selectivity criterion aims to distinguish State aid measures from general measures. Thus a measure that is considered to be general can never constitute State aid according to Article 87(1) EC. In order to conclude what is selective, it seems to be essential to understand what is considered as general.

2.5.3.1 General measures

The Commission, in its First Survey on State aid, held that general measures comprise any State interventions that apply uniformly across the economy and which do not favour certain enterprises or sectors. Examples mentioned in the survey are a generally applied fiscal system and a system of social security contribution (e.g. rules of depreciation applied

[56] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9.

[57] Competition law in the European Communities, Vol. IIB, Situation in December 1996, pp. 8–9.

to capital equipment and charges on employers and employees to finance social benefits).[58] Furthermore, the survey indicated that the Commission had started to investigate in greater detail the distinction between general measures and aid and that the results of this investigation should be integrated in later annual updates of the survey.

This "definition" of general measures and the statement about a Commission investigation regarding the distinction between general measures and aid, were repeated in the Second Survey on State aid.[59] No results from this investigation have yet been published. What does exist is an unpublished working paper on the differences between State aid and general measures.[60] This document is referred to briefly in the following chapters, but it must be remembered that this is an unpublished and non-official document.

According to an official working in the Commission, the clarification of the distinction between State aid and general measures is an ongoing task for the Commission as well as for the ECJ and CFI.[61] The dynamic character of the subject matter requires an ongoing analysis. Against this background, according to the official, the Commission has no intention of preparing a general document on this distinction. Instead, the official referred to different policy frameworks, in which the distinction between State aid and general measures has been an issue. Examples of relevant policy frameworks mentioned by the official were:

- Commission notice on the application of the State aid rules to measures relating to direct business taxation,[62]
- Commission notice on monitoring of State aid and reduction of labour costs,[63]
- Commission communication on State aid elements in sales of land and buildings by public authorities,[64] and
- Council Regulation (EC) No 68/2001 of 12 January 2001 on the application of Articles 87 and 88 to training aid.[65]

[58] First Survey on State Aids in the European Community, 1989, paragraph 14.

[59] Second Survey on State Aids in the European Community, 1990, paragraph 8.

[60] DG IV working paper on the difference between state aid and general measures, IV/310/95-EN Rev.1.

[61] Adinda Sinnaeve, administrator of DG Competition.

[62] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9.

[63] Commission notice on monitoring of State aid and reduction of labour costs, OJ C 1, 3.1.1997, pp. 10–14.

[64] Commission communication on State aid elements in sales of land and buildings by public authorities, OJ C 209, 10.7.1997, pp. 3–5.

[65] Commission Regulation (EC) No 68/2001.

In the Commission Regulation on training aid, it is stated that: 'Many training measures ... constitute general measures because they are open to all enterprises in all sectors without discrimination and without discretionary power for the authorities applying the measure, e.g. general tax incentive schemes, such as automatic tax credits, open to all firms investing in employee training.'[66] In the Commission notice on tax measures, it is stated that:

> Tax measures which are open to all economic agents operating within a Member State are in principle general measures. They must be effectively open to all firms on an equal access basis, and they may not *de facto* be reduced in scope through, for example, the discretionary power of the State to grant them or through other factors that restrict their practical effect. However, this condition does not restrict the power of Member States to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production. Provided that they apply without distinction to all firms and to the production of all goods, the following measures do not constitute State aid:
> – tax measures of a purely technical nature (for example, setting the rate of taxation, depreciation rules and rules on loss carry-overs; provisions to prevent double taxation or tax avoidance),
> – measures pursuing general economic policy objectives through a reduction of the tax burden related to certain production costs (research and development (R&D), the environment, training, employment).[67]

According to Bacon, general measures are characterised by the fact that they are general legislative and regulatory measures affecting the overall economy within a given Member State.[68] General measures have traditionally been considered to be measures of a general economic policy character such as measures relating to interests rates or currency devaluation.[69] Also general social policy is usually not considered to constitute State aid.

The meaning of general measures is further elaborated upon in the 25th report on competition policy. It follows from this report that Article 92(1) of the Treaty (Article 87(1) EC) does not apply to general measures applicable to all undertakings in a Member State, which meet objective, non-discriminatory, and non-discretionary requirements. The application

[66] Commission Regulation (EC) No 68/2001, paragraph 6.

[67] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9, paragraph 13.

[68] Bacon, p. 270.

[69] DG IV working paper on the difference between state aid and general measures, IV/310/95-EN Rev.1; paragraph 2; D'Sa, p.83; Quigley, (1988), p. 244.

of these criteria means that measures potentially open to all undertakings may still be deemed by the Commission to constitute State aid under Article 92(1) if the public authorities can decide, on a discretionary basis, which and/or to what extent undertakings may benefit from the measure or if the effect of the objective requirements is for only certain undertakings to benefit from the measure.[70]

Most definitions of general measures are, in some way or another, based on the assumption that a measure is general if it is open to all undertakings, firms, enterprises, or economic agents without discrimination or on an equal access basis. What is meant by the phrase "all undertakings"? Moreover, what is meant by undertakings "on equal access basis"?

2.5.3.1.1 All undertakings

It appears that "all undertakings" is a relative term and refers to a particular group of undertakings in a particular Member State. In Case 249/81, Buy Irish, the Irish Government had initiated and financed a campaign to promote the sale and purchase of Irish products in Ireland. It seems to follow that all undertakings, at least according to the Commission, appears to have meant all undertakings selling Irish products. In this case, however, the Commission claimed that the measure was too general to constitute State aid according to Article 92 of the Treaty (Article 87(1) EC), and the Commission therefore based its decision on Article 30 of the Treaty (Article 28 EC). The ECJ, on its part, never dealt with the question of whether or not the measure was too general to constitute State aid according to Article 92 (Article 87 EC). It simply assessed the case under Article 30 of the Treaty (Article 28 EC).[71]

Another example of interest in the discussion of what constitutes all undertakings is the Court's judgment in Case C-75/97, Maribel bis /ter. In the relevant case, the Belgian law laying down the general principles of social security for wage earners adopted in 1981 provided, for employers employing manual workers, a reduction in social security contributions for each employee. As of 1 January 1993, employers with fewer than 20 manual workers were, under certain conditions, granted a reduction in contribution of BEF 2825 per manual worker per quarter, to a maximum of five manual workers and BEF 1875 for up to 14 other manual workers. If the employer employed 20 workers or more, the reduction was BEF 1875 per manual worker.

The Maribel *bis* scheme and the Maribel *ter* scheme introduced amendments to these rules. The Maribel *bis* scheme introduced a new amend-

[70] 25th report on competition policy, 1995, paragraph 160.

[71] Case 249/81 Commission *v* Ireland [1982] ECR 4005.

ment effective 1 July 1993. The reduction per quarter and per worker was increased to BEF 3000 for a maximum of five manual workers in undertakings employing fewer than 20 workers. The other conditions remained unchanged. The Maribel *ter* scheme, effective 1 January 1994, for undertakings conducting their activities in one of the sectors most exposed to international competition, increased the reduction per quarter and per worker to BEF 9300, for a maximum of five manual workers; to BEF 8437 for other manual workers in undertakings with fewer than 20 workers; and to BEF 8437 for manual workers in undertakings employing 20 workers or more.

Eventually, the Maribel *ter* scheme was extended in several stages to embrace the international transport sector; certain other sectors covering air and sea transport; certain other transport-related activities; and horticulture, forestry, and the exploitation of forests. The reduction according to the Maribel *bis* and *ter* schemes applied only to manual workers who worked at least 51 % of the maximum working hours or working days stipulated in the collective labour agreement by which they were covered.[72]

In this case, the Belgian Government argued that 'by "all undertakings" must be understood those which are in an objectively similar position'.[73] It seems that the Court upheld this argument, although its interpretation of undertakings being in an objectively similar position did not coincide with the view of the Belgian Government. Thus the Court considered all undertakings employing manual workers to be in a similar situation. However, the measures were considered to constitute State aid because the reductions in social security contributions applied neither 1) to undertakings belonging to other sectors marked by the employment of manual labour, such as sectors of the processing industry, but not referred to in the decree introducing the reduced increase of social security contributions, nor 2) to undertakings in the service sector or the building sector.[74]

The view that "all undertakings" means all undertakings being in objectively similar situations was held also by the Commission in its decision concerning fiscal aid given to German airlines in the form of a depreciation facility.[75]

[72] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

[73] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I--3671, paragraph 17.

[74] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

[75] Commission Decision 96/369/EC of 13 March 1996 concerning fiscal aid given to German airlines in the form of depreciation facility, OJ L 146, 20.6.1996, pp. 42–48, at p. 46.

The Commission's view in Case 249/81, Buy Irish, has been questioned by, for example, Quigley. Quigley is critical of the fact that the measures in that case were considered to be too general for Article 92(1) (Article 87(1) EC) to apply; whereas the measures at issue in joined Cases 6 and 11/69 were considered to constitute State aid.[76] In joined Cases 6 and 11/69, the Bank of France had, for some years, granted a more favourable rediscount rate for export claims than for domestic claims.

After some correspondence between the Commission and the French Government, the Commission adopted two decisions: One in the field of ECSC, because the favourable rediscount rate also included export claims for steel products; and the other in the EEC field. In both decisions, the Commission agreed to accept the possibility for export undertakings to benefit from a preferential rediscount rate in respect of export credits, but only under certain conditions. In its decisions, the Commission held that the discount rate should not be less than 2 % and that the advantage granted to exporters should not be more than 3 points (must be percentage points) during the period ending 31 October 1968 and 1.5 points during the period 1 November 1968 to 31 January 1969.

On 5 November 1968, the French authorities informed the Commission of its intention to maintain the rediscount rate at 2 % for export claims until 31 December 1968. As the domestic rediscount rate remained fixed at 5 %, a difference of 3 points was maintained after 31 October 1968, contrary to the Commission's decisions. The matter was brought to the ECJ by both the Commission (Case 6/69) and the French Government (Case 11/69). The Court stated that: 'A preferential rediscount rate for exports, granted by a State in favour only of national products exported and for the purpose of helping them to compete in other Member States with products originating in the latter, constitutes an aid within the meaning of Article 92 the observance of which it is the Commission's task to ensure'.[77]

Quigley's argument – that it is difficult to see the difference between a measure favouring all undertakings selling domestic products and a measure favouring all undertakings exporting their products[78] – seems to be a reasonable one.

On the one hand, the reference to undertakings in objectively similar positions seems reasonable, especially from the point of view of compe-

[76] Joined Cases 6 and 11/69 Commission *v* French Republic [1969] ECR 523.

[77] Joined Cases 6 and 11/69 Commission *v* French Republic [1969] ECR 523, paragraph 20.

[78] Quigley, (1988), p. 246.

tition. It is only when a measure benefits one or a group of undertakings acting in competition with others that it is relevant to talk about distorted competition. On the other hand, it seems difficult in practice to determine the circumstances in which undertakings are in objectively the same position. Under what circumstances are things objectively similar and what factors should be taken into account in establishing if certain undertakings are in an objectively similar position?

It seems that Tridimas' discussion regarding the application of the principle of equal treatment may be of value in this context.[79] According to that author, the Court, in order to determine if certain products or undertakings have been treated equally, may have recourse to the competition rules. Thus Tridimas argues in the case of products, that the Court will consider whether or not the products in question fulfil the same function and are being substituted for another. Accordingly, interchangeable products are in a comparably competitive position and should in principle, according to Tridimas, be treated in the same manner. In the case of undertakings, the Court may, accordingly, take into account their production or to their legal structure, with a view to determining if their competitive positions are comparable.

However, it is emphasised by Tridimas that, although the principle of equality requires that traders that are in the same situation must be treated in the same manner, it is logically and practically impossible to account for every difference that may exist among the various groups of economic operators. In this context, the author cites two statements worthy of mention. The first is a statement by the Court in joined Cases 17 and 20/61, Klöckner *v* High Authority [1962] ECR 325, at p. 340, in which the ECJ held that: 'By reason of the varied and changing nature of economic life, clear and objective criteria of general application and presenting certain common fundamental characteristics must be used in the establishment and functioning of the financial arrangements for safeguarding the stability of the Common market. It is thus impossible to take account of every difference that may exist in the organisation of economic units subject to the action of the High Authority for fear of fettering that action and rendering it ineffective.'

The second noteworthy citation made by Tridimas is a statement by AG Jacobs in joined Cases C-13 to C-16/92, Driessen and others [1993] ECR I-4751, at p. 4780. AG Jacobs held that '... the principle of equality cannot preclude the legislature from adopting a criterion of general application – indeed that is inherent in the nature of legislation. It may affect different persons in different ways, but beyond certain limits any

[79] Tridimas, pp. 214–242.

attempt to tailor the legislation to different circumstances is likely only to lead to new claims of unequal treatment.'

In summary, it seems that the assessment involved in determining if undertakings are "objectively" in a similar position is a relative one that can always be viewed from another angle.

2.5.3.1.2 General geographic measures

Not only sectoral measures have been considered relevant for the purposes of Article 87(1) EC, but also geographical measures. According to paragraph 17 of the Commission notice on tax measures, geographically, only measures with a scope extending to the entire territory of a State escape the selectivity criterion laid down in Article 87. "All" in the geographical sense of the meaning, therefore, seems to mean all regions or all other geographical areas of a State, for example Länder. Accordingly, a measure that is open to all regions or other geographical areas should be considered general.

2.5.3.1.3 Equal access basis

As mentioned in Section 2.5.3.1, paragraph 13 of the Commission notice on tax measures states that a tax measure is considered general when it is open to all economic agents operating within a Member State if it is effectively open to all firms on an *equal access basis*. What is meant by an "equal access basis"? It could mean that all undertakings shall be treated equal. The meaning of equal treatment has been addressed in Section 2.5.3.1.1, and, as mentioned, equal treatment is always relative,[80] and most certainly dependent on such factors as values, political views, cultural background and traditions. Moreover, an aid measure that may seem equal in a narrow perspective may not appear to be equal when evaluated in a wider perspective with respect to other factors.

The difficulties of determining when certain measures are equal may be illuminated by the following question: Would it be considered equal to tax a student who receives a Federal or State scholarship, while exempting the one that can attend a public institution without charge?[81] At first

[80] Tridimas, pp. 214–242.

[81] The question, as well as the example, is extracted from the article "A 'Comprehensive Tax Base' as a Goal of Income Tax Reform" by Bittker (1967), p. 936. The article was a contribution in the discussion on achieving a comprehensive tax base that was part of the tax expenditure debate held in the 1970s and 1980s. The most obvious problem with a comprehensive tax base is that it presupposes a neutral tax, i.e. that all are taxed equal. In the article, Bittker questioned if not all tax systems will consist of loopholes that will be used by some but not by others. If this is true, which it probably is, the consequence is

glance, the most evident answer would seem to be "no", because the first student has to pay tax and the other does not. The answer could, however, be dependent upon several factors. Does the Federal or State scholarship do the first student a favour by offering him or her the possibility of going to a more prestigious school, which will probably result in a more prestigious and better paying job, which should compensate for the tax? Another aspect could be the size of the scholarship. The tax effect may have been taken into account when the size of the scholarship was decided. Even if this scenario does not seem plausible, it would alter the view about the equality of the treatment.

It follows that it is not an easy task to determine and understand the meaning and application of the concept of "all undertakings". It also follows that the task of determining if an aid measure is equal is difficult and may be dependent on several factors.

2.5.3.1.4 General measures with distorting effects on competition

In the context of a discussion of general measures, it should also be mentioned that they may have distorting effects on competition and that these distortions are not considered prohibited by the Treaty. In the French version of Case 173/73, Italy *v* Commission, ECJ held that '*que, d'ailleurs, dans ces articles 99 à 102, le traité prévoit les modalités pour éleminer des distorsions génériques provenant des divergences entre les systèmes fiscaux et de sécurité sociale des différents États membres, en tenant compte des difficultés structurelles de certains secteurs industriels; ...*' In the English version of the same judgment, however, reference is made to Articles 92 to 102 of the Treaty. But, as none of Articles 92 to 98 provide for such rules, the English version is most certainly erroneous. Relying, in this context, on the French version of Case 173/73, Italy *v* Commission, the ECJ appears to have held that Articles 99 to 102 of the Treaty provided for detailed rules for the abolition of generic distortions resulting from differences between the tax and social security systems of the

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that there is no such thing as equal tax. The relevance of Bittker's argument may be questioned, however, as no legislator will ever be able to foresee every possible situation. A tax system will always have loopholes. It can be argued that what the legislator can do, and what may be of relevance for the discussion of equal taxing, is to create the necessary conditions for equal taxing. According to such reasoning, the application of the tax rules, consequently, would be seen as a separate problem, without relevance to the reference to an equal tax system. Irrespective of the view one may have concerning this issue it is clear that the question of what constitute equal taxing remains difficult. Moreover, it is clear that the same reasoning would be of relevance in all legislation claiming to be based on the principle of equal treatment.

different Member States, whilst taking account of structural difficulties in certain sectors of industry.[82]

Consequently, measures of general application that are distorting competition or may cause distorting effects could be combated with reference to Articles 96 and 97 of the Treaty (former Articles 101 and 102 of the Treaty). As Bacon wisely wrote, it could probably not be considered to 'be part of EC competition policy to eliminate all differences in the cost structure between countries, many of which derive from the economic and social conditions in those countries. Any other view would lead, logically, to the inconceivable result that almost any difference in Member States' laws which affected undertakings would fall within the supervisory power of the Commission under Article 92 and 93'.[83] Articles 96 and 97 (formerly Articles 101 and 102), however, do not appear to have been applied by the EU institutions. Perhaps, as Beseler and Williams suggest, the international effects of a Member State's national measures may be difficult or even impossible to determine, as they are often mitigated or counterbalanced by other macro-economic circumstances such as the variation in exchange rates or the level of taxation influenced by the measure in question.[84] As could be expected, not everyone agrees with this dividing line of application between Article 87 (former Article 92) and Articles 96–97 of the Treaty (former Articles 101 and 102) respectively. Bourgeois is one such person.[85]

2.5.3.2 Specificity or selectivity

2.5.3.2.1 Introduction

It is often posited that the selectivity criterion aims to distinguish State aid measures from general measures. General measures where discussed above and it is now time to move to an exploration of the selective character of an aid measure. In its 2003 implementation report, the Commission makes a distinction between material and geographic selectivity, and a similar distinction will be upheld here.[86]

[82] Case 173/73 Italian Government *v* Commission [1974] ECR 709, paragraph 17.

[83] Bacon, p. 270.

[84] Beseler and Williams, p. 138.

[85] Bourgeois.

[86] Paragraphs 25–33 of the report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C

2.5.3.2.2 Material selectivity

A measure is selective when it is addressed to or has the effect of benefitting only some undertakings. For some time, the selectivity criterion was considered to be fulfilled only when the measure benefitted a certain undertaking or undertakings in one or several specific sectors of a Member State's economy or in one or several specific industries or undertakings in a given region.[87] The latter now seems to be referred to as geographic selectivity. Thus material selectivity seems to be aid addressed to certain sectors, or aid with the effect of benefitting certain sectors, specific undertakings, or undertakings in a certain industry.

One factor that may be considered confusing is the Commission's use of the terms "sector" and "industry" as synonyms. In Case 173/73, Italy *v* Commission, for example, the Italian Government refers to the Italian textile *industry* whereas the Court in paragraph 18 refers to the Italian textile *sector*. In paragraph 19, however, the Court also refers to the Italian textile *industry*.[88] According to Longman's dictionary, an industry is a particular branch of industry or trade usually employing large numbers of people and using machinery and/or modern methods: the steel, food, aerospace, and clothing industries, for example. Tourist trade is considered to be an industry.[89] According to the same source, a sector is part of a field of activity, especially of business or trade. One can refer to the private or public sector, the banking, insurance, or electronics sectors.[90]

In this context, it is important to mention that, according to Case 248/84, Germany *v* Commission, an aid programme covered by Article 87(1) EC may concern a whole sector of the economy of a Member State.[91] The Commission upheld this view in a 1998 decision in which it established that a measure concerning the whole of the manufacturing sector constituted State aid.[92] This view was repeated by the ECJ in a recent case, namely Case C-143/99, Adria-Wien Pipeline.[93] Thus the

[87] DG IV working paper on the difference between state aid and general measures, IV/310/95-EN Rev.1.

[88] Case 173/73 Italian Government *v* Commission [1974] ECR 709.

[89] Longman Dictionary.

[90] Ibid.

[91] Case 248/84 Federal Republic of Germany *v* Commission [1987] ECR 4013, paragraph 18.

[92] Commission Decision concerning Case E/1/98 of 18 December 1998 regarding a proposal for appropriate measures under Article 93(1) of the EC Treaty concerning the International Financial Service Centre and Shannon customs-free airport zone, OJ C 395, 18.12.1998, pp. 14–18.

[93] Case C-143/99 Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH *v* Finanzlandesdirektion für Kärnten [2001] ECR I-8365.

selectivity criterion is considered fulfilled when, for example, a certain tax reduction is available only to the manufacturing sector of a certain Member State.

Under certain conditions, however, rules like a sector-specific tax are considered to be general because of the specific characteristics of the sector. This aspect is discussed further in Section 4.4.3.3.

2.5.3.2.3 Geographic selectivity

Although not particularly mentioned in Article 87(1) EC, measures addressed to undertakings in certain regions have also been considered selective. According to the Commission, the Treaty itself, which in Articles 87(3) (a) and (c) EC classifies measures intended 'to promote the economic development' of a particular region as aid that may be considered compatible with the common market, indicates that benefits, the scope of which is limited to a certain region, may be considered selective.[94] As mentioned in Section 2.5.3.1.2 of this chapter, only the scope of measures extending to the entire territory of a State can escape the selectivity criterion established in Article 87.[95]

Consequently, aid measures benefitting undertakings in a given region or a certain geographical area may be considered selective enough to constitute State aid. With regard to regional aid, however, it is important to draw a distinction between 1) regional aid schemes initiated and governed by the central government, and 2) measures taken by a regional government applicable to all undertakings within the relevant region. A measure can be applied to all undertakings in a certain region and still constitute State aid according to Article 87 of the Treaty in the first situation, but would most probably fall outside Article 87 in the latter situation due to principles of subsidiarity and decentralisation.[96] The latter is discussed further in Section 4.4.3.2.

2.5.3.2.4 Other forms of selectivity

Measures restricted to certain economic sectors or certain categories of undertakings are referred to by the Commission as "standard" cases. The view that the selectivity criterion should also be considered fulfilled on

[94] Commission Decision 2003/442/EC of 11 December 2002 on the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax, OJ L 150, 18.6.2003, pp. 52–63, paragraph 26.

[95] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9, paragraph 17.

[96] Bacon, p. 293.

terms other than those referred to as standard cases was offered by AG Capotorti in his opinion of Case 249/81, Buy Irish. As mentioned in Section 2.5.3.1.1, the question in this case was whether or not a campaign to promote the sale and purchase of Irish products in Ireland, initiated and financed by the Irish Government, was contrary to Article 30 or 92 of the Treaty. In his opinion, AG Capotorti held that Article 92(1) (Article 87(1) EC)

> ... has frequently been interpreted in such a way that the reference to "certain undertakings or the production of certain goods" has a strictly limited meaning: in other words, as if the only State aids declared incompatible with the common market were those of a sectorial nature. But I consider that that interpretation is mistaken. It is sufficient to observe that among the categories of aid which are or may be considered to be compatible with the common market (Article 92(2) and (3), there are some which are clearly not sectorial in character (such as aid to make good the damage caused by natural disasters, or aid to remedy a serious disturbance in the economy of a Member State); it is not clear why it should have been necessary to mention these forms of aid if the general rule of incompatibility contained in paragraph (1) of the article in question concerned only sectorial aids. In any case, quite apart from the wording of Article 92, I take the view that it is perfectly justifiable to speak of a general principle of the prohibition of public aids to domestic products, if one wishes to avoid the incongruous view that sectorial aids are prohibited and those of wider scope are permitted.[97]

Consequently, it seems that AG Capotorti suggested a wider application of the selectivity criterion. As mentioned in Section 2.5.3.1.1, the Court instead assessed the case under Article 30 of the Treaty (Article 28 EC).

AG Jacobs supported Capotorti's opinion in Case C-241/94, Kimberly Clark Sopalin, which is analysed in greater detail in Section 5.8. AG Jacobs held that: 'Since Article 92(1) refers to aid which favours certain undertakings or the production of certain goods it is usually assumed that measures which are generally applicable do not fall within its scope.' In addition, he stated that there was some force in AG Capotorti's arguments, as articulated in Case 249/81, Buy Irish, that it was perfectly justifiable to speak of a general principle of the prohibition of public aids to domestic products if one wished to avoid the incongruous view that sectoral aids are prohibited and those of wider scope are permitted. However, AG Jacobs expressed some doubts about the application of a principle like this '... since the essential distinction between prohibited aid, on the one hand and general social and economic policy on the

[97] Case 249/81 Commission *v* Ireland [1982] ECR 4005, at p. 4031.

other becomes blurred'.[98] The measure at issue in Case C-241/94, Kimberly Clark Sopalin, was, however, considered to be selective, due to the discretionary powers of the authority.[99]

The issue of other forms of selectivity was also dealt with by AG Darmon in his opinion of the joined Cases C-72 and 73/91, Sloman Neptun. He held that the meaning of "certain undertakings or the production of certain goods" should have a wider application than merely referring to measures of sectoral or regional effect.[100] He also agreed with AG Capotorti and acknowledged the difficulty of distinguishing between general measures and measures constituting State aid. AG Darmon, however, especially referred to the distinction between general measures and *general aid*. He concluded, after having read the Court's case law that in cases of application of the selectivity criterion to taxes, the ECJ, had, above all, applied a 'derogation method'. The application of this method is discussed further in Section 4.2.

By applying the derogation method, AG Darmon distinguished between general measures and general aid in a rather convincing manner. According to this distinction, general measures that benefit all undertakings in a Member State may not constitute State aid according to Article 87 of the Treaty. General aid, however, may constitute State aid. AG Darmon mentioned the Court's judgment in joined Cases 6 and 11/69, Commission *v* France, as an example.[101]

In joined Cases 6 and 11/69, described in Section 2.5.3.1.1, the Bank of France had granted a more favourable rediscount rate for export claims than for domestic claims. AG Darmon argued that if the fixed discount rate had been equal for all French products, whether or not they were intended for export, the measure would have been considered general. However, as the rediscount rate applied only to undertakings exporting their products, the selectivity criterion was considered to be fulfilled and the measure in question consequently constituted State aid. In this case, the Court considered the measure at issue to constitute State aid, as it favoured only national products being exported.[102]

[98] Case C-241/94 French Republic *v* Commission [1996] ECR I-4551, at 4559, paragraph 30.

[99] Case C-241/94 French Republic *v* Commission [1996] ECR I-4551, paragraph 23 and 24.

[100] Joined Cases C-72 and 73/91 Sloman Neptun Shiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887, at I-915, paragraphs 49–52.

[101] Joined Cases 6 and 11/69 Commission *v* French Republic [1969] ECR 523.

[102] Joined Cases 6 and 11/69 Commission *v* French Republic [1969] ECR 523, paragraph 20.

Against this background, aid to exporting undertakings has also been considered selective in the sense required in Article 87(1) EC.[103] The ECJ seems to have applied a similar reasoning in the judgment in Case C-75/97, Maribel bis/ter, in which the ECJ held that a measure which targets all of the sectors subjected to international competition constitutes aid.[104]

Moreover, it follows from Commission case practice that the Commission, too, has adopted this view. In two decisions, Commission Decision 2003/81/EC concerning Spanish aid schemes to coordination centres in Vizcaya and Commission Decision 2003/755/EC concerning Belgian aid to coordination centres, the Commission found that certain compulsory criteria relating to, for example, the size and multinational character of the group of undertakings at issue and the nature and type of activities conducted by the group fulfilled the requirement of selectivity.[105]

Furthermore, in a decision regarding Dutch international financing activities, Commission Decision 2003/515/EC, the Commission found the selectivity criterion to be fulfilled because the aid scheme in question not only applied purely to intra-group financial transactions but, more narrowly, to particular types of transactions. The Commission held that the criteria articulated by the Dutch Government confirmed that the express aim of the Dutch authorities was to reserve the scheme for internationally active groups that have a financial centre in the Netherlands but conduct financial activities focused primarily on the group's entities abroad. The Commission added that these circumstances made the aid scheme selective, if only because it did not apply to groups based primarily on Dutch territory or to multinationals with operations in fewer than four countries.[106]

Finally, measures reserved for certain types of intra-group transactions were also at issue in a decision regarding a Finnish aid scheme for Åland Islands' captive insurance companies, Commission Decision 2002/937/

[103] DG IV working paper on the difference between state aid and general measures, IV/310/95-EN Rev.1, paragraph 4.1.2.

[104] Commission Decision 97/239/EC of 4 December 1996, concerning aid granted by Belgium under the Maribel bis/ter scheme, OJ L 95, 10.4.1997, p. 25–29.

[105] Commission Decision 2003/81/EC of 22 August 2002 on the aid scheme implemented by Spain in favour of coordination centres in Vizcaya C 48/2001, OJ L 31, 6.2.2003, pp. 26–31, paragraphs 11–12 and 32; Commission Decision 2003/755/EC of 17 February 2003 on the aid scheme implemented by Belgium for coordination centres established in Belgium, OJ L 282, 30.10.2003, pp. 25–45, paragraphs 13 and 104.

[106] Commission Decision 2003/515/EC of 17 February 2003 on the State aid implemented by the Netherlands for international financing activities, OJ L 180, 18.7.2003, pp. 52–66, paragraphs 87–88.

EC. In its decision, the Commission held that the measure was considered to be selective or specific, as the aid favoured only captive insurance companies and barred insurance companies which normally insure non-affiliated companies from operating on exactly the same market and under the same conditions as captive insurance companies.

Furthermore, the Commission also found that the selectivity criterion is fulfilled by the fact that the conditions under which the measure applied implicitly required a certain economic strength and could therefore apply only to sufficiently large undertakings.[107] Thus the group of undertakings receiving aid may have features in common other than belonging to the same sector or being situated in the same region.

2.5.3.2.5 Selection

For the purposes of this dissertation, selection refers to the way in which the group of beneficiaries is determined. Selection can take place in different ways and on different levels. The selection may follow from the wording of legislation or from any other regulatory instrument. Thus it could follow from a provision – from a certain legislation, for example – that allows certain undertakings or a certain group of undertakings to be treated more advantageously than others. A legislation or regulation according to which the granting of aid is made possible by the very adoption of the legislation is called an aid scheme. An aid scheme is different from *ad hoc* aid, the granting of which requires an individual decision.

The following example may be useful to illustrate the difference between an *aid scheme* and *ad hoc* aid. Imagine that a Member State in the EU wants to create incentives for the industry to use more environmentally friendly techniques. In order to achieve this goal, the Government decides to introduce a new regulation making it possible to receive up to a certain amount of aid, subject to the condition that certain investments are made. The authority appointed to be in charge of the granting of aid follows from the regulation. Moreover, the regulation provides conditions for receiving the aid. The very adoption of this regulation would make it possible for the authority to grant aid to certain undertakings or a certain group of undertakings, in accordance with the conditions of the regulation. Thus the regulation is an aid scheme.

In contrast, *ad hoc* aid is illustrated by cases of the Government deciding to grant aid to, for example, a certain steel company. Imagine that the steel company has economic difficulties and asks the Government

[107] Commission Decision 2002/937/EC of 10 July 2002 on aid scheme implemented by Finland for Åland Islands' captive insurance companies, OJ L 329, 5.12.2002, pp. 22–29, paragraphs 50–52.

for economic assistance. If the Government made a decision to assist the steel company, this action would be classified as *ad hoc* aid. It follows that also *ad hoc* aid may be based on national legislation or other legal instruments but the difference is that the *ad hoc* aid requires an individual decision by an authority. This authority may be the Government but it may also be a central, local, or regional authority.

When an *aid scheme* is adopted, it is possible that the authority appointed to administer the granting of aid is entrusted with the power to grant aid, but only in strict accordance with certain conditions laid down in legislation or in a regulation. The authority, however, may have been embodied with the power to grant aid on a discretionary basis. In the latter case, it is sufficient that the authority has been empowered with discretionary powers for the selectivity criterion to be fulfilled, due to the selective effect of the measure.

In Sweden, for example, it was not unusual that, for example, R&D aid schemes were adopted in which the power to grant aid was delegated to a public authority and that the authority was empowered with discretionary powers to decide under what circumstances and to whom aid should be granted.

2.5.3.2.6 Selective effect

An aid measure may appear to be general on the face of it but on further analysis be seen to be selective with regard to the effect of the measure. In a case from the early 1980s, Case 203/82, Commission *v* Italy, the Italian Government had reduced the total level of contributions for compulsory sickness insurance payable by undertakings by four percentage points for male employees and by ten percentage points for female employees.[108] The Commission considered that a system like that constituted State aid according to Article 92 of the Treaty (Article 87 EC), as the State's assumption of financial responsibility entailed a greater reduction in employers' contributions to the sickness insurance scheme for female employees than for male employees. The Commission was of the opinion that the Italian Government thereby favoured certain Italian industries employing large numbers of female employees – in particular, those in the textile, clothing, footwear, and leather-goods sectors.

The Italian Government did not dispute the decision. On the contrary, it notified the Commission that it was cognisant of the decision and intended to comply with it when the provisions governing contributions for medical care were amended. The Commission accepted a temporary extension of the system until 30 June 1981, after which it was on the

[108] Case 203/82 Commission *v* Italian Republic [1983] ECR 2525.

clear understanding that the system should be abolished. Nonetheless, the system remained technically in force after that date, which was the reason for the Commission bringing the matter to the ECJ. The ECJ concluded that the Italian Government had failed to comply with the Commission's decision within the prescribed period and, consequently, had failed to fulfil its obligations under the EEC Treaty.

It is unclear if the view of the Commission in Case 203/82, Commission *v* Italy, would be upheld by the ECJ or CFI today. In Case C-75/97, Maribel bis/ter, described in Section 2.5.3.1.1, the Court held, in paragraph 36, that an increased reduction of social security contributions concerning only a limited category of employers, owing to their belonging to a certain industrial sector, does not at first sight appear to derogate from the nature and scheme of the general system of social protection.

In paragraph 37, the Court argued that the Member States retain their powers to organise their social security system: 'They may therefore pursue objectives of employment policy, such as those relied on by the Kingdom of Belgium, amongst which are, in particular, the maintenance of a high level of employment amongst manual workers and the maintenance of an industrial sector in order to balance the Belgian economy.' However, in paragraph 38 the Court held that: 'However, it must be emphasised that the increased reductions introduced by the Belgian authorities in order to attain that *objective have the sole direct effect of according an economic advantage to the recipient undertakings alone*, relieving them from part of the social costs which they would normally have to bear ...' (emphasis added).[109]

Moreover, the Court implied that if the increased reduction of social security charges had applied to all undertakings in sectors marked by the employment of manual workers, the reduction would not have been considered to constitute State aid,[110] and a question must be posed in this context: Is the opinion of the Court in conflict with the Commission's view in Case 203/82, Commission *v* Italy? Or, put differently, ought not the Court, if it had accepted the Commission's interpretation in Case 203/82, Commission *v* Italy, have considered the increased reduction for sectors marked by the employment of manual workers as State aid, in itself, as the effect was that certain sectors – those that employ large numbers of manual workers – were favoured?

Accordingly, one might question whether or not the Court's judgment in Case C-75/97, Maribel bis/ter means that the Court has revised its view with regard to selectivity, in particular from the way selectivity

[109] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671, paragraph 38.
[110] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR 3671, paragraph 30.

was interpreted in Case 203/82: That a greater reduction in social security contribution for female employees than for male employees would be considered selective because of the selective effect of the kind of aid measure on industries typically employing women?

Moreover, as indicated in Section 2.5.3.2.5 of this chapter, aid schemes that entrust the authority for administrating the aid scheme, with the power to grant aid on a discretionary basis, are considered to be fulfilling the selectivity criterion, due to the selective effect of the discretionary powers.

2.5.3.3 Ancillary effects

Also general systems may sometimes seem selective. It has, however, been acknowledged that general systems usually benefit some undertakings more than others. An example follows from paragraph 2.2 b) of the working paper on the difference between State aid and general measures.[111] According to the example, a general system of accelerated depreciation benefits highly capital intensive industries in particular. In this example, the sectoral effects, however, were considered to be ancillary and not disproportionate and were considered to be the inevitable consequence of the nature and general scheme of the depreciation arrangements.

Moreover, the Commission, in its notice on tax measures, argues that measures designed to reduce the taxation of labour for all firms have a relatively greater effect on labour-intensive industries than on capital-intensive industries, without necessarily constituting State aid. It is added that the same reasoning is valid for tax incentives for environmental, R&D, or training investments, as these measures only favour undertakings which pursue the relevant type of investments.[112] Consequently, it seems that general systems may benefit some beneficiaries more than others without constituting State aid.

2.5.4 Summary

It is often mentioned that the selectivity criterion aims to distinguish between general measures and measures that are selective or specific in some way. Measures are considered to be general if they are open to all

[111] DG IV working paper on the difference between state aid and general measures, IV/310/95-EN Rev.1.

[112] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.98, p. 3–9, paragraph 14.

undertakings on an equal access basis. "All undertakings" appears to mean all undertakings in an objectively similar position. The complexity of assessing if undertakings are in an objectively similar situation and to establish the meaning of equal access basis, arises from the fact that it must be determined when two products or two undertakings are being treated equally. This assessment is always relative, and dependent upon various factors. Thus in practice, it is difficult to determine if a measure is general.

A measure is considered to be selective if it is addressed to or has the effect of favouring certain undertakings, sectors, or regions, or a group of undertakings with other features in common – that they are exporting their products, for example.

2.6 The relationships among the criteria of Article 87(1) EC

2.6.1 Introduction

It follows from this chapter that Article 87(1) EC contains five criteria. It is, however, unclear how they interrelate. To begin with the wording of Article 87(1) EC, it states that '... any aid granted ..., in any form whatsoever which distorts or threatens to distort competition *by* favouring certain undertakings or the production of certain goods ...'(emphasis added). It may be that this wording implies that the assessment of distorted competition is closely linked, or perhaps even connected, to the assessment of the selectivity criterion – that the competition is distorted or threatened to be distorted when an undertaking or the production of certain goods are favoured by an aid measure.

Moreover, the requirement of an advantage, although it does not appear to follow from the wording of Article 87(1) EC, is nevertheless required by the Commission as well as by the ECJ and CFI. The requirement of an advantage is sometimes placed in the context of other undertakings; the question is whether or not the beneficiary of the undertaking has received an advantage compared with other undertakings.[113] When this is the case, the requirement of an advantage seems to be assessed from the point of view of competition. Sometimes, however, the

[113] Commission Decision 2003/515/EC of 17 February 2003 on the State aid implemented by the Netherlands for international financing activities, OJ L 180, 18.7.2003, pp. 52–66, paragraph 82.

question is whether or not there has been a selective advantage.[114] In those cases it seems to be the requirements of selectivity and of an advantage that are treated together.

Finally, it follows from the discussion of the competition criterion and the intra-Community trade criterion that the two often are treated as one. If all these views are valid, all criteria would be linked: competition and selectivity, advantage and competition, advantage and selectivity, and competition and intra-Community trade. As the aim of this dissertation is to analyse the assessment of only the selectivity criterion, it is necessary to examine if all criteria are connected as implied or if it is possible to make a distinction among the different criteria.

2.6.2 The relationships among advantage, selectivity, and competition

It has been mentioned that the requirement that a measure must confer on its recipients an advantage which relieves them of charges that are normally borne by their budgets, is sometimes assessed in comparison with other companies. However, although blurred in some Commission Decisions,[115] it follows more clearly from other Commission Decisions that, instead, it is the situation for the recipient undertaking itself that is relevant. It is held, for example, in Commission Decision 2002/937/EC concerning aid to captive insurance companies on the Åland Islands, that '... a lower rate of taxation confers an advantage on a company by enabling it to retain a greater proportion of its profits either for distribution to its members or shareholders or for reinvestment and therefore confers an advantage on eligible companies'.[116] Another example is Commission Decision 2000/795/EC, concerning aid to Ramondín Cápsulas, in which it was held that the 45 % tax credit in question undoubtedly fulfilled the requirements of an advantage as, 'thanks to the credit, Ramondín enjoys a reduction in its tax burden equivalent to 45 % of the

[114] Paragraph 7 of the report on the implementation of the commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C

[115] For example Commission Decision 2003/515/EC of 17 February 2003 on the State aid implemented by the Netherlands for international financing activities, OJ L 180, 18.7.2003, pp. 52–66, paragraph 82.

[116] Commission Decision 2002/937/EC of 10 July 2002 on the aid scheme implemented by Finland for Åland Islands' captive insurance companies, OJ L 329, 5.12.2002, pp. 22–29, paragraph 36.

amount of the investment as determined by the Álava Provincial Council.'[117]

If the advantage criterion was to be assessed in comparison to other companies, a separate assessment of the selectivity (in the way it has been described in Sections 2.5.3.2.2 to 2.5.3.2.5) would seem to lose its meaning. Therefore, it seems more plausible that the advantage requirement is to be assessed separately, rather than being confused or intermixed with either the selectivity criterion or with the competition criterion.

2.6.3 The relationships among selectivity, competition, and intra-Community trade

As mentioned above, the wording of Article 87(1) EC, in itself, may make it tempting to suggest that the assessment of distorted competition is closely linked, or perhaps even connected, to the assessment of the selectivity criterion. In that case, it could be relevant to question if the two assessments are, in fact, separate assessments or a single assessment. Thus once the selectivity criterion was fulfilled, the measure was automatically considered to distort competition.

This conclusion would seem reasonable against the background that the phrase "all undertakings" in Section 2.5.3.1.1 was considered to constitute all undertakings in objectively the same position. As the assessment of what constitutes "all undertakings" is made in a national perspective, it could be possible to consider that the requirement of distorted competition should also be read in a national context. But if this were true, there would be no need to assess distortion of competition as a separate criterion, and this does not seem to be the way in which these criteria have been interpreted with regard to the case law described in Sections 2.3 to 2.5 of this chapter.

According to another interpretation of the relationship between the assessment of distorted competition and the assessment of the selectivity criterion, the two could be separate assessments which would sometimes coincide and sometimes not. In this scenario, the requirement of distorted competition would still be considered a national assessment.

A third possibility, which seems to be the common view, is that the requirement of distorted competition is to be pursued in a European perspective. According to AG Darmon's opinion in Case 72 and 73/91, Slo-

[117] Commission Decision 2000/795/EC of 22 December 1999 on the State aid implemented by Spain for Ramondín Cápsulas SA, OJ L 318, 16.12.2000, pp. 36–61, paragraph 74.

man Neptun,[118] it followed from the Court's judgment in Case 203/82[119] that derogation from the normal application of a particular system, in itself, distorts competition to the detriment of, if not national competitors, undertakings established in other Member States. AG Darmon, therefore, claimed that it was unnecessary to identify discrimination (i.e. that among several undertakings acting in competition with each other only one or a few received aid) within the Member State in question.

A relatively recent example that seems to confirm AG Darmon's interpretation of Case 203/82 is the Court's judgment in Case T-67/94, Ladbroke Racing.[120] A British corporation, Ladbroke Racing Ltd and seven companies belonging to the Ladbroke Group submitted a complaint to the Commission on 7 April 1989 in respect of several forms of aid which the French authorities had granted to the Pari Mutuel Urbain (PMU). Eventually, the Commission adopted a decision which was contested by Ladbroke Racing Ltd. It was this Commission Decision that was taken under consideration by the Court in Case T-67/94, Ladbroke Racing.

It follows from paragraph 2 of Case T-67/94, Ladbroke Racing, that the PMU was an economic interest group in France which had been established in order to manage the organisation of off-course totalisator betting on behalf of its members. According to a French decree, it was the PMU alone that had the right to manage the organisation of off-course totalisator betting by the racecourse undertakings. This exclusive position was further safeguarded by an inter-ministerial order, according to which persons other than the PMU were precluded from offering or receiving bets on horse races. The exclusive right of PMU contained the taking of bets on races in France and bets in France on races abroad. The latter services could apparently also be offered by other racecourse undertakings, but only under the condition that they were authorised to do so.

One of the issues of particular interest here is that PMU seems to have been granted an exclusive position, at least with regard to taking bets on races in France and perhaps also with regard to bets in France on races abroad (which would be the result if no one else were authorised to do this). Consequently, PMU had no competitors in France in this respect and, therefore one might question how the CFI concluded that the selectivity criterion was fulfilled – a conclusion that the CFI must have reached. Otherwise, it would not have been possible for the CFI to con-

[118] Joined Cases C-72 and 73/91 Sloman Neptun Shiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887, at I-917, paragraph 61 et seq.

[119] Case 203/82 Commission *v* Italian Republic [1983] ECR 2525.

[120] Case T-67/94 Ladbroke Racing Ltd *v* Commission [1998] ECR II-1.

sider the measures in question as State aid in the first place. It seems that the only possible explanation is that the CFI considered racecourse undertakings that had not been authorised with the right to take bets on races in France and bets in France on races abroad as undertakings in objectively the same position. Otherwise it would be possible to circumvent the State aid rules by granting undertakings special or exclusive rights, an action that would be contrary to the explicit statement in Article 86(1) EC and an issue dealt with in, Section 2.7. This conclusion, moreover, seems to support the view that the selectivity criterion should be assessed on a national basis, whereas the assessment of distorted competition is to be assessed at a European level. But what would have happened if the PMU had been the sole actor on the market due to market forces? This question is further explored in Section 2.8.

2.6.4 Summary

Although four of the presumed five criteria of Article 87(1) EC are closely linked, it appears plausible that at least the advantage criterion and the selectivity criterion should be applied without connection to each other or to the criteria of distorted competition and intra-Community trade. Accordingly, the advantage criterion would be an assessment in which the situation of the recipient is compared before and after the receipt of the aid. Furthermore, the selectivity criterion is a national assessment, whereas the criterion of distorted competition seems to be an assessment pursued at the European level. Thus the criterion of distorted competition and the intra-Community trade criterion seem to be integrated. This view, however, poses an essential question: If the requirement of distorted competition is to be considered in a European perspective, what is the usefulness of the requirement in Article 87(1) EC that the measure must affect the trade between Member States? This question will not, however, be addressed in this dissertation.

2.7 State aid or public service compensation?

2.7.1 Introduction

A particular problem in the application of Article 87(1) EC occurs with regards to the funding of services of general interest. Is this funding considered to constitute State aid? This question is dealt with in Section 2.7.3. But before continuing, it is necessary to examine the concept of "services of general interest".

2.7.2 Services of general interest

Services of general interest are key elements in the European model of society, a statement that is articulated in the Commission's communications concerning services of general interest in Europe.[121] According to the communications, the new Article 16 of the EC Treaty now confirms the place of services of general interest among the shared values of the Union and their role in promoting social and territorial cohesion. The centre of Community policy on services of general interest is the interests of the citizens. The citizens demand that certain services are provided with a guarantee of universal access, high quality, and affordable prices. There are certain services that the public authorities believe that they must provide – in particular, services for which market forces alone do not provide satisfactory service. If the public authorities believe that certain services are in the general interest and that market forces do not have sufficient incentive to provide these services, the public authorities can establish a number of specific service provisions to meet the identified needs in the form of service of general interest obligations.

Under what circumstances might a service be considered to be a service of general interest? In Case C-320/91, Corbeau, the obligation to collect, carry, and distribute mail on behalf of all users throughout the territory of the Member State concerned, at uniform tariffs and under conditions of similar quality, irrespective of the specific situations or the degree of economic profitability of each individual operation was entrusted to the Régie des Postes, a legal person under public law, and was considered to be a service of general economic interest by the ECJ.[122] In Case C-393/92, Almelo, the granting of a nonexclusive concession, governed by public law, of ensuring the supply of electricity in part of the national territory was considered to be a service of general interest. In this judgment, the ECJ emphasised that an undertaking granted this kind of concession must ensure that, throughout the territory in which the concession is granted, all consumers, if local distributors or end users, receive uninterrupted supplies of electricity in sufficient quantities to meet demand at any given time, at uniform tariff rates, and on terms which may not vary, save in accordance with objective criteria applicable to all customers.[123]

[121] Commission communication on Services of general interest in Europe, OJ C 17, 19.1.2001, pp. 4–23.

[122] Case C-320/91 Criminal proceedings against Paul Corbeau [1993] ECR I-2533, paragraph 15.

[123] Case C-393/92, Municipality of Almelo and Others *v* Energiebedrijf Ijsselmij NV [1994] ECR I-1477, paragraphs 47–48.

In Case 66/86, Ahmed Saeed Flugreisen, the obligation the public authorities entrusted to an air transport carrier to operate, on routes that were not commercially viable but that were considered necessary to operate for reasons of general interest, was considered a service of general interest.[124] In Case C-159/94, Commission *v* France, the supply of electricity and gas in compliance with various public service obligations was considered to be a service of general interest.[125] In Case C-179/90, Porto di Genova, however, the organising of dock work for third parties, entrusted to dock-works undertakings established under private law, was found not to be a service of general interest.[126]

It follows from Case 127/73,[127] BRT II, and Case C-159/94,[128] Commission *v* France, that for an undertaking to be regarded as being entrusted with the operation of a service of general economic interest within the meaning of Article 90(2) of the Treaty (Article 86(2) EC), it must have been so entrusted by an act of public authority. It follows, however, from Case C-159/94, Commission *v* France, that this does not mean that a legislative measure or regulation is required.[129] In Case C-393/92, Almelo,[130] the ECJ recognised that an undertaking may be entrusted with a service of general interest through the granting of a concession governed by public law. According to paragraph 22 of the Commission communication on services of general interest in Europe, a contract between the public authority and an undertaking is sufficient for considering that the undertaking has been "entrusted" with a certain service.

According to paragraph 22, it is the Member States that are primarily responsible for defining what they regard as services of general interest, on the basis of the specific features of the activities. This definition can only be subject to control for manifest error.

The public authorities may decide to apply general interest obligations on all operators in a market, or, in some cases, to designate one or a limited number of operators with specific obligations. Pursued in this

[124] Case 66/86 Ahmed Saeed Flugreisen and Silver Line Reisebüro GmbH *v* Zentrale zur Bekämpfung unlauteren Wettbewerbs e.V. [1989] ECR 803, paragraph 55.

[125] Case C-159/94 Commission *v* French Republic [1997] ECR I-5815, paragraphs 60–67.

[126] Case C-179/90 Merci convenzionali porto di Genova SpA *v* Siderurgica Gabrielli SpA [1991] ECR I-5889, paragraph 28.

[127] Case 127/73 Belgische Radio en Televisie and Société belge des auteurs, compositeurs et éditeurs *v* SV SABAM and NV Fonior [1974] ECR 313, paragraph 20.

[128] Case C-159/94 Commission *v* French Republic [1997] ECR I-5815, paragraph 65.

[129] Case C-159/94 Commission *v* French Republic [1997] ECR I-5815, paragraph 66.

[130] Case C-393/92, Municipality of Almelo and Others *v* Energiebedrijf Ijsselmij NV [1994] ECR I-1477, paragraphs 47–48.

way, it is believed that the greatest degree of competition will occur and that users will have retained maximum freedom with regard to choice of service provider. It is stated in the Commission communication on services of general interest that, where only one or a limited number of all operators competing in a certain market are charged with public service obligations, it may be appropriate to involve all operators active in that market in the financing of the net extra cost of the service of general interest by a system of additional charges or a public service fund.[131] It appears that public voice telephony is an example of public service obligations arranged in this manner.[132]

However, according to paragraph 17 of the Commission communication, there are certain services of general interest that do not lend themselves to a plurality of providers – cases in which only a single provider can be economically viable, for example. In those cases, the public authorities usually grant exclusive and special rights for providing the service of general interest by awarding concessions for limited periods through tendering procedures. It is stated that competition at the moment of the award of tender is meant to ensure that the missions assigned to a service of general interest are met with the lowest public cost.

When neither of these two options allow for satisfactorily fulfilment of the mission of general interest, it may be necessary to combine the entrusting of a single operator or a number of operators with a particular public service task with the granting of special or exclusive rights in favour of those operators. In these situations, the public authorities may ensure appropriate funding, enabling the entrusted operator to perform the particular public service task assigned.[133] It seems that most competition problems occur when the mission of general interest is combined with the granting of special or exclusive rights and/or funding. State aid problems, in particular, seem to occur in connection with the funding.

2.7.3 Services of general interest and State aid rules

According to paragraph 19 of the Commission communication on services of general interest, Article 86 EC is the central provision for reconciling the Community objectives of competition and internal market

[131] Commission communication on Services of general interest in Europe, OJ C 17, 19.1.2001, pp. 4–23, paragraph 15.

[132] Commission communication on Services of general interest in Europe, OJ C 17, 19.1.2001, pp. 4–23, paragraph 16.

[133] Commission communication on Services of general interest in Europe, OJ C 17, 19.1.2001, pp. 4–23, paragraph 18.

freedoms, on the one hand, and the effective fulfilment of the mission of general economic interest entrusted by the public authorities on the other. Article 86 EC reads:

> 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 12 and Articles 81 to 89.
> 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.

Thus undertakings entrusted with the obligation to provide services of general interest, with or without special or exclusive rights, are, as a rule, covered by the rules of competition. Article 86(1) EC which is addressed to the Member States, provides that the Member States are obliged neither to enact nor maintain rules concerning public undertakings and undertakings to which the Member State has granted special or exclusive rights that are contrary to the rules provided for in Article 12 and 81 to 89 EC. Furthermore, Article 86(2) EC, which is addressed to the Member States and to undertakings, provides that 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 of EC Treaty, in particular those on competition. Article 86(2) EC, however, also provides for a possibility of exemption. This possibility is not be dealt with here but is covered in Section 3.3.2.3.2.

As a result of the wording of Articles 86(1) and (2) EC, the State aid rules have long been considered to apply to public and private undertakings alike, a viewpoint that was confirmed in 1994 by the Court in Case C-387/92, Banco de Crédito Industrial.[134]

As mentioned in Section 2.7.2, it is the funding of services of general interest that is of interest from a State aid perspective. Prior to 1997, the funding of services of general interest was not usually considered to con-

[134] Case C-387/92 Banco de Crédito Industrial SA, now Banco Exterior de España SA *v* Ayuntamiento de Valencia [1994] ECR I-887, paragraph 11.

stitute State aid, unless the funding did not exceed the net extra costs of the services of general interest. This type of funding was not considered to constitute an advantage in favour of the recipient. As a consequence, the Commission was not able to examine funding that it suspected would exceed the net extra costs until after the funding had already been put into effect. This view changed, however, such that all compensation was to be considered as State aid whether or not the aid was in excess of the net extra costs for the service at issue. This matter was touched upon in Case C-387/92, Banco de Crédito Industrial.[135] In Case T-106/95, FFSA and Others *v* Commission, however, in which competitors of the French La Poste alleged that the French La Poste had received unjustified fiscal benefits, the change of reasoning was confirmed.[136]

In the case in question, the Commission had considered the benefits necessary in order for La Poste to perform various public obligations. As the benefits did not fully offset the net extra costs, the Commission did not consider the benefits to constitute State aid according to Article 92 (Article 87 EC). The CFI did not agree with this approach. In paragraph 167, the Court held that: 'In principle, that tax concession constitutes State aid within the meaning of Article 92(1) since, although not taking the form of a transfer of State resources, it places La Poste in a more favourable financial situation than other taxpayers, including the companies represented by the applicants.' Thus the funding of the exercise of services of general economic interest was classified as aid and the Commission should have been notified according to Article 88(3) EC. The Commission relied on these judgments in its Communication on services of general interest in Europe.[137]

The ECJ, however, seems to have changed its view once again in Case C-53/00, Ferring, in which Ferring SA claimed that the tax on direct sales in France constituted State aid, as the tax was directed only to pharmaceutical laboratories and not to wholesalers; the wholesalers were exempted as compensation for the provision of certain public service obligations. In this case, the ECJ appears to repeat its previous practice in holding that a measure amounts to State aid only to the extent that the advantage exceeds the additional costs that the recipient bears in discharging the public service obligation imposed on them by national

[135] Case C-387/92 Banco de Crédito Industrial SA, now Banco Exterior de España SA *v* Ayuntamiento de Valencia [1994] ECR I-887, paragraph 16.

[136] Case T-106/95 Fédération Française des Sociétés d'Assurances (FFSA) and Others *v* Commission [1997] ECR II-229.

[137] Commission communication on Services of general interest in Europe, OJ C 17, 19.1.01, pp. 4–23.

law.[138] Subsequent to Case C-53/00, Ferring, the ECJ handed down its judgment in Case C-280/00, Altmark,[139] which was described in Section 2.4.4.2. As mentioned, the ECJ's ruling articulated four criteria of public services, which, if all the criteria were met, meant that compensation for these public services was considered to be public compensation and not State aid. The four criteria were:

1) that the recipient undertaking is actually required to discharge public service obligations and those obligations have been clearly defined;
2) that the parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner;
3) that the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations; and
4) that, where the undertaking of discharging public service obligations is not chosen in a public procurement procedure, the level of compensation required has been determined on the basis of an analysis of the costs which a typical undertaking, well run and adequately provided with means of transport, so as to be able to meet the necessary public service requirements, would have incurred in discharging those obligations, taking into account the relevant receipts and a reasonable profit for discharging the obligations.

Thus if all these requirements are met, the compensation to an undertaking pursuing public service obligations would not be considered as State aid according to Article 87(1) EC and would, therefore, not fall under the notification obligation provided for in Article 88(3) EC. However, if it cannot be established that all four requirements are met, the funding would be considered as State aid, which would require prior notification to the Commission and would require justification pursuant to Article 86(2) EC. As already mentioned, Article 86(2) EC is discussed in Section 3.3.2.3.2.

The method of applying the Altmark conditions to determine if certain compensation is to be classified as State aid was reaffirmed by the

[138] Case C-53/00 Ferring SA *v* Agence centrale des organismes de sécurité sociale (ACOSS) [2001] ECR I-9067, paragraph 29.

[139] Case C-280/00 Altmark Trans GmbH and Regierungspräsidium Magdeburg *v* Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747, paragraphs 89–93.

ECJ in Case C-34/01 to C-38/01, Enirisorse. In this case, Enirisorse brought an action against the Ministry of Finance in Italy and challenged orders made by the Ministry to pay certain port charges. According to Italian Law, the "Aziende", public undertakings under the supervision of the Merchant Navy Ministry were responsible for the management of mechanical loading and unloading equipment, storage areas, and other real and personal property owned by the State and used for the movement of goods. The financial means that were available to the Aziende included the receipts from the property they managed and the income they received for their commercial activities, such as the loading and unloading of goods and some financial transactions. All the operating costs were born by the Aziende itself, but the costs of installing new plants, i.e. new Aziende, was normally borne by the Merchant Navy Ministry. Charges on the loading and unloading of goods were introduced in all Italian harbours in 1974.

Enirisorse had loaded and unloaded domestic and foreign goods in the harbour of Cagliari without making use of the Aziende operating in that port and was, nonetheless, ordered to pay port charges. Enirisorse brought an action to the Tribunale de Cagliari, claiming that the orders were contrary to Community law. The action was dismissed and appealed to the Corte di Appello di Cagliari. This time the action was rejected and Enirisorse brought an appeal in cassation. The Corte Suprema de Cassazione stayed the proceedings and asked the ECJ for a preliminary ruling. The decisive question was, in essence, whether or not the measure by which a Member State allocates to a public undertaking a significant proportion of charges, such as the port charges at issue, constituted State aid within the meaning of Article 92 of the Treaty (Article 87 EC). In dealing with this issue, the ECJ first assessed all the criteria of Article 87(1) EC and then assessed the Altmark conditions. The ECJ did not find the Altmark conditions to be fulfilled and thus classified the measure as State aid.[140] It appears that the Commission also applied the method of assessing the Altmark conditions to determine if a certain measure may be classified as State aid in several recent decisions.[141]

According to Article 86 EC, the Commission, in accordance with Article 86(3) EC, is obliged to ensure that the application of Article 86(1) and (2) EC and should, where necessary, address appropriate directives or decisions to Member States. The Commission has taken this opportu-

[140] Joined Cases C-34/01 to C-38/01 Enirisorse SpA *v* Ministero della Finanze of 27 November 2003, paragraphs 25–40.

[141] Rapp-Jung, pp. 27–29.

nity and has articulated a draft decision[142] which was discussed at a multilateral meeting in February 2004. The Commission proposes that, in cases of public funding constituting State aid with regard to the Altmark conditions, the Commission does not have to be notified, providing that the funding consists of small amounts and the undertaking providing the service of general interest has a limited turnover. Reference is also made to Commission Regulation (EC) No 69/2001 on *de minimis* aid.[143] In that decision, the Commission also suggests that hospitals and social housing undertakings entrusted with services of general interest should benefit from exemption from notification irrespective of the level of their turnover and the level of compensation. The decision has yet not been adopted and, thus, its final content is yet to be revealed.

2.8 Concluding remarks

Article 87(1) contains the criteria for assessing if measures are to be classified as State aid. Because there is no definition of what constitutes State aid, the State aid concept is dynamic and all-embracing. Presumably, Article 87(1) EC consists of five criteria: 1) the measure must be granted by a Member State or through State resources; 2) it must constitute an advantage for the recipient; 3) it must distort or threaten to distort competition, actually or potentially; 4) it must be selective; and 5) it must affect trade between Member States. If all these criteria are met, the measure is classified as State aid according to Article 87(1) EC. For several reasons four of the five criteria appear to be closely connected and difficult to distinguish from one another. As the central question posed in this dissertation concern how the selectivity criterion is assessed to taxes, it is necessary to at least try to make a distinction between the various criteria.

It appears that the advantage criterion is an assessment in which the situation of the undertaking itself should be compared before and after the granting of the aid. Thus it seems that it is the situation of the recipient that is of interest in this assessment and not the situation of the recipient's competitors. Moreover, the examination seems to provide arguments for the view that the selectivity criterion is a purely national assess-

[142] Commission Decision on the application of Article 86 of the Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, available at http://europa.eu.int/comm/competition/state_aid/others/

[143] Commission Regulation (EC) No 69/2001.

ment, whereas the criterion of distorted competition is an assessment pursued on the European level. Thus it appears that the criterion of distorted competition and the criterion of intra-Community trade are treated together. Moreover, it has been clarified that the criteria of Article 87(1) EC are cumulative.

Assuming that all these conclusions are correct, at least two questions remain. First, what is the purpose of the intra-Community trade criterion if the criterion of distorted competition is pursued on the European level and inter-mixed with the intra-Community trade criterion? Second, if all the criteria of Article 87(1) EC are cumulative and the assessment of the selectivity criterion is a purely national assessment, could the selectivity criterion be upheld in a global economy that creates new market structures? The question posed in Section 2.6.3 should be read in this context: What would have happened if PMU had been the sole actor in the market with regard to its racecourse betting activities due to market forces?

The ECJ's judgment in Case C-280/00, Altmark, may present a good example.[144] In this case, the ECJ held that it is not impossible that a public subsidy granted to an undertaking which provides only local or regional transport services and does not provide any transport services outside its State of origin may nonetheless have an effect on trade between Member States, as the supply of transport services by the recipient may, for that reason, be maintained or increased with the result that undertakings established in other Member States have less chance of providing their transport services in the market in that Member State. Moreover, the ECJ held that this finding was not merely hypothetical, as, beginning in 1995, several Member States opened certain transport markets for competition from undertakings established in other Member States. So a number of undertakings are already offering their urban, suburban, or regional transport service in Member States other than their State of origin.[145]

Some 20 years ago, the urban, suburban, or regional transport service in a Member State was performed by publicly owned companies. In the early years after privatisation, these services were provided by local undertakings. Thus from a State aid perspective, the provision of these services was believed to be a local matter and one that was not considered to affect intra-Community trade or to be a question of State aid. Today

[144] Case C-280/00 Altmark Trans GmbH and Regierungspräsidium Magdeburg *v* Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747.

[145] Case C-280/00 Altmark Trans GmbH and Regierungspräsidium Magdeburg *v* Nahverkehrsgesellschaft Altmark GmbH [2003] ECR I-7747, paragraphs 77–79.

there is an international market featuring multinational undertakings competing to provide these services. Although there may still exist local undertakings willing to provide these services, it must be questioned whether or not they could be considered to be undertakings in objectively the same situation? In other words, would it be possible to consider that the selectivity criterion would be fulfilled in a case like that? On the other hand, the aid granted no doubt threatens to distort competition on a European level if there are European competitors. Thus the question is: Is it possible to uphold the requirement that all criteria of Article 87(1) EC are cumulative in the current development toward a global economy, given that the selectivity criterion is a purely national assessment? Neither of the questions posed here are addressed in this dissertation, but are posed as general questions in the context of the overview provided of the criteria of Article 87(1) EC.

3 Procedure, exemptions, and categorisation

3.1 Introduction

The classification of a measure as State aid according to Article 87(1) EC is of great importance because it triggers several rules of State aid procedures. Therefore the most important procedural rules connected to the classification of a measure as State aid is discussed in Section 3.2 below.

Once the Commission has been notified about a measure, it is up to the Commission to determine if the measure can be classified as aid according to Article 87(1) EC and if the measure is or can be considered to be compatible with the common market. In order to assess if a measure is or may be considered to be compatible with the common market, the exemptions provided for by the EC Treaty are essential. Article 87 EC, paragraphs 2 and 3 provides for exemptions. Four of the exemptions provided for in Article 87(3) EC may be granted by the Commission, whereas Article 87(3)(e) and Article 88(2) EC empowers the Council to exempt aid under certain circumstances.

There are other provisions for exemptions in the Treaty. Article 86(2) EC provides for an exemption for aid granted to undertakings entrusted with the operation of services of general economic interest or undertakings having the character of a revenue-producing monopoly; Article 120 EC refers to aid dealing with crises in the balance of payments and Articles 296-298 EC refers to aid to national defence. These exemptions will be further discussed in Section 3.3.

In the assessment of a measure's acceptance, at least in accordance with Article 87(3) EC, it is necessary for the Commission to categorise the relevant measure in various ways, some of which are dealt with in Section 3.3.2.2.8, in connection with the discussion of exemptions provided for in Article 87(3) EC.

3.2 Procedure

3.2.1 Introduction

Once a measure has been classified as State aid under to Article 87(1) EC, the Member State is obliged to notify the Commission in sufficient time for the Commission to submit its comments before the measure is due to be adopted or enforced. The Member State is further obligated to await the final decision of the Commission before it puts its proposed measure into effect (the standstill clause). These obligations follow from the first and third sentence of Article 88(3) EC.

The Commission is able to make three different types of decisions after a preliminary examination of the measure in question: 1) that the measure is not considered as constituting aid because one or several of the criteria made account for in Chapter 2 is not met – a decision that the Commission should record by way of a decision; 2) that the Commission finds that no doubts are to be raised as to the measure's compatibility with the common market, requiring that it be established through a decision that the measure does fall within the scope of Article 87(1) EC but has been found to be compatible with the common market in accordance with any of the exemptions provided for by the Treaty; and 3) that the Commission finds that doubts are raised about compatibility with the common market of the notified measure. In the latter case, the Commission should decide to initiate the procedure provided for in Article 88(2) EC.

The Commission is obliged to make one of these three types of decisions within two months of the day following the receipt of a complete notification.[1] As it is the Commission alone that determines when a notification is considered to be complete, it may take several months before a decision is made. The notification will, however, be considered complete if, within two months of its receipt or of the receipt of any additional information requested, the Commission requests no further information. The wait for a final decision is extended even further when the Commission decides to initiate the procedure provided for in Article 88(2) EC.

The procedure provided for in Article 88(2) EC is initiated by a decision in which the Commission summarises the relevant issues of fact and law. Moreover, in this decision the Commission also provides for a preliminary assessment to the effect that the measure is, indeed, aid, and further assesses any doubts as to the compatibility of the measure with the common market. The decision should call upon the Member States

[1] Article 4 (5) of Council Regulation (EC) No 659/1999.

concerned and upon other interested parties to submit their comments within a prescribed period.[2]

The Article 88(2) EC procedure is completed by means of one of four decisions. 1) The Commission makes a decision, following the modifications of a Member State, to no longer consider the measure as constituting State aid. 2) The Commission, after modifications made by the Member State, considers that any doubts have been removed as to the compatibility of the notified measure with the common market. In this case the Commission would make a decision to accept the measure in accordance with exemptions provided for in the EC Treaty (a positive decision). 3) The Commission places conditions on a positive decision – conditions which must be fulfilled in order for the aid to be accepted under one of the exemptions provided for by the EC Treaty. These conditions may dictate obligations to enable compliance with the decision to be monitored (conditional decisions). 4) The Commission makes a negative decision, in which it finds that the aid is not compatible with the common market.

3.2.2 The obligation to notify

The scope of the notification requirement provided for in the first sentence of Article 88(3) EC has been debated over the years. Earlier the Commission took the view that the notification requirement in Article 88(3) EC applied to all measures which could possibly involve State aid. Due to the adoption of Council Regulation No 994/98,[3] this view has now changed. In Article 2 of Council Regulation No 994/98, the Commission is empowered to decide that certain aid does not meet the criteria of Article 87(1) EC and is therefore exempt from the notification requirements (*de minimis* aid). According to Sinnaeve and Slot, the wording "therefore" suggests that if all the conditions of Article 87(1) EC are not effectively fulfilled, the measure is not covered by the notification requirement in Article 88(3) EC. The view that the scope of Article 87(1) EC is identical to the scope of the first sentence of Article 88(3) EC was, moreover, confirmed by the adoption of Council Regulation 659/1999,[4] as Article 2 explicitly limits the notification requirement to "plans to grant new aid" – aid being defined in Article 1(a) as "any measure fulfilling all the criteria laid down in Article 87(1) of the Treaty".[5]

[2] Article 6(1) of Council Regulation (EC) No 659/1999.

[3] Council Regulation (EC) No 994/98.

[4] Council Regulation (EC) No 659/1999.

[5] Sinnaeve and Slot, p. 1163.

Besides empowering the Commission to decide that certain aid does not meet the criteria of Article 87(1) EC, Council Regulation No 994/98 contains a delegation to the Commission to adopt Commission Regulations in accordance with rules set out in the Council Regulation No 994/98 with regard to certain categories of horizontal aid, i.e. aid eligible to all economic sectors. Thus the Commission may, in accordance with Article 1 of Council Regulation 994/98, adopt regulations in which it is declared that the aid should be compatible with the common market and should therefore not be subject to the notification requirements in Article 88(3) EC:

(a) aid in favour of :
  (i) small and medium-sized enterprises;
  (ii) research and development;
  (iii) environmental protection;
  (iv) employment and training aid; and

(b) aid that complies with the map approved by the Commission for each Member State for the grant of regional aid.

Article 2 of the same regulation provides that the Commission may adopt a Commission Regulation also with to *de minimis* aid.

At present the Commission has adopted four enabling regulations:

1) Commission Regulation No 68/2001 regarding training aid,[6]
2) Commission Regulation No 69/2001 regarding *de minimis* aid,[7]
3) Commission Regulation No 70/2001 on aid to small and medium-sized companies,[8] and
4) Commission Regulation No 2204/2002 covering State aid to employment.[9]

Thus an aid measure that falls within the scope of any of these enabling regulations falls outside the notification requirement.

[6] Commission Regulation (EC) No 68/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to training aid, OJ L 10, 13.1.2001, pp. 20–29.

[7] Commission Regulation (EC) No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to de minimis aid, OJ L 10, 13.1.2001, pp. 30–32.

[8] Commission Regulation (EC) No 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to small and medium-sized enterprises, OJ L 10, 13.1.2001, pp. 33–42.

[9] Commission Regulation (EC) No 2204/2002 of 12 December 2002 on the application of Articles 87 and 88 of the EC Treaty to State aid for employment, OJ L 337, 13.12.2002, pp. 3–14.

3.2.3 The consequences of not notifying

In a situation in which a Member State, whether deliberately or not, has refrained from notifying the Commission or acted in contravention of the standstill clause, the aid is considered "unlawful".[10] The procedure for unlawful aid resembles the procedure for notification, but provides for several additional instruments.

As the Commission has not received notification of the measure or the Member States have acted without the acceptance of the Commission, the Commission must rely upon information reached by the Commission *ex officio*, by way of a complaint or as a result of cooperation between national courts and the Commission.[11] Although the Commission is not bound by the time limits of Article 88(3) and 88(2) procedures of 2 and 18 months respectively, the Commission, according to Sinnaeve and Slot, should respect a reasonable time limit in all cases of unlawful aid.[12] In dealing with unlawful aid the Commission has the power to apply three types of injunctions: an information injunction, an injunction to suspend any unlawful aid until the Commission has made a decision about the compatibility of the aid to the common market, or, if the aid has already been paid, an injunction to provisionally recover the aid.[13]

When the Commission concludes an investigation of unlawful aid with a negative decision, it should decide, in accordance with Article 14 of Council Regulation No 659/1999, that the Member State concerned should take all necessary measures to recover the aid from the beneficiary. However, the Commission should however not require recovery of the aid if recovery would be contrary to a general principle of Community law.

The last sentence of Article 88(3) EC has direct effect, and thus requires that individual rights are upheld by the national courts.[14] In Case 120/73, Lorenz, the ECJ held that the immediately applicable nature of the prohibition on implementation provided for in the last sentence of Article 88(3) EC extends to the whole of the period to which it applies.[15] That is to say that the direct effect of the prohibition extends to all aid which has been implemented without notification and, in the event of notification, operates during the preliminary period; and, in

[10] Article 1(f) of Council Regulation (EC) No 659/1999.

[11] Sinnaeve and Slot, p. 1175.

[12] Ibid, p. 1177.

[13] Articles 10 and 11 of Council Regulation (EC) No 659/1999.

[14] Case 67/64 Flaminio Costa v ENEL [1964] ECR 585, p. 596.

[15] Case 120/73 Gebr. Lorenz GmbH *v* Federal Republic of Germany and the land Rheinland/Pfalz [1973] ECR 1471.

cases in which the Commission has initiated the procedure provided for in Article 88(2) EC, up to the final decision.

Furthermore, in Case C-354/90, Fédération Nationale, the ECJ emphasised that the national courts are obliged to offer individuals in a position to rely on a breach of the notification requirement the certain prospect that all the necessary inferences will be drawn, in accordance with their national law, as regards the validity of measures giving effect to the aid, the recovery of financial support granted in disregard of that provision, and possible interim measures.[16]

The principle that the State is liable for damages inflicted on individuals as a result of breaches of EC law for which it can be held responsible is inherent in the system of the EC Treaty.[17] Accordingly, the State has been considered to be responsible for claims for damages brought in respect of unlawfully granted aid.[18]

Thus the consequences of not notifying the Commission or of acting in contravention of the "stand still clause" or of a negative decision may cause unpleasant surprises for both the Member State and the beneficiaries of the aid.

3.2.4 The dilemma of the Member States

As mentioned in Section 3.2.2, the scope of Article 87(1) EC is identical to the scope of the first sentence of Article 88(3) EC. The absence of a definition of State aid, however, makes it difficult for the Member States to foresee when an aid measure falls within the scope of Article 87(1) EC. Therefore the Member States must keep informed about the development of the notion in the Commission's case practice and in the case law by the ECJ and the CFI. The risk remains, however, that the Commission or a national court will eventually decide that a certain aid measure is to be considered State aid according to Article 87(1) EC. Only by notifying the Commission in advance, therefore, can a Member State attain certainty about the status of a certain measure, and thereby protect the interest of the beneficiaries.

[16] Case C-354/90 Fédération Nationale du Commerce Extérieur des Produits Alimentaires and Syndicat National des Négociants et Transformateurs de Saumon *v* French State [1991] ECR I-5505, paragraph 12.

[17] Joined Cases C-6 and 9/90 Andrea Francovich and Danila Bonifaci and Others *v* Italian Republic [1991] ECR I-5357, paragraph 35.

[18] AG Tesauro in Case 142/87 Belgium *v* Commission [1990] ECR I-959, at p. I-985; AG Jacobs in Case C-39/94, Syndicat Français de l'Express International (SFEI) and Others *v* La Poste and Others [1996] ECR I-3547, at p. I-3573. For further reading see, for example, Quigley and Collins, pp. 373–381.

3.3 Article 87(1) – not an absolute prohibition

3.3.1 Introduction

As mentioned in Section 1.1, Article 87(1) EC is not an absolute prohibition. It is the Commission, and in some cases the Council, that has been empowered to decide if an aid or aid scheme may or must be considered compatible with the common market. The Commission has the authority to grant exemption according to Article 87(2) and 87(3)(a) to (d) EC, Articles 86(2) EC, 120 EC and 296 EC, whereas the Council's power to grant exemption is provided for in Article 87(3)(e) EC and in Article 88(2) EC, sub-paragraph 3.

Article 87(2) EC entails that:

> 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.

Moreover, in Article 87(a) to (d) EC, it is stated that:

> 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;
> (d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest; ...

According to Schina, the wording "shall be compatible" in Article 87(2) EC, as opposed to "may be compatible" in Article 87(3) EC, as well as the Court's judgment in Case 730/79, Philip Morris *v* Commission,[19]

[19] Case 730/79 Philip Morris Holland B.V. *v* Commission [1980] ECR 2671, paragraph 17.

indicates that aid fulfilling the conditions in the second paragraph are compatible with the common market *de jure*, whereas the exemptions in Article 87(3) EC are discretionary. According to Schina, the Commission has no discretion to refuse its authorisation once it has established that the Member State concerned has correctly interpreted the technical conditions for the application of the second paragraph and the proposed aid actually is of the kind provided for in the paragraph.[20] Schina has emphasised that the Member State concerned would have the right to bring the matter before the Court, according to Article 173 of the Treaty (Article 230 EC) if the Commission refused to authorise a plan of aid falling within the scope of Article 87(2) EC. Schina's interpretation – that the Commission can refuse its authorisation according to the second paragraph if the aid measure in question infringes other provisions of the Treaty – seems reasonable, especially in the light of the principle established by the Court and mentioned by Schina: that exceptions to general Community rules and derogation from Treaty obligations must be interpreted restrictively.[21]

It could, and, in fact, has been debated whether or not aid measures, which are automatically compatible with the common market actually require notification to the Commission. According to the Commission, however, and supported by Schina and by Hancher, Ottervanger and Slot, these aid measures are covered by the notification requirement in Article 88(3) EC.[22]

The authority of the Council to grant exemptions follows from Article 87(e), in which it is stated that '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' may be considered compatible with the common market. Moreover, according to Article 88(2) EC, sub-paragraph 3, the Council may '[o]n 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 87 or from the regulations provided for in Article 89, if such a decision is justified by exceptional circumstances ...'.

This section, Section 3.3, begins with an account of the exemptions that may or must be granted by the Commission 1) in accordance with Article, 87(2) EC; 2) in accordance with Article 87(3) EC; and 3) in

[20] Schina, p. 38.

[21] For further reading, see Schina, p. 38.

[22] Competition Law in the European Communities, Vol. IIB, Situation in December 1996, p. 11; Schina, p. 38; Hancher, Ottervanger & Slot, pp. 69–70.

accordance with provisions elsewhere in the Treaty. Section 3.3 ends with an account of the exemptions that may be granted by the Council.

All exemptions provided for by the Treaty have one thing in common: They reflect the idea of promoting Community objectives other than the maximisation of competition. Considered against that background, they all can be seen as providing for the authorisation of aid which will promote Community objectives. This aim should be kept in mind when discussing the discretionary powers of the Commission in Section 3.3.2.2.2.

3.3.2 Exemptions granted by the Commission

3.3.2.1 Aid measures compatible with the common market de jure

Article 87(2) EC provide for the following provisions.

3.3.2.1.1 Article 87(2)(a) – Aid having social character

According to Article 87(2)(a), aid shall be exempted if it has a social character granted to individual consumers, provided that the aid is granted without discrimination related to the origin of the products concerned. The application of this exemption raises at least two questions: When is the aid of social character? What does "individual consumer" mean? Schina has suggested that aid of social character is aid to products like clothes, foodstuffs, and fuel that relate to the standard of living of the recipients. However, the aid may not be linked to quantities.[23] Apparently, the Commission has considered that a German measure designed to give tax relief to individual consumers purchasing cars fitted with pollution reduction devices could be exempt according to Article 87(2)(a).[24] Consequently, consumer issues relating to the environment may be considered to be of a "social character".[25]

The condition that the aid shall be addressed to individual consumers seems to mean that it is essential that the aid is addressed *directly* to the consumer. In Case 52/76 Benedetti *v* Munari, it seems that the Italian Government had purchased wheat on the world market and had subsequently authorised AIMA (State Co-operative for Intervention on the Agricultural Market) to resell the wheat on the Community market below the market price. It appears that AIMA could maintain low prices as a result of State funding. The object was to reduce the price of bread for

[23] Schina, p. 40.

[24] Hancher, Ottervanger and Slot, p. 70.

[25] D'Sa, p. 129.

consumers in Italy. However, this aid was not found to be compatible with the common market under Article 87(2)(a), as the measure was found not to subsidise the consumers directly but rather to give an advantage to the milling enterprises.[26] According to Schina, as a general rule, Article 87(2)(a) will not be applicable in situations of price subsidies benefitting the entire population. However, the provision may be applicable in exceptional cases, when the extent of the social problem requires it or when it is impossible to apply the aid more selectively.[27]

3.3.2.1.2 Article 87(2)(b) – Aid to natural disasters

According to Schina, the exemption in Article 87(2)(b) means that aid which merely establishes the competitive position of undertakings that has deteriorated because of natural disasters or other extraordinary events shall be considered compatible with the common market *de jure*. Accordingly, the aid must be of an appropriate amount to repair the damages sustained, but may not go beyond this amount. Preventive aid measures that have been implemented in order to avoid natural disasters do not fall under this provision. The issue that is dealt with next concerns the meaning of the terms "natural disasters" and "exceptional occurrences".

Natural disasters

According to Schina, "natural disasters" within the meaning of this provision are extraordinary environmental phenomena with serious consequences, such as floods, droughts, tornadoes, forest fires, earthquakes, volcanic eruptions, or plant and animal diseases of catastrophic proportions.[28] Assistance provided in Liguria for repairs and reconstruction that were required as a result of the floods in 1977 and low-interest loans and subsidies to Friuli-Venezia Giulia for the reconstruction of industrial plants destroyed by the 1976 earthquake are two examples provided by Wyatt and Dashwood.[29] The Commission also decided to approve aid for firms in the areas of Italy that were worst hit by the 1997 earthquake.[30]

[26] Case 52/76 Luigi Benedetti *v* Munari F.lli s.a.s. [1977] ECR 163, at 190, cited in Schina, p. 39.

[27] Schina, p. 39.

[28] Ibid, p. 41.

[29] 8th report on competition policy, 1978, point 164, cited in Wyatt and Dashwood, p. 689.

[30] Commission Decision concerning Case N 784/99 of 2 May 2000 regarding *Aumento degli stanziamenti previsti per gli aiuti d'urgenza a favore delle zone colpite dal sisma del 1997*, SG(2000) D/103395, 30th report on competition policy, 2000, p. 251, point 4.8.

On 17 October 1999 the Commission decided to approve a temporary aid scheme for small and medium-sized French enterprises which had suffered serious damages in the storms of 26 and 28 December 1999 or as a result of the oil spill caused by the wreck of the oil tanker Erika.[31] The oil spill was considered to be an "exceptional occurrence", a phenomenon that is discussed in greater detail under the next heading.

The Commission also decided to apply the label of "natural disaster" when it granted aid under Article 87(2)(b) EC, in order to make good the damage caused in the Netherlands as a result of heavy rains (at least 100 mm in two days) that had caused floods in "polder" areas, i.e. areas of heavy clay situated below sea level, rendering natural draining of the water more difficult. The combination of strong winds from the sea pushing more water inwards towards the land and a breakdown in the water management system in the region convinced the Commission to approve the aid under Article 87(2)(b) EC.[32] Moreover, in Commission Decision 2004/89/EC concerning an aid scheme implemented in Italy for natural disasters, the Commission accepted the Italian legislation containing various aid measures designed to compensate farmers for the damage caused by natural disasters and adverse weather events; these measures were considered to be compatible with the common market under Article 87(2)(b) EC.[33]

Exceptional occurrences

As mentioned by Wyatt and Dashwood, the notion of "exceptional occurrences" may appear to be a vague one.[34] Bellamy and Child's suggestion that this phrase could include acts of God and war may be enlightening to some people but not to others.[35] According to Schina, however, "exceptional occurrences" include war, serious internal political disturbances, explosions, and catastrophic mine accidents. Schina also believes that damages suffered because of the Second World War, although it may seem far-fetched, or because of social or racial persecution are occur-

[31] Commission Decision concerning Case NN 62/2000 of 17 October 2000 regarding *Régime temporaire d'aides aux enterprises victimes des intempéries et de la marée noire*, SG(2000) D/107589, 30th report on competition policy, 2000, p. 251, point 4.8.

[32] Commission Decision concerning Case NN 136/98 regarding aid for natural disaster in the Netherlands, 29th report on competition policy, 1999, p. 247–248.

[33] Commission Decision 2004/89/EC of 9 July 2003 on the aid scheme implemented by Italy for natural disasters up to 31 December 1999, OJ L 31, 4.2.2004, pp. 1–20.

[34] Wyatt and Dashwood, p. 689.

[35] Bellamy and Child, (1993), p. 920. This explanation was not repeated in the 5th edition published in 2001.

rences that should be exempted on the basis of this Article. Another situation mentioned by Wyatt and Dashwood, which presumably would be covered by this phrase, is the repair of business premises damaged by acts of political terrorism.

Aid measures provided in order to handle economic difficulties probably fall within the scope of Article 87(3)(b) rather then under Article 87(2)(b). In recent years Article 87(2)(b) EC has been used as a basis for the Commission to approve aid to undertakings in the agricultural sector which have been damaged by the dioxin and BSE crises. In 1999 and 2000 the Commission authorised aid to producers and firms hit by the crisis sparked by the dioxin contamination of animal feeds.[36] In 2001 the Commission decided to accept aid that would make good the damage caused by the BSE crisis to beef farmers in Austria, Belgium, France, Germany, Italy, and Spain.[37]

3.3.2.1.3 Article 87(2)(c) – Aid to the economy of certain areas of the Federal Republic of Germany

The third automatic exemption was introduced in order for the former West Germany to safeguard its right to assist areas of the country affected by the Second World War and the subsequent division of Germany.

[36] Commission Decision concerning Cases NN 87/99, NN 88/99, NN 89/99, N 380/99 and N 386/99 of 20 July 1999 regarding aid to Belgium, 29th report on competition policy, 1999, p. 237, OJ C 253, 4.9.1999, pp. 14–15; Commission Decision concerning Cases N 510/99, N 511/99 and N 512/99 of 29 September 1999 regarding aid to Belgium, 29th report on competition policy, 1999, p. 237; OJ C 326, 13.11.1999, p. 10 and Commission Decision concerning Case N 770/99 of 18 January 2000 regarding aid to Belgium, 30th report on competition policy 2000, p. 221.

[37] Commission Decision concerning Case NN 58/2001 of 25 July 2001 regarding aid to Austria, 31st report on competition policy, 2001, p. 270; Commission Decision concerning Cases N 437/2001 and N 657/2001 of 7 November 2001 regarding aid to Belgium, 31st report on competition policy, 2001, p. 270; Commission Decision concerning Case NN 46/2001 of 25 July 2001 regarding aid to France, 31st report on competition policy 2001, p. 270; Commission Decision concerning Cases N 193/2001, N 170/2001, N 164/2001 and N 248/2001 of 25 July 2001 regarding aid to Germany, 31st report on competition policy, 2001, pp. 270–271; Commission Decision concerning Case N 150/B/2001 of 2 October 2001 regarding aid to Germany, 31st report on competition policy, p. 271; Commission Decision concerning Case N 249/2001 of 30 October 2001 regarding aid to Germany, 31st report on competition policy, 2001, p. 271; Commission Decision concerning Case N 113/A/2001 of 25 July 2001, regarding aid to Italy, 31st report on competition policy, 2001, p. 271; Commission Decision concerning Case N 411/2001 of 30 October 2001 regarding aid to Italy and Commission Decision concerning Cases N 269/2001 and N 377/2001 of 25 July 2001 regarding aid to Spain, 31st report on competition policy 2001, pp. 270–271.

Apparently, Article 87(2)(c) EC originally applied to aid for areas in the Zonenrandgebiet (an area of West Germany bordering the East), as well as for West Berlin.[38] Soon after the reunification of Germany on 3 October 1990, the Commission took the view that there would be no further economic justification for continuing to subsidise these areas.[39] One may wonder why the Article still stands. According to Hancher, Ottervanger, and Slot, a proposal to delete Article 92(2)(c) (Article 87(2)(c) EC) completely from the Treaty of Union was dropped, and up until the time of this writing, no further amendments have been introduced.

It has been argued, however, that aid granted after the political unification but with respect to economic circumstances existing before that date may qualify for exemption according to Article 87(2)(c) EC.[40] From the analyses made by D'Sa and by Hancher, Ottervanger, and Slot, it follows that the Article in question actually has been applied after the reunification: the Commission's decision in Daimler Benz serves as one of these examples.[41] In this decision the Commission recognised that Daimler Benz had made its intention to invest in a major site in the former West Berlin in 1988, 12 months before the political unification. The Commission decided to apply Article 92(2)(c) (Article 87(2)(c) EC) to the procedure of arriving at a value for the site in question in so far as that procedure reflected the additional real economic costs, which arose because of the location of the site. Consequently, the aid to offset these real economic costs was justified on the basis of Article 92(2)(c) (Article 87(2)(c) EC). The remaining aid element, i.e. the reduced price for the land was considered in the light of Article 92(3)(c) (Article 87(3)(c) EC), however, and was not authorised by the Commission.

Member States have argued without success that Article 87(2)(c) should have been applicable.[42] In Commission Decision 94/1068/EC regarding investment aid to the Volkswagen Group in the new Länder, for example, the Commission initiated a procedure according to Article 93(2) (Article 88(2) EC) in respect of the aid measure proposed by the German authorities. Among other things the German authorities argued that the aid measures should be exempted in accordance with Article 92(2)(c) (Article 87(2)(c) EC). They argued that despite the fact that Germany was unified on 3 October 1990, the new Länder still suffered from eco-

[38] Schina, pp. 41–43.

[39] 20th report on competition policy, 1990, point 178.

[40] Hancher, Ottervanger and Slot, p. 71.

[41] Commission Decision 92/465/EEC of 14 April 1992 concerning aid granted by the Land of Berlin to Daimler-Benz AG Germany OJ L 263, 9.9.1992, pp. 15–25.

[42] For further reading, see Hancher, Ottervanger and Slot, pp. 70–72; D'Sa, pp. 130–133.

nomic disadvantages resulting from the division of Germany. The Commission responded by saying that '[t]he exemption provided for in Article 92(2)(c) must be interpreted strictly ...'.[43] The Commission continued to hold that it considered the derogation provided for in Article 92(3)(a) and (c) (Article 87(3)(a) and (c) EC) and the Community framework on State aid to the motor vehicle industry to be sufficient to deal with the difficulties faced by the new Länder. The Commission's view that Article 92(3)(c) (Article 87(3)(c) EC) was to be applied to exempt aid to the new Länder had already been emphasised in 1991, when several aid measures to the new Länder were exempted on the basis of that provision.[44]

Thus the question is: Is Article 87(2)(c) EC obsolete? According to the CFI in the judgment in Joined Cases C-57/00P and C-61/00P, Freistaat Sachsen and Others *v* Commission, the answer to this question is no. The CFI emphasised that Article 87(2)(c) EC was far from being implicitly repealed following the German reunification, as the provision had been retained by both the Maastricht Treaty concluded on the 7 February 1992 and the Amsterdam Treaty concluded on 2 October 1997. The CFI added that an identical provision had been inserted into Article 61(2)(c) of the EEA Agreement. Thus the CFI claimed that ... 'it cannot therefore be assumed that that provision has become devoid of purpose since the reunification of Germany, ...'[45] The CFI argued that the interpretation of a provision of Community law necessitates not only an examination of the provision's wording but also an examination of the context in which the provision occurs and the aims of the rules of which the relevant provision forms part. Thus in interpreting Article 87(2)(2) EC, it must be taken into account that the phrase "division of Germany" refers historically to the establishment of the dividing line between the two zones in 1948. The CFI concludes:

> ... Therefore, the economic disadvantages caused by that division can only mean the economic disadvantages caused by the isolation which the establishment or maintenance of that frontier entailed, such as, for example, the encirclement of certain areas (see the Daimler-Benz decision), the breaking of communication links (see the Tettau Decision), or the loss of the nat-

[43] Commission Decision 94/1068/EC of 27 July 1994 concerning aid granted to the Volkswagen Group for investments in the new German Länder, OJ L 385, 31.12.1994, pp. 1–13.

[44] 21st report on competition policy, 1991, point 181.

[45] Joined Cases C-57/00P and C-61/00P Freistaat Sachsen, Volkswagen AG and Volkswagen Sachsen GmbH *v* Commission of 30 September 2003.

[46] Joined Cases C-57/00P and C-61/00P Freistaat Sachsen, Volkswagen AG and Volkswagen Sachsen GmbH *v* Commission of 30 September 2003.

ural markets of certain undertakings, which therefore need support, either to be able to adapt to new conditions or to be able to survive that disadvantage ...[46]

Against this background, it seems that Article 87(2)(c) is still, in fact, applicable, but only in very specific situations.

However, it appears that the very existence of this provision still may be questioned against the background that, according to Schina, Article 87(2)(c) EC was superfluous from the beginning, as the situations it aimed to cover would have been considered under "exceptional occurrences" and would have been exempted according to Article 87(2)(b) in any case.[47]

3.3.2.2 Discretionary derogations

3.3.2.2.1 Introduction

This section focuses on the authority of the Commission and the exemptions it may grant under Article 87(3) EC. Before considering the exemptions, however, the discretionary powers of the Commission are examined.

3.3.2.2.2 The discretionary powers of the Commission

According to well established case law, the Commission enjoys a wide discretion under Article 87(3) EC, which involves assessments of an economic and social nature. These assessments must be made within a Community context, however.[48] But how wide is this discretion? And what is meant by the requirement that the assessments must be made in a Community context?

The connection between the discretionary powers of the Commission under Article 87(3) EC and the reference to a Community context is often referred to as the principle of *compensatory justification*. However, the principle seems to be elusive, and few authors have analysed it in depth.[49]

Apparently, the Commission had already developed the general principles of the compensatory justification criterion in its first report on competition policy in 1971. But it was not until the recession in the late 1970s, which brought increased pressure on the Member States to introduce State aid measures in order to overcome economic difficulties,

[47] Schina, p. 41.

[48] Case 730/79 Philip Morris Holland B.V. *v* Commission [1980] ECR 2671, paragraphs 17 and 24; Case C-301/87 French Republic *v* Commission [1990] ECR I-307, paragraph 49; Case C-303/88 Italian Republic *v* Commission [1991] ECR I-1433, paragraph 34; Case C-156/98 Federal Republic of Germany *v* Commission [2000] ECR I-6857, paragraph 67.

[49] Mortelmans.

which in turn resulted in a growing number of State aid cases, that the principle was applied in practice. As a result of the increased number of State aid cases, the Commission issued guidelines on sectoral aid (aid to particular sectors) and specified its principles of co-ordination for regional aid.[50] With regard to general aid schemes, the Commission stated that it considered them to be too vague for it to determine whether their application could be considered compatible with the rules on State aid. Consequently, the Commission requested the timely notification of individual cases from the Member States. The Commission was concerned that the criterion for judging individual cases of aid should be as stringent as those applied to sectoral and regional aid proposals. In order to formulate its position, the Commission established the principle of compensatory justification.[51]

Although the general principles of the compensatory justification criterion were already developed in the first competition report, it was in the 10th report on competition policy that the question received serious consideration. At point 213, the Commission held that given the increasing number of aid proposals, and particularly the number of proposals for general aid schemes, with which it was required to deal, it would exercise its discretion by not raising objections to a proposed aid if that aid contained a compensatory justification.[52]

In the 10th report on competition policy, it was stated that this justification would have to take the form of a contribution by the beneficiary of the aid over and above the effects of the normal play of market forces to the achievement of the Community objectives contained in the derogation of Article 92(3) (Article 87(3) EC). Furthermore, according to Evans, it is only when an aid can be considered to contribute to the achievement of the Community's general policy, that the Commission is able to apply Article 87(3) EC.[53] What does it mean in practice, that an aid must contribute to the achievement of the Community's general policy?

According to Evans, it appears that Article 87(3) EC shall be applicable if the aid in question would generate "positive externalities" of Community interest – if the aid provides these positive economic effects for society at large as increased employment or regional development. Let us consider, for example, that a certain investment was being considered by an undertaking. If that investment was to be made on a grander scale employment would increase. But given its resources, the undertaking,

[50] For further reading regarding sectoral aid, see Sections 2.5.3.2.2 and 3.3.2.2.8.

[51] Mortelmans, pp. 405–406.

[52] 10th report on competition policy, 1980, point 213.

[53] Evans, p. 108.

driven by rational considerations, would make the investment on a smaller scale.

According to Evans, aid may also be applied in situations, in which it tackles "negative externalities". Pollution would be one obvious example. If the market does not penalise polluters, aid may be used in order to provide undertakings with an incentive to reduce pollution.[54] In other words, it seems that aid could be authorised to accomplish Union objectives in the presence of market failure.[55]

Thus it seems that the principle of compensatory justification means that, in exercising its discretionary powers, the Commission must consider the fact that there may be desirable objectives for the Community other than the maximisation of competition. It is when the attainment of these objectives is more important than striving for complete competition that the Commission may accept the application of Article 87(3) EC. Thus the Commission must determine if the benefits to be expected from the aid will outweigh the disadvantages, which notably include the distortion of competition.

In Case 730/79, Philip Morris (see Section 2.4.3.2), the ECJ reviewed the validity of the principle of compensatory justification.[56] In this case Philip Morris submitted that in order to grant an exemption, the Commission's task in applying Article 92(3) (Article 87(3) EC) was to consider if the investment plan at issue conformed with the objectives mentioned in Article 92(3)(a) to (c) (Article 87(3)(a) to (c) EC). The Commission, however, submitted that a derogation should be possible only if it could be established that the aid would contribute to the attainment of one of the objectives specified in Article 92(3)(a) to (c) (Article 87(3)(a) to (c) EC), which under normal circumstances, the recipient undertaking would not attain on its own. The Court confirmed this view and continued to hold the position that Article 92(3) (Article 87(3) EC) permits exemption only when aid appears indispensable and if the undertakings contribute to the achievement of the objectives provided for in that paragraph. The Court stated that another interpretation would disregard the fact that Article 92(3) (Article 87(3) EC), unlike Article 92(2) Article 87(2) EC), gives discretion to the Commission.

In the same case the Court confirmed that the word "may" in Article 87(3) EC empowers the Commission with the authority to decide the type of aid that should be considered to be compatible with the common market. The mere fact that an aid package falls within one or more of the

[54] Evans, p. 109.

[55] Ibid. Evans' reasoning is supported also by Buigues and Meiklejohn, p. 71.

[56] Case 730/79 Philip Morris Holland B.V. *v* Commission [1980] ECR 2671.

subsections of Article 92(3) (Article 87(3) EC) is, consequently, insufficient reason to qualify it for an exemption; rather, the decision is in the hands of the Commission. It should also be emphasised that the derogation in Article 92(3) (Article 87(3) EC) must be applied strictly; thus derogation may only be considered if and when any of the objectives in Article 92(3)(a) to (d) (Article 87(3)(a) to (d) EC) are fulfilled. Against this background it seems correct to assume that Schina was right in suggesting that the Commission's application of Article 92(3) (Article 87(3) EC) first required an assessment of the existence of the technical criterion listed in Article 87(3)(a) to (d) EC before making a discretionary decision.[57] Thus if there are doubts about any of the criteria listed in Article 87(3)(a) to (d) EC being fulfilled, the Commission may refuse to exempt the aid.

The main principles stated by the Court in Case 730/79 were articulated by the Commission in its 12th report on competition policy. According to this report, three sets of factors have to be taken into account when the Commission exercises its discretionary powers.[58] According to that report, these three sets of factors are:

(i) that the aid should promote a development which is in the interest of the Community as a whole. Member States propose to grant aid primarily to further national interests. The promotion of these national interest is not enough to justify the Commission exercising its discretionary powers under Article 92(3) EEC;
(ii) that the aid is necessary to bring about that development, in that without the aid the measure in question would not be realised;
(iii) that the modalities of the aid, i.e. its intensity, its duration, the dangers it creates of transferring difficulties from one Member State to another, the degree of distortion of competition, etc., must be commensurate with the importance of the objective of the aid.

Scrutinised more closely, (i) seems to represents the kernel of the principle of compensatory justification. The principles embodied in (ii) and (iii) that represent what Evans summarises as the requirement of considering the necessity of the aid (the latter may be referred to as the principle of proportionality), are probably not part of the compensatory justification principle, but must be assessed as a consequence of the compensatory justification principle.

The requirement that the Commission must assess the effects of the aid measures in question in a Community perspective rather than from

[57] Schina, p. 44.
[58] 12th report on competition policy, 1982, point 160.

a national point of view aims to ensure that the aid does not simply transfer economic difficulties from one Member State to another.[59] As the aid measures must be considered from a Community point of view, the Commission is incapable of authorising aid that is contrary to any other provision in the Treaty. This principle was laid down by the Court in Case 73/79, Commission *v* Italy, in which it held that: 'whilst the procedure provided for in Articles 92 and 93 leaves a wide discretion to the Commission, and in certain conditions to the Council, to come to a decision regarding the compatibility of a system of aids granted by States with the requirements of the common market it is clear from the general plan of the Treaty that that procedure must never produce a result which is contrary to the specific provisions of the Treaty concerning, for example, internal taxation.'[60] Although it was not specifically mentioned by the Court, D'Sa argues that the same principle would apply with regard to secondary Community law.[61]

As clarified in a previous section, the principle developed for individual aid measures should also be applied with regard to sectoral and regional aid measures.[62] Nevertheless, it has been suggested that the Commission is not consistent in its application of the principle of compensatory justification,[63] perhaps, as suggested by Mortelmans, because it is sometimes impossible to apply the principle. According to Mortelmans, the compensatory justification test is not applicable in sectors in which the Council has developed special rules because the normal market conditions prevailing in the relevant economic climate are inappropriate or insufficient. Thus it follows that because the compensatory justification principle uses the normal market conditions as benchmark, it would not be possible to apply the principle in sectors in which normal market conditions do not exist. Mortelmans provides the examples of the coal, steel, and shipbuilding industries.[64]

The compensatory justification principle seems not to apply to export aid measures, either, because this type of aid is automatically considered to affect trade between Member States, which is probably why Article 87(3) EC may not be invoked in cases of export aid. As mentioned in the

[59] Competition law in the European Communities, Vol. IIB, Situation in December 1996, p. 13.

[60] Case 73/79 Commission *v* Italian Republic [1980] ECR 1533, paragraph 11.

[61] D'Sa, p. 135.

[62] Mortelmans, p. 407.

[63] Hancher, Ottervanger and Slot, p. 74.

[64] Mortelmans, pp. 411–413.

beginning of this section, the principle of compensatory justification is applied when the Commission exercises its discretionary powers only with regard to the application of Article 87(3) EC. It has been proposed that the principle of compensatory justification is applicable not to existing aid, but only to new aid. However, Mortelmans seems to be of the opinion that the principle of compensatory justification may be applied also in cases of existing aid.[65]

The Commission also exercised its discretionary powers in requiring that the aid must be effective. Thus the aid must enable the recipient firm permanently to resolve the economic difficulties that motivated the granting of the aid. The firm must be able to compete on its own merits after the aid has been granted. In conjunction with the general principle of proportionality, this principle of effectiveness requires that the amount and duration of the aid is limited to what is strictly necessary.[66]

These many examples demonstrate that the Commission must make complex economic and social assessments in a Community context when exercising its discretionary powers. The Court has confirmed these discretionary powers, which have, in turn, had procedural consequences. In Cases 74/76, Ianelli and 78/76, Steinike and Weinlig, the Court considered that in view of the wide discretion of the Commission, undertakings concerned could not, merely on the basis of Article 92 (Article 87 EC), challenge the compatibility of a particular aid grant with Community law before the national courts.[67] Thus it seems that the ECJ considered the discretion of the Commission to be too wide for Article 92 (Article 87 EC) to have a direct effect. An interesting question is if there are any limits, legal or others, to the Commission's discretion.

Although the Commission has been empowered with wide discretionary powers, it cannot make arbitrary decisions. When determining if an aid measure is compatible with the common market, the Commission needs to establish the nature of the aid. Perhaps, as Evans suggests, most aid measures can be classified as restructuring aid, rescue aid, or operating aid.[68] Nonetheless, it is necessary for the Commission to determine the objective or the character of the aid: Does it constitute a financial

[65] Mortelmans, p. 417.

[66] Competition law in the European Communities, Vol. IIB, Situation in December 1996, p. 13.

[67] Case 74/76 Ianelli & Volpi SpA *v* Ditta Paolo Meroni [1977] ECR 557, paragraph 12; Case 78/76 Firma Steinike and Weinlig *v* Federal Republic of Germany [1977] ECR 595, paragraph 10.

[68] Evans, p. 110.

transfer or transaction? Is it horizontal, sectoral, or regional? These categorisations are further discussed in Section 3.3.2.2.8.

Once these questions have been answered, the type of measure must be determined. If the aid is a horizontal aid, for example is it, aid to R&D, for instance, or aid to environmental protection? The Commission has issued various policy frameworks, in which it has expressed its view on various forms of aid.

The Commission has issued policy frameworks regarding various types of horizontal aid, such as the Community framework for research and development[69] and the guidelines for environmental protection.[70] Similarly, the Commission has issued policy frameworks with regard to financial transfers – the Commission's notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees,[71] for example, and the Commission's notice on tax measures.[72] With regard to sectoral aid, the Commission has issued, for example Communication from the Commission on the application of State aid rules to public service broadcasting[73] and guidelines for the examination of State aid to fisheries and aquaculture.[74] The Commission has also issued guidelines on aid for rescue and restructuring.[75]

In order to avoid arbitrary decisions, the Commission is obliged to act in accordance with its policy frameworks and with the case law of the CFI and the ECJ. Does this obligation cure the risk of arbitrary decisions? Because the Commission applies the application of the principle of compensatory justification when exercising its discretionary powers, perhaps Mortelmans' suggestion that the Commission should have issued guidelines on the application of the compensatory justification principle

[69] Community framework for State aid to research and development, OJ C 45, 17.2.1996, pp. 5–16.

[70] Community guidelines on State aid for environmental protection, OJ C 37, 3.2.2001, pp. 3–15.

[71] Commission notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees, OJ C 71, 11.03.2000.

[72] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, pp. 3–9.

[73] Communication from the Commission on the application of State aid rules to public service broadcasting, OJ C 320, 15.11.2001, pp. 5–11.

[74] Guidelines for the examination of State aid to fisheries and aquaculture, OJ C 19, 20.01.2001, pp. 7–15.

[75] Community guidelines on State aid for rescue and restructuring firms in difficulty, OJ C 288, 9.10.1999, pp. 2–18.

was a good idea.[76] Perhaps, however, the Commission has integrated the application of the compensatory justification in all the relevant guidelines in such a way that a separate guideline on the application of the compensatory justification would be superfluous. Although it would be interesting to analyse this situation, no such analysis has been pursued in this dissertation. However, it may be interesting to question whether the obligation for the Commission to act in accordance with its many policy frameworks is enough of a safeguard that arbitrary decisions are not being adopted.

In the next section an account is made for the various exemptions provided for in Article 87(3) EC.

3.3.2.2.3 Article 87(3)(a) – Aid to regions with abnormally low standard of living or serious unemployment

In Case 248/84, Germany *v* Commission, Germany had notified the Commission of a regional aid programme. The Commission was of the opinion that the aid measures distorted or threatened to distort competition within the meaning of Article 92(1) of the Treaty (Article 87(1) EC) and made a negative decision that was appealed to the Court of Justice. The Court annulled the Commission Decision because the Commission had failed to state satisfactorily the reasons for its decision. In this case the Court took the opportunity to clarify the interpretation of the State aid rules with regard to the application of Article 87(3)(a) and (c). Thus the Court held that with regard to Article 87(3)(a), the use of the words "abnormally" and "serious" in the exemption contained in Article 92(3)(a) (Article 87(3)(a) EC) shows that it concerns only areas in which the economic situation is extremely unfavourable in relation to the Community as a whole.[77] Thus the mere fact that a certain region is suffering from more underemployment than other regions in the same Member State is not sufficient reason for granting an exemption under Article 87(3)(a). As D'Sa states, however, this decision does not mean that the national context is irrelevant.[78]

It is important that the aid granted to a region referred to in Article 87(3)(a) (an "a)-region") has the purpose to promote the economic development of the area at issue, and not merely the promotion of a certain undertaking.[79]

[76] Mortelmans, pp. 430–433.

[77] Case 248/84 Federal Republic of Germany *v* Commission [1987] ECR 4013, paragraph 19.

[78] D'Sa, p. 136 and Schina, pp. 52–53.

[79] Schina, p. 55.

The Commission, in cooperation with the Member States, has laid down the criteria for considering a region to be an a)-region. These criteria were established in an annex to a Commission communication from 1988,[80] which was replaced by new guidelines on regional aid.[81] The new guidelines came into force on 1 January 2000. According to these guidelines, a region is considered to be an a)-region if it corresponds to a geographic unit on NUTS II-level in which the per capita gross domestic product does not exceed 75 % of the Community average in purchasing power parities.[82] For several reasons, as Evans has pointed out, however, the reference to NUTS II-level and the reference to the 75 % threshold are controversial accounting methods. The regions that are classified as a)-regions according to these criteria are listed in Annex B of the guideline.

The application of Article 87(3)(a) has been rare in the past but it is possible that the enlargement of the Community will result in more frequent applications of this provision.

3.3.2.2.4 Article 87(3)(b) – Aid to promote important projects of common European interest or to remedy serious disturbance in the economy of a Member State

Article 87(3)(b) contains two exemptions. The first refers to aid towards 'the execution of an important project of common European interest'; the second may be applied in order to 'remedy a serious disturbance in the economy of a Member State.'

Common European interest

The phrase "common European interest" has not been defined. It has been suggested that the use of the word "European" instead of "Community" implies that the project of interest covers non-members as well as members of the European Union.[83]

[80] Commission communication of 1988 on the method for the application of Article 92(3)(a) and (c) to regional aid, OJ C 212, 12.8.1988, pp. 2–5, amended at least in 1990, OJ C 163, 4.7.1990.

[81] Guidelines on national regional aid, OJ C 74, 10.3.1998, pp. 9–18. These guidelines have been amended in Amendments to the Guidelines on national regional aid, OJ C 258, 9.9.2000, p. 5.

[82] "NUTS" is the abbreviation for 'Nomenclatures des Unités Territoriales Statistique', which is the hierarchical division of regions in five different levels. The aim of this system is to obtain comparable geographical areas with respect to for example surface area and population of the different Member States.

[83] Schina, p. 57.

According to Schina, "common European interest" may be considered to be an interest shared by all Member States but not necessary requiring the participation of all Member States in its completion. Even a project conducted by a single Member State may come within the scope of Article 87(3)(b) EC.[84] An aid to a single undertaking in a particular sector, however, is not likely to qualify as a project of common European interest.[85] In several reports on competition policy, the Commission has indicated that schemes for energy saving and for the diversification of energy resources may be exempted, as important projects of common European interest.[86] In joined Cases 62 and 72/87, Glaverbel, discussed in Section 2.4.4.3, the ECJ confirmed the Commission's view that a project is not of common European interest unless it forms part of a transnational European programme supported jointly by a number of Member States or unless it arises from concerted action by a number of Member States to combat a common threat such as environmental pollution.[87]

Examples of aid that have been considered to promote projects of common European interest and therefore exempted according to Article 87(3)(b) EC have been cited by Bellamy and Child: the manufacture of aircraft and aircraft parts, improvements to the environment, and R&D projects which are transnational, quantitatively and qualitatively important, and related to the definition of industrial standards that can allow community industry to benefit from all the advantages of the single market.[88] Van Bael and Bellis[89] as well as Hancher, Ottervanger and Slot[90] have mentioned other examples.

Aid to remedy a serious disturbance

In order to exempt aid to remedy a serious disturbance, the disturbance must affect the whole of the national economy and not merely one sector or region (which is covered by sub-paragraphs (a) or (c). The Commission has expressly stated that aid to remedy serious disturbances will be exempted only in exceptional cases. Exceptional circumstances apparently existed when the Italian Government adopted certain decrees to deal with the decline of economic activity, increasing unemployment,

[84] Schina, p. 57.

[85] Hancher, Ottervanger and Slot, p. 76.

[86] Ibid.

[87] Case 62 and 72/87 Exécutif régional wallon and SA Glaverbel *v* Commission [1988] ECR 1573, paragraph 22.

[88] Bellamy and Child, (2001), p. 1243, footnote 11.

[89] Van Bael and Bellis, pp. 844–845.

[90] Hancher, Ottervanger and Slot, p. 76.

and the slow-down in investment besetting the Italian economy. Measures that were exempted were, for example, a temporary and partial abatement of welfare charges for craft firms, small and medium-sized industrial firms, and all textile firms throughout Italy. Apparently these operating measures were of sufficiently short duration (one year) and its award could not be further extended in the case of the textile industry.[91] This exemption has been used, for example, when the effects following the energy crisis of 1974 had to be remedied[92] and when the Commission approved aid involving financial reorganisation of companies in the Greek public sector, a crisis that the Commission considered to have extended beyond any one sector of the economy.[93]

In this context, it is interesting to note that aid to remedy the serious deterioration in the balance of payments in France caused by the political events in May 1968 was authorised by the Commission under Article 108(3) (Article 120 EC) and not under Article 92(3)(b) (Article 87(3)(b) EC). According to Schina, the inherent reasoning seemed to be that deterioration in the balance of payment does not in itself constitute a 'serious disturbance in the economy of a Member State'. Therefore Article 108(3) (Article 120 EC) was applied instead of Article 92(3)(b) (Article 87(3)(b) EC).[94] Article 120 EC is dealt with in Section 3.3.2.3.3.

3.3.2.2.5 Article 87(3)(c) – Aid to facilitate the development of a region or certain economic activities

Article 87(3)(c) EC is the exemption most frequently applied by the Commission. It covers two different categories of aid: aid facilitating the development of certain economic activities (sectoral aid) and aid facilitating the development of certain economic areas (regional aid).

As mentioned in Section 3.3.2.2.3, in Case 248/84, Germany *v* Commission, the Court took the opportunity to clarify the interpretation of the State aid rules with regard to the application of Article 87(3)(a) and (c). With regard to the application of Article 87(3)(c) EC the Court held that '[t]he exemption in Article 92(3)(c), on the other hand, is wider in scope inasmuch as it permits the development of certain areas without being restricted by the economic conditions laid down in Article 92(3)(a), provided such aid "does not adversely affect trading conditions to an extent contrary to the common interest". That provision gives the

[91] 2nd report on competition policy, 1972, paragraph 120, cited in Schina, p. 58.

[92] Schina, p. 58.

[93] Bellamy and Child, (2001) p. 1243, footnote 12.

[94] Schina, p. 59.

Commission power to authorise aid intended to further the economic development of areas of a Member State which are disadvantaged in relation to the national average.'[95] Consequently, the assessment under Article 87(3)(c) EC is made from a national perspective, whereas Article 87(a) EC is to be assessed from a Community perspective. Although Article 87(3)(c) EC is assessed in a national context, the development must promote Community objectives, according to the compensatory justification principle mentioned in Section 3.3.2.2.2.

In order for an aid measure to be exempted under this provision, the aid in question may not adversely affect trading conditions to an extent that is contrary to the common interest. It is for the Commission to consider whether this is likely to happen or not. According to Schina, the Commission's assessment considers the competitive situation in the market concerned, declined demand, and surplus capacity.[96] The competition assessment in Article 87(3)(c) EC will be dealt with in Section 3.3.2.2.7.

Aid to develop economic activities

The requirement on "development" presupposes an improvement in economic performance or prospects. Consequently, aid designed merely to prevent undertakings from going out of business cannot be approved under Article 87(3)(c).[97] It has been suggested that the aid must be aimed at developing the entire sector in question rather than particular undertakings within the sector.[98] If this theory is upheld in practice, is however, unclear.

In its 8th report on competition policy from 1978 the Commission articulated the main criteria for examining sectoral aid proposals. According to the report these main criteria are:

(i) sectoral aid should be limited to cases where it is justified by circumstances in the industry concerned;
(ii) aid should lead to a restoration of long-term viability by resolving problems rather than preserve the *status quo* and put off decisions and changes which are inevitable;

[95] Case 248/84 Federal Republic of Germany *v* EC Commission [1987] ECR 4013, paragraph 19.

[96] Schina, p. 61.

[97] Wyatt and Dashwood, p. 692, referring to AG Slynn in Case 84/82 Federal Republic of Germany *v* Commission [1982] ECR 1451, at 1505.

[98] Wyatt and Dashwood, p. 692 and Hancher, Ottervanger and Slot, p. 78, referring to AG Slynn in Case 84/82, Federal Republic of Germany *v* Commission [1982] ECR 1451, at 1505.

(iii) nevertheless, since adjustment takes time, a limited use of resources to reduce the social and economic costs of change is admissible in certain circumstances and subject to strict conditions;
(iv) unless granted over relatively short periods, aids should be progressively reduced and clearly linked to the restructuring of the sector concerned;
(v) the intensity of aid should be proportionate to the problem it is designed to resolve so that distortions of competition are kept to a minimum; and
(vi) industrial problems and unemployment should not be transferred from one Member State to another.[99]

Several rules have been established regarding the application of Article 87(3)(c) EC, most of them in various policy frameworks issued by the Commission. Some rules are also regulated in Commission and Council Regulations.

Regional aid

As mentioned previously in this section, following the ruling in Case 248/84, Germany *v* Commission, the Commission is empowered to apply Article 87(3)(c) and to authorise aid intended to further the economic development of areas of a Member State which are disadvantaged in relation to the national average. Consequently, the regional conditions are regarded in relation to the conditions existing in the Member State as a whole. The fact that the application of Article 87(3)(c) includes an opportunity to account for national characteristics to a greater extent than is possible according to Article 87(3)(a) does not mean, however, that accounting for the common interest can be excluded.[100] It follows from the statement by the Court that the application of Article 87(3)(c) leaves more room for manoeuvring, to determine the regional difficulties that can be facilitated by aid.

In earlier rules, it followed from an annex to the 1988 Communication on the method for the application of Article 92(3)(a) and (c) (Article 87(3)(a) and (c) EC) to regional aid, what regions in the Community were considered to constitute regions referred to in Article 87(3)(c) ("(c)-regions").[101] However, this system has changed since the implementation of the new Guidelines on National Regional Aid in 1998. Instead the Commission has set an overall ceiling for regional aid in the Commu-

[99] 8th report on competition policy, 1978, point 176.

[100] Paragraph 3.7 of the guidelines on national regional aid, OJ C 74, 10.3.1998, pp. 9–18.

[101] Competition Law in the European Communities, Vol. IIA, Situation at 31 December 1994, p. 220.

nity, determined by population. The overall ceiling covers all the regions eligible under the exemptions in Articles 92(3)(a) and (c) (Article 87(3)(a) and (c) EC). The Article 92(3)(c) (Article 87(3)(c) EC) ceiling is obtained by deducting from the overall ceiling the population of the eligible regions under the Article 92(3)(a) (Article 87(3)(a) EC) derogation. It is then distributed among the different Member States in light of the relative socio-economic situation of the regions within each Member State, assessed in the context of the Community.[102] It has been the responsibility of each Member State, with confirmation by the Commission, to decide which areas should be considered to constitute c)-regions, subject to a range of stringent parameters to which their area designation methodologies were required to conform.

3.3.2.2.6 Article 87(3)(d) – Aid to promote culture and heritage conservation

Article 87(3)(d) is a relatively new provision that covers cultural aid. It was introduced in 1993, together with Article 128 (Article 151 EC), a provision dealing explicitly with culture, as a result of amendments introduced in the Treaty of Union signed at Maastricht. In general it seems that aid to non-commercial cultural activities does not constitute State aid in the meaning of Article 87 EC. As suggested by Hancher, Ottervanger and Slot, it is reasonable to believe that certain forms of cultural aid for general infrastructure – for theatres or sporting facilities, for example – are unlikely to constitute aid according to Article 87 EC.[103] Other forms of cultural aid will most certainly fall outside the definition of Article 87 EC because they have little effect on community trade. There are, however, forms of aid to culture activities that do fall under the definition of aid in Article 87 EC and these forms of aid have to be exempted according to Article 87(3)(d): aid for film production,[104] for example, and aid for the exporting of books to non-French-speaking countries.[105] The latter decision was appealed to the CFI in case T-155/98, which will be dealt with under Section 3.3.2.2.7.

[102] Paragraph 3.9 of the guidelines on national regional aid, OJ C 74, 10.3.1998, pp. 9–18.

[103] Hancher, Ottervanger and Slot, p. 80.

[104] Commission Decision concerning Case N 3/98 of 29 July 1998 regarding an aid scheme for film production, OJ C 279, 8.9.1998, p. 4 and Commission Decision concerning Case N 486/97 of 25 November 1998 regarding an aid scheme for film production, 28th report on competition policy, 1998, point 274.

[105] Commission Decision 1999/133/EC of 10 June 1998 concerning State aid in favour of Coopérative d'exportation du livre français (CELF), OJ L 44, 18.2.1999, pp. 37–54.

3.3.2.2.7 The competition assessment in Articles 87(3)(c) and (d) EC

It follows from Sections 2.4.3.2, 2.4.4.2 and 2.4.4.3 that the Court does not seem to require the same kind of market analysis required in the application of Articles 81 and 82 EC dealing with concerted practices and the abuse of dominant position, at least not with regard to the application of Article 87(1) EC. However, the judgment in Case T-155/98, Société internationale de diffusion et d'édition (SIDE) *v* Commission seems to suggest that the situation differs, at least with regard to the application of Article 87(3)(d) EC.[106]

SIDE was an agency company established in France. Its activities consisted, in particular, of exporting French-language books to other Member States of the European Union and to non-member countries. Coopérative d'exportation du livre français, trading as Centre d'exportation du livre français (CELF) was another agent active in distributing books, chiefly in countries and areas that were not French speaking, because in the French speaking areas, in particularly in Belgium, Canada, and Switzerland, that task was performed by the distribution networks set up by publishers.

An agent is an operator who deals with retailers or organisations rather than the final consumer. The agent collects orders from customers and approaches the publisher or distributor, who then delivers the orders to one place. Similarly, the agent gathers orders for the works of various publishers from booksellers or institutional customers. In this way the agent is sparing customers the need to place multiple orders with many different suppliers.

CELF was a limited cooperative society the object of which was to handle directly orders from abroad or the overseas territories and departments for books, brochures, and all communication media, and to conduct transactions for the particular purpose of promoting French culture throughout the world. Membership in CELF was open to all persons engaged in the publication or distribution of French-language books, but most of CELF's members were publishers established in France.

In 1979 CELF was in financial difficulties, and booksellers, publishers, the Syndicat National de l'Édition, and the public authorities agreed that it should be preserved. Thus it was decided that CELF would receive compensatory subsidies to offset the extra costs involved in handling small orders from booksellers abroad. The subsidies enabled CELF to meet orders, which, because of the substantial transport costs in rela-

[106] Case T-155/98 Société internationale de diffusion et d'édition (SIDE) *v* Commission [2002] ECR II-1179.

tion to the total value of the order involved, were regarded by the publishers or their associated distributors as being hardly worthwhile. Thus the subsidy helped to spread the French language and to propagate French-language literature.

In 1992 the legal advisor of SIDE drew the Commission's attention to the subsidy for promoting, transporting, and marketing French books. The Commission, in turn, asked the French authorities for information. In May 1993 the Commission adopted a decision authorising the aid in question.[107] After an appeal, the CFI, by judgment of 18 September 1995 in Case T-49/93 SIDE *v* Commission [1995] ECR II-2501, annulled the Commission's decision in so far as it concerned the subsidy granted exclusively to CELF to offset the extra costs involved in handling small orders for French-language books placed by booksellers established abroad. In October 1995 the Commission asked the French authorities by letter about the changes that the French authorities were required to make in the light of the judgment of the CFI of the 18 September the same year. The French authorities responded that no changes had been made to the aid in question. As a result, in June 1996 the Commission decided to open the procedure provided for in Article 88(2) EC.

Subsequent to substantial correspondence between the Commission and the French authorities and between the Commission and SIDE, in June 1998 the Commission adopted Decision 1999/133/EC concerning State aid in favour of Coopérative d'exportation du livre français (CELF).[108] In this decision, the Commission considered that the aid granted to CELF for the handling of small orders for French-language books constituted aid in accordance with Article 92(1) of the Treaty (Article 87(1) EC). The Commission continued to hold that, as the Commission had not been notified about the aid prior to its implementation, the aid had been granted unlawfully. The Commission, however, concluded that the aid was to be considered as compatible aid, as it was considered to be satisfying the conditions for derogation under Article 92(3)(d) of the Treaty (Article 87(3)(d) EC). It was this decision that was appealed in Case T-155/98, SIDE *v* Commission.

One plea advanced by the applicant was that the Commission had

[107] Commission Decision concerning Case NN 127/92 of 18 May 1993 on aid to exporters of French books, OJ C 174, 25.6.1993, p. 6, referred to in paragraph 11 of Case T-155/98 Société internationale de diffusion et d'édition (SIDE) *v* Commission [2002] ECR II-1179.

[108] Commission Decision 1999/133/EC of 10 June 1998 concerning State aid in favour of Coopérative d'exportation du livre français (CELF), OJ L 44, 18.2.1999, pp. 37–54.

committed a manifest error of assessment in selecting as the reference market the export market for French-language books in general. In this context, in paragraph 56 the Court held that '[i]n order to establish whether, in the present case, competition is affected to an extent that is contrary to the common interest for the purposes of Article 92(3)(d) of the Treaty, it is necessary to consider first the definition of the market for the services in question'. The Court continued to hold that, as concerns the material definition of the market, in order to be considered the subject of a sufficiently distinct market, it must be possible to distinguish the service or the good in question by virtue of particular characteristics in order to differentiate it from other services and other goods, and that only to a small degree is it interchangeable with those options and affected by competition from them. In this context the Court added that the degree of interchangeability among products or services must be assessed in terms of their objective characteristics, the structure of market supply and demand, and competitive conditions. In this context, the Court made reference to Case T-229/94 Deutsche Bahn *v* Commission [1997] ECR II-1689, paragraph 54 and the case law cited therein.

With regard to the plea that the Commission had committed a manifest error of assessment in selecting the export market for French-language books in general as the reference market, the Court agreed. Accordingly, in paragraph 71 the Court held that '... the Commission should have examined the effects of the contested aid on competition and trade between the other operators carrying on the same activity as that for which the aid was granted, in this case the handling of small orders of French-language books. In selecting the export market for French-language books in general as the reference market, the Commission was unable to assess the true impact of the aid on competition. Accordingly, the Commission committed a manifest error of assessment as regards the definition of the market.'

This judgment is of interest because it seems to emphasise a difference in the assessment of distorted competition and intra-Community-trade effects for the purpose of the application of Article 87(1) EC and Article 87(3)(d) EC respectively. Thus, the judgment states that with regard to the application of Article 87(3)(d) EC and contrary to what was held with regard to the application of Article 87(1) EC, the Court does require a similar market analysis in the application of Articles 81 and 82 EC, at least with regard to the definition of the relevant product market, because in paragraph 56 of Case T-155/98, SIDE *v* Commission, the Court made reference to Case T-229/94 Deutsche Bahn *v* Commission [1997] ECR II-1689, paragraph 54 and the case law cited therein. Case T-229/94, Deutsche Bahn *v* Commission, is a case in which abuse of dominant posi-

tion, among other things, is assessed.[109] The case law referred to in paragraph 54 of Case T-229/94, Deutsche Bahn *v* Commission, is Case 66/86 Ahmed Saeed Flugreisen, paragraphs 39 and 40,[110] Case 27/76 United Brands, paragraphs 11 and 12[111] Case T-30/89 Hilti *v* Commission, paragraph 64,[112] Case 322/81 Michelin *v* Commission, paragraph 37,[113] and Case T-83/91 Tetra Pak *v* Commission, paragraph 63.[114]

Thus it follows from Case T-155/98, SIDE *v* Commission, that the Commission is required to define the relevant product market in the application of Article 87(3)(d) EC. What does this ruling mean with regard to the application of Article 87(3)(c) EC? According to the wording of Article 87(3)(d) EC, aid to promote culture and heritage conservation may be considered to be compatible with the common market '..., where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest; ...'. However, the wording of Article 87(3)(c) EC states that aid to facilitate the development of certain economic activities or certain economic areas may be considered to be compatible with the common market '... where such aid does not adversely affect trading conditions to an extent contrary to the common interest; ...'. The word "competition" has been omitted in Article 87(3)(c) EC. Does this mean that the conclusions drawn from the judgment in Case T-155/98, SIDE *v* Commission, would not apply to the application of Article 87(3)(c) EC? That may be the case. But another possible interpretation is that, as Article 87(3)(d) EC was introduced in 1993, the wording in this provision mirrors the development according to which the assessment of distorted competition is treated together with the intra-Community trade effects and that although the wording is different in Article 87(3)(c) EC, it must be read in the light of this development. A result of this interpretation would be that the application of Article 87(3)(c) EC would require a market analysis similar to the one required in the application of Articles 81 and 82 EC dealing with concerted practices and the abuse of a dominant position, at least with regard to the definition of the relevant product market.

[109] Case T-229/94 Deutsche Bahn AG *v* Commission [1997] ECR II-1689.

[110] Case 66/86 Ahmed Saeed Flugreisen and Silver Line Reisebüro GmbH *v* Zentrale zur Bekämpfung unlautereren Wettbewerbs e.V. [1989] ECR 803.

[111] Case 27/76 United Brands Company and United Brands Continentaal B.V. *v* Commission [1978] ECR 207.

[112] Case T-30/89 Hilti AG *v* Commission [1991] ECR II-1439.

[113] Case 322/81 NV Nederlandsche Banden Industrie Michelin *v* Commission [1983] ECR 3461.

[114] Case T-83/91 Tetra Pak International SA *v* Commission [1994] ECR II-755.

3.3.2.2.8 Various ways to categorise aid

Once notified, it is up to the Commission to examine the aid measure, the aim being to determine 1) if the measure constitutes State aid according to Article 87(1) EC and 2) if the measure can be exempted according to any of the possible exemptions mentioned in Sections 3.3.2.2.3 to 3.3.2.2.6. The conditions for applying the exemptions provided for in Articles 87(3)(a) to (d) EC have been elaborated upon in great detail in various policy frameworks issued by the Commission. Several policy frameworks are based on the exemption in Article 87(3)(c) EC. It follows from Section 3.3.2.2.5 that the application of Article 87(3)(c) EC contains not only the possibility of accepting the granting of aid to (c)-regions,[115] but also, under certain circumstances, to certain economic activities.

Consequently, the first stage in the application of Article 87(3)(c) EC must be to determine if the aid measure is addressed to a certain region or to certain economic activities. If it is an aid measure aimed at facilitating the development of a region, it is necessary to establish if the region qualifies as a (c)-region. If the measure aims at developing certain economic activities, however, it is necessary to distinguish between horizontal and sectoral aid measures because the conditions for acceptance vary as a function of this factor. The distinctions between 1) aid furthering certain economic activities and aid furthering certain regional activities, and 2) between horizontal and sectoral aid is often referred to as a categorisation with reference to the objective of the aid measure. Moreover, because the possibilities to accept aid in general depends on whether the aid is defined as investment aid or operating aid, it is necessary to distinguish between these two categories. Some of the most important categorisations will be accounted for under the following headings that address horizontal, sectoral, investment, operating, rescue, and restructuring aid.

Horizontal or sectoral aid

State aid that is eligible to all economic sectors is referred to by the Commission as horizontal aid: aid to research and development, aid to environmental protection, and aid to rescue and restructuring, for instance. Sectoral aid, however, is an aid measure addressed solely to such economic sectors as agricultural or transport, broadcasting, electricity, fisheries, motor vehicles, shipbuilding, and synthetic fibres. The Commission has issued policy frameworks for each of these categories.

The categorisation of horizontal or sectoral aid is not clear cut. State aid in the form of tax reductions, for example, could perhaps be consid-

[115] The definition has been provided for in Section 3.3.2.2.5.

ered horizontal with regard to its objectives. The Commission notice on tax measures is, however, not referred to as horizontal aid by the Commission but is categorised as financial transfers and transactions.

Investment aid or operating aid
When Article 87(3) EC is assessed, it is important to distinguish between measures that constitute investment aid and measures that constitute operating aid, as the conditions for acceptance differ.

Investment aid
Investment aid is aid for making certain investments. It can be used as an incentive for making investments in certain regions, but it may also be an incentive for undertakings to make investments in general. Although investment aid would be considered to constitute State aid according to Article 87(1) EC, it is accepted under certain conditions according to several of the Commission's policy frameworks. Investment aid can take any of the forms of aid mentioned in Section 2.4.2. In paragraph 31 of the notice on tax measures, for example, it is stated that where a fiscal aid is granted in order to provide an incentive for firms to embark upon certain specific projects (investments in particular) and where its intensity is limited with respect to the costs of carrying out the project, it is no different from a subsidy and may be accorded the same treatment. Nevertheless, it is added, such arrangements must establish rules that are sufficiently transparent to enable quantification of the benefit conferred.

There is a range of different policy frameworks according to which investment aid could be accepted. Paragraph 31 of the notice on tax measures states that the Commission will also apply to tax measures all these policy frameworks that provide rules for different types of investment aid and other rules (following from the case law of the Courts or from the case practice of the Commission) relevant for investment aid situations. However, in order to apply these different rules, it is important that the net grant equivalent of the tax measures be established.

According to Annex I of the guidelines on national regional aid, it is stated under the heading 'General principles' that the calculation of net grant equivalent (NGE) consists of reducing all forms of aid connected with an investment to a common measure, irrespective of the country concerned – that is to say, the net intensity – for the purposes of comparing them with each other or with a predetermined ceiling. Moreover, it is said that what is involved here is an *ex ante* comparative method that does not always reflect accounting principles. With regard to tax measures, it is emphasised in a footnote that tax aid may be considered to be aid connected with an investment when it is based on an amount invest-

ed in the region. In addition, it follows that any tax aid may be connected to be an investment if one sets a ceiling expressed as a percentage of the amount invested in the region. Furthermore, in the second subsection under general principles, it is said that the net intensity represents the final benefit which a firm is deemed to derive from the value without tax of the aid in relation to the assisted investment.[116] The following example should elucidate the application of the principle of net grant equivalent.

Assume that an undertaking is offered a tax reduction in order to set up a plant. Various scenarios would be possible. The character of the tax measure varies from one situation to another or the way in which the measure at issue can be accepted varies, depending if the aid is sectoral or regional. Let us assume two different situations. In Situation A, the objective of the aid is to create incentives for the undertaking to make investment in a certain region. In Situation B, the objective of the aid is to create incentives for an undertaking to pursue research and development within a certain subject area.

It is worth repeating that a measure, a reduction from tax, can be pursued at a central, regional, or local level. Consequently, one may assume that the tax reductions are granted from centrally imposed taxes like State income tax and from regionally imposed taxes like local establishment taxes and regional income taxes in autonomous regions. The reduction can be granted in an individual case of investment, but could also be formulated as a general grant of tax reduction for all undertakings making certain investments.

In Situation A, the tax measure could, for example, be relief for the undertaking from a local establishment tax or relief from income tax. In joined Cases T-269/99, T-271/99, and T-272/99, Diputación de Guipúzcoa and Others *v* Commission,[117] in joined Cases T-92/00 and T-103/00 Territorio Histórico Álava – Diputación Foral de Álava and Others *v* Commission,[118] and in joined Cases T-127/99, T-129/99 and T-148/99, Territorio Histórico de Álava - Deputacíon Foral de Álava and Others *v*

[116] Annex I of the guidelines on national regional aid, OJ C 74, 10.3.98, p. 19–28.

[117] Joined Cases T-269/99, T-271/99 and T-272/99 Diputación de Guipúzcoa and Others *v* Commission [2002] ECR II-4217.

[118] Joined Cases T-92/00 and T-103/00 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1385. Joined Cases T-92/00 and T-103/00 have been appealed to the ECJ, who has made a preliminary ruling in Cases C-186/02P and in C-188/02P of 6 May 2004. The appeals do not, however, cover any of the questions of interest in this dissertation. Thus none of the conclusions drawn from the judgments of joined Cases T-92/00 and T-103/00 are altered because of the appeal.

Commission,[119] it was possible for undertakings, in certain provinces of Spain and under certain conditions, to receive a tax credit of 45 % of the cost of investment determined by the province, to be applied to the final amount of tax payable.

In Situation B, if the research and development project were to be pursued in order to find more environmentally friendly products, the possible tax aid might be a reduction from certain environmental taxes.

In order to be able to accept the aid measure in Situation A, the Commission would have to determine the value of the tax reduction seen in relation to the investment cost as a whole and consider if the value of the tax reduction correspond to the accepted maximum level of intensity of the aid and if the costs are eligible according to the guidelines on national regional aid. Similarly, in Situation B, the Commission would have to determine the value of the tax reduction in relation to the investment but would have to assess the case in accordance with the Community framework for State aid for research and development, in order to establish the acceptable aid levels allowed and the costs that are considered eligible.[120]

Operating aid

According to D'Sa's citing of a Commission Notice, operating aid is aid which has direct effect on the production costs and selling prices of recipients.[121] Moreover, according to Van Bael and Bellis, referring to the Commission guideline for the examination of State aids in the fisheries and aquaculture sector, operating aid is aid that covers operating costs otherwise borne by undertakings in the normal course of their business.[122] Whereas the first definition seems vague and difficult to comprehend, the second seems to provide some guidance about the notion of "operat-

[119] Joined Cases T-127/99, T-129/99 and T-148/99 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1275. Joined Cases T-127/99, T-129/99, and T-148/99 have been appealed to the ECJ, who has made a preliminary ruling in Cases C-183/02P and in C-187/02P of 6 May 2004. The appeals do not, however, cover any of the questions of interest in this dissertation. Thus none of the conclusions drawn from the judgments of joined Cases T-127/99, T-129/99 and T-148/99 are altered because of the appeal.

[120] Community framework for State aid for research and development, OJ C 45, 17.2.1996, pp. 5–16.

[121] D'Sa, p. 58.

[122] Van Bael and Bellis, p. 848.

ing aid". The latter definition is also similar to the explanation often referred to by the ECJ.[123]

According to paragraph 32 of the Commission notice on tax measures, most tax relief provisions are general in nature – that is to say they are not linked to the completion of specific projects, and reduce a firm's current expenditure without it being possible to assess the precise volume involved when the Commission carries out its *ex ante* examination. This type of measures, it is stated, constitutes "operating aid". According to the same source, operating aid is prohibited in principle. It follows from paragraph 32 that at present the Commission authorises operating aid only in exceptional cases and subject to certain conditions. Shipbuilding is an example, as is aid to certain types of environmental protection and certain regions, including ultra peripheral regions, covered by the Article 92(3)(a) (Article 87(3)(a) EC) derogation, provided that they are duly justified and their level is proportional to the handicaps they are intended to offset. In addition, the aid must (with the exception of the two categories of aid mentioned below), in principle, be degressive and time-limited. It is further mentioned that at present operating aid can also be authorised in the form of transport aid in ultra-peripheral regions and in the sparsely populated and inaccessible Nordic regions. It is emphasised, however, that operating aid may not be authorised where it represents aid for exports between Member States. The paragraph concludes with the remark that there are specific rules that apply to State aid in favour of the maritime transport sector.[124]

Rescue and restructuring aid

If there is any question of an aid measure being rescue or restructuring aid, it is to be assessed in accordance with the Community guidelines on State aid for rescue and restructuring that were adopted in 1999.[125] State aid for rescuing firms in difficulties from bankruptcy and assisting them to restructure may be regarded as legitimate under certain conditions. It may be justified, for example, by social or regional policy considerations, by the need to account for the beneficial role played by small and medium-sized enterprises in the economy, or by the desirability of main-

[123] See, for example, Case C-156/98, Federal Republic of Germany *v* Commission [2000] ECR I-6857, paragraph 30.

[124] Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998.

[125] Community Guidelines on State Aid for rescue and restructuring firms in difficulty, OJ C 288, 9.10.1999, pp. 2–18.

taining a competitive market structure when the disappearance of firms could lead to a monopoly or to a tight oligopolistic situation.[126]

There is no firm Community definition of "a firm in difficulty". According to paragraph 2.1(4) of the Community guidelines on State aid for rescuing and restructuring, however, the Commission regards a firm as being in difficulty when it is unable, through its own funds or with the funds it is able to obtain from its owner/shareholders or creditors, to stem losses which, without outside intervention by the public authorities, almost certainly would condemn it to go out of business in the short or medium-length term. Moreover, a firm is, in any event, irrespective of its size, considered as being in difficulty:

(a) in the case of a limited company (6), where more than half of its registered capital has disappeared (7) and more than one quarter of that capital has been lost over the preceding 12 months; or
(b) in the case of an unlimited company (8), where more than half of its capital as shown in the company accounts has disappeared and more than one quarter of that capital has been lost over the preceding 12 months; or
(c) whatever the type of company concerned, where it fulfils the criteria under its domestic law for being the subject of collective insolvency proceedings.[127]

The usual signs of a firm being in difficulty are according to paragraph 2.1(6) of the Community guidelines on State aid for rescuing and restructuring; increasing losses, diminishing turnover, growing stock inventories, excess capacity, declining cash flow, mounting debts, rising interest charges, and falling or nil net asset value. If the beneficiary of the aid is insolvent or subject of collective insolvency proceedings, it is the Community guidelines on State aid for rescue and restructuring that will be applied.

Rescue and restructuring aid are two different parts of the same operation, namely to assist an undertaking in difficulty from bankruptcy. Rescue aid is supposed to be temporary assistance, a one-off aid to keep the undertaking afloat during the time that is necessary for working out a restructuring plan or a liquidation plan and for the time it takes the Commission to reach a decision on the basis of that plan.

If rescue aid is aimed at keeping the undertaking afloat for a certain period, restructuring aid is aimed at restoring the long-term viability of

[126] Community Guidelines on State Aid for rescue and restructuring firms in difficulty, OJ C 288, 9.10.1999, pp. 2–18, paragraph 1(3).
[127] Community Guidelines on State Aid for rescue and restructuring firms in difficulty, OJ C 288, 9.10.1999, pp. 2–18, paragraph 2.1(5).

the undertaking. According to paragraph 2.2(11) of the Community guidelines on State aid for rescuing and restructuring, restructuring usually involves one or more elements: It may be the reorganisation or rationalisation of the activities of the undertaking to more efficient basis, often involving the withdrawal from loss-making activities, the restructuring of existing activities that can be made competitive again, and, if possible, diversification in the direction of new and viable activities.

The physical restructuring must usually be accompanied by financial restructuring. The important thing to be remembered, however, is that restructuring operations within the scope of the Community guidelines on State aid for rescuing and restructuring cannot be limited to financial aid designed to make good the past losses without tackling the reasons behind those losses.[128]

The conditions according to which the Commission may consider an aid measure to be compatible with the common market, which follows from the Community guidelines on State aid for rescue and restructuring, will not be discussed here. Suffice to say that it is essential to determine if the aid measure should be classified as rescuing or restructuring aid.

Calculation of aid

In the assessment of an aid measure's compatibility with the common market, it may be essential to assess the aid element – the value of the aid measure. The calculation of the aid element is also of importance in cases of claims of recovery. The method of assessing the value of the aid element varies depending on the form of aid. In the Ninth Survey on State aid, various forms of aid have been categorised with respect to the method of assessment of the aid element. 1) One of the forms embraces two subcategories a) grants and interest rate subsidies and b) relief from taxes and social charges, neither of which require calculation, because the amount of aid is equal to the grant or its equivalent. 2) Aid can also take the form of equity (including debt conversion), the method of calculation for which is based on the benefit of the intervention to the recipient, or 3) soft loans and tax deferrals, for which the aid element is much lower than the capital values of the aid. When a Member State fails to provide information on the aid element, 15 % of the total amount lent by the Government is taken as a proxy. When the Member State, in the case of reimbursable advances, has not indicated the reimbursement

[128] Community Guidelines on State Aid for rescue and restructuring firms in difficulty, OJ C 288, 9.10.1999, pp. 2–18, paragraph 2.2(11).

ratio, the aid element is presumed to be 90 % of all advances. Yet another form of aid covers guarantees. In this category, the aid element is much lower than the capital value guaranteed. Where the information on the exact amount of the aid element is not available, losses to the Government are taken as an approximation. Where Member State data only contain figures on the capital value guaranteed, the aid element is presumed to be 10 % of this figure.[129]

3.3.2.3 Exemptions elsewhere in the Treaty

3.3.2.3.1 Introduction

As mentioned in Section 3.1, the Treaty provides for exemptions other than those provided for in Articles 87. In the next section an account will be made for those exemptions.

3.3.2.3.2 Aid to undertakings entrusted with the operation of certain services

Aid to undertakings entrusted with the operation of services of general interest and the way to distinguish between public service compensation and State aid was discussed in Section 2.7.3. Accordingly, a measure is not classified as State aid when the measure fulfils the Altmark conditions. If the Altmark conditions are not fulfilled, however, the measure will be classified as State aid. It is in this context that the exemption provided for in Article 86(2) EC is of interest. Article 86(2) reads: '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'.

Thus if the application of the State aid rules would obstruct the performance of the services of general interest to be provided, the State aid rules may not apply to the funding of the services in question. There is a condition, however: that the development of trade is not affected to an extent that would be contrary to the interests of the Community. It follows from paragraph 20 of the Commission communication on services of general interest in Europe that there are three principles underlying

[129] Ninth Survey on State Aid in the European Union, available at http://europa.eu.int/comm/competition/state_aid/others/, p. 100.

the application of Article 86 in general.[130] These principles are neutrality, freedom to define, and proportionality.

The principle of neutrality ensures neutrality with respect to the ownership of the undertakings responsible for providing general interest services. This means that the Commission does not question if the undertaking is public or private and it does not require the privatisation of public undertakings. As a result, the Treaty rules on competition and internal market apply regardless of the ownership of the undertaking.

The principle of freedom to define is the principle stating that the Member States are primarily responsible for defining what they regard as services of general interest. It follows from paragraph 22 of the Commission communication on services of general interest in Europe that for the purpose of the exemption provided for in Article 86(2) EC to apply, it is necessary to define clearly what the public service mission consists of and to ensure that the services are explicitly entrusted through an act of public authority (including contracts).[131]

The principle of proportionality is explained in paragraph 23 of the Commission communication on services of general interest in Europe: The means used to fulfil the general interest mission should not create unnecessary distortions of trade. It is stated that it must be specifically ensured that any restrictions to the rules of the EC Treaty – in particular, restrictions of competition and limitations of the freedoms of the internal market – do not exceed what is necessary to guarantee effective fulfilment of the mission. The performance of the service of general economic interest must be ensured and the entrusted undertakings must be able to carry the specific burden and the net extra cost of the particular task assigned to them. In this context it may be added that the ECJ in Case C-159/94, Commission *v* French Republic, held that it is not necessary for the conditions of Article 90(2) of the Treaty (Article 86(2) EC) to apply – that the economic viability of the undertaking entrusted with the operation of the service of general interest should be threatened. It is considered sufficient that, in the absence of the rights at issue, it would not be possible for the undertaking to perform the particular tasks entrusted to it, as defined by reference to its public service obligations.[132]

According to paragraph 24 of the Commission communication on services of general interest in Europe, the principles formulated in Arti-

[130] Commission communication on Services of general interest in Europe, OJ C 17, 19.1.2001, pp. 4–23.

[131] Ibid.

[132] Case C-159/94 Commission *v* French Republic [1997] ECR I-5815, paragraph 95.

cle 86 allow for a flexible and context-sensitive balance that account for the different circumstances and objectives of the various Member States, as well as the technical constraints that may vary from sector to sector. Although this information may provide some clues about when the exemption in Article 86(2) EC apply, it appears vague. However, the Commission has recently exempted a service of general interest on the basis of Article 86(2) EC.

In this case the UK authorities had notified the Commission of a measure according to which the Secretary of State had approved of a new project, proposed by BBC: the Digital Curriculum Service. The Digital Curriculum was a new online service that would provide interactive learning materials free to homes and schools. The approval would allow the BBC to spend £150 million from the license fee funds on the Digital Curriculum over a period of five years from the date of approval of the scheme by the Commission. In the assessment of Article 86(2) EC, the Commission emphasised that as Article 86 EC is a derogation, it must be interpreted strictly. Moreover, in order to qualify for an exemption, the Commission held that the Digital Curriculum needed to fulfil the following conditions

- the Digital Curriculum must be a service of general economic interest and be as clearly defined by the Member State;
- the undertaking in question must be officially entrusted by the Member State with the provision of the service;
- the application of Article 87(1) would prevent the performance of the entrusted service; and
- the 86(2) exemption must not affect the development of trade to an extent that would be contrary to the interest of the community.

Regarding the nature of the service and its definition, the Commission first held that it did not consider the UK Government to have made a manifest error by defining the Digital Curriculum service to be of general economic interest. The Commission then found the public service mission to be adequately defined and explicitly entrusted, as the formal approval of the Digital Curriculum by the Secretary of State was considered to be an official entrustment of the service.

With regard to the necessity and proportionality of State financing, the Commission first concluded that under its public service remit the BBC was not able to charge homes and schools for the delivery of the new service. Thus it was considered clarified that the services could not be provided without State financing. According to the principle of proportionality, financing beyond the net extra cost of the public service should be prevented. To ensure proportionality, the Commission exam-

ined the fact in approving the funding the Government had approved £20 million over the £150 million that the Secretary of State had approved for the BBC. Among other things, the Commission noted that the BBC complied with the obligation of the Transparency Directive in keeping separate accounts for commercial and public services activities and that the non-public service activities were performed by separate commercial subsidiaries of the BBC. Moreover, the Commission examined the UK Companies Acts – for example, the legal Acts to prevent cross-subsidisation and abuse of the compensation – and concluded that these legal Acts, together with other mechanisms, in principle, safeguarded that the advantages derived from the public service mission were properly taken into account when calculating the net public service cost and, in principle, would prevent cross-subsidisation from the public funded parts of the BBC to its commercial entities.

With reference to the question if an exemption in accordance to Article 86(2) EC would have effects contrary to the interest of the community, the Commission took account of the fact that, among other things, although the Commission was asked to approve the funding of the new service for five years (that is to say, until 2008 if the scheme were approved in 2003), the Department for Education and Skills would not be able to commit funding beyond 2006, due to a three-year spending cycle for all Government funding. Moreover, the Commission noted that according to Article 3 and 149 EC, quality education is one of the objectives of the Community. Thus the Commission concluded that the scheme met all the conditions for the derogation provided for in Article 86(2) EC.

It seems that the exemption provided for in Article 86(2) will increase in importance, as it has turned out that the Altmark conditions are vague and difficult to meet. As a result, the Commission has proposed a draft framework for State aid in the form of public service compensation. The framework provides for conditions specifying the public service obligations and the methods of calculating compensation. The framework has not yet been issued and the final content remains to be seen.[133]

3.3.2.3.3 Crisis in the balance of payment

The provision for crisis in the balance of payment was articulated in Article 108 of the Treaty, later in Article 109i of the EC Treaty, and at present in Article 120 EC. Article 120 EC provides for an opportunity to exempt aid to remedy a serious deterioration in the balance of pay-

[133] Community framework for State aid in the form of public service compensation available at http://europa.eu.int/comm/competition/state_aid/others/

ments, as when the Commission authorised aid to remedy the deterioration in the balance of payments in France caused by the political events in May 1968.[134]

According to Article 120(4) EC, however, Article 120 will cease to apply, from the beginning of the third stage of the economic and monetary union, to all countries except the United Kingdom, Denmark, and Sweden.[135] What will be the consequences for the application of State aid rules? Will aid aimed at hindering the deterioration in the balance of payment be regarded under Article 120 EC with regard to aid granted by the United Kingdom, Denmark, and Sweden and under Article 87(3)(b) EC with regard to aid granted by any other Member State? Another possibility may be that the introduction of the economic and monetary union brings with it a new structure according to which crisis in the balance of payment should be treated, which, in turn, would mean that Article 87(3)(b) would lose its relevance to those Member States being members of the EMU project.

3.3.2.3.4 National defence

According to Article 296 EC, any Member State may take any measures it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions, and war material. However, these measures must not adversely affect the conditions of competition in the common market regarding products which are not intended for specific military purposes. In order to prevent the functioning of the common market being affected by measures which a Member State may be forced to take in the event of serious internal disturbances affecting the maintenance of law and order, in the event of war, serious international tension constituting a threat of war, or in order to carry out obligations it has accepted for the purpose of maintaining peace and international security, Member States should consult each other according to Article 297 EC. If these measures have the effect of distorting the conditions of competition in the common market, it is up to the Commission and the Member State to examine how these measures can be adjusted to the rules of the Treaty.

According to Article 296(2), the Council may, acting unanimously on a proposal from the Commission, make changes to a list that it drew up on 15 April 1958, of the products to which the provisions of Article 296(1)(b) EC apply. In reply to a written question 574/85, the Council

[134] Schina, p. 59.

[135] D'Sa, p. 142, footnote 1.

clarified that a list had been drawn up on 15 April 1958.[136] According to the reply in November 1985, however, the list had never been published, updated, or amended. According to Oliver, the situation remained unchanged, at least until 1995.[137]

Cornish believes that the list from 1958 was based on one of the lists of Coordinating Committee for Multilateral Export Controls (CoCom), which constitutes a semi formal, non–Treaty-based body that was created in 1949 during the Cold War in order to prevent important technology and/or weapons being exported to the Soviet Union or other communist countries. The members of the CoCom (the members of NATO up to 1995, not including Iceland but also embracing Japan and Australia since 1989) agreed that the mission to prevent export to the Communist block must also be handled on a national level. Three lists containing technology and weapons that should not be exported were drawn up and updated every four years:

- The "International Munitions List" (IML), which contained conventional weapons and ammunition, and other products intended for military purposes;
- the "International Atomic Energy List" (IAEL), which contained technology necessary for the production of and testing of nuclear weapons; and
- the "International Industrial List" (IIL), which contained various products connected to military purposes.

As mentioned it is claimed that the list drawn up by the Council on 15 April 1958 was based on one of the CoCom's lists – more precisely on the IML list. The fact that the list has not been updated or amended since 1958 makes part of the list obsolete, as no modern military equipment is included. According to Cornish, this fact has led Member States to the conclusion that it is not what is on the list that is of importance but the principle of exemption.[138]

According to a reply to questions 3015/86[139] and 1109/87[140] given on behalf of the Commission by Mr. de Clercq, the Commission does not

[136] Written question No 574/85 by Mrs Marijke Van Hemeldonck to the Council: Article 223 of the EEC Treaty on the protection of, and trade in arms, OJ C 287, 11.11.1985, p. 9.

[137] Oliver, pp. 316–318.

[138] Cornish, pp. 33, 37 and 38.

[139] Written question No 3015/86 by Mr Klaus Haensch to the Commission: Interpretation of Article 223 of the EEC Treaty, OJ C 296, 21.11.1988, p. 1.

[140] Written question No 1109/87 by Mr Klaus Haensch to the Commission: Interpretation of Article 223 of the EEC Treaty, OJ C 296, 21.11.1988, p. 2.

seem to be of the same opinion, although it seems clear that Article 223 (Article 296 EC) shall be interpreted strictly. It follows from de Clercq's reply that the list drawn up under Article 223 is constitutive and exhaustive and not declaratory and, consequently, must be applied in a strict manner.

This statement confirms Cornish's interpretation that Article 223 (Article 296 EC) may not be considered applicable to products of "dual use", which can be used for both civilian and military purposes. According to Cornish, it is common knowledge that Member States are unable to circumvent the Commission's commercial and industrial policy on legal grounds by forwarding arguments of "dual use". As soon as a product has civil use, it is within the authority of the Commission.[141]

Against this background, it seems that the scope of Article 296 EC is relatively narrow. In practice, however, the scope seems to be a bit wider. On 15 September 1995, Nel van Dijk put forth a written question, E-2527/95, to the Commission referring to a Commission reply to another question. According to that reply, the Commission had stated that as a certain shipyard had built only military vessels, Article 223 could be applied, and that the aid that had been granted could therefore be exempted. In the question of 15 September 1995, it was asked if the opinion upheld in the earlier reply still stood, as it had become clear to the public that the shipyard at issue had not only built military vessels. In Mr van Miert's reply on behalf of the Commission, he confirmed that the shipyard had also built ships for other purposes, emphasising that it engaged in this construction because of an absence of other assignments. It may be questioned whether this argument is convincing or not. Thus Article 296 EC is perhaps not as narrow as it would seem at first glance. A recent example supporting this view is Commission Decision 1999/763/EC on the measures implemented and proposed by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG.

The Bremen Vulkan Verbund AG, a maritime industrial holding with subsidiaries mainly in the shipbuilding sector, based in the Federal State of Bremen (BVV) fell into financial difficulties in late 1995. In May 1996, bankruptcy proceedings were initiated. BVV had a 100 % share in BVM Beteiligungs GmbH, which itself was the sole shareholder of Bremer Vulkan Marine Schiffbau GmbH (BVM), a small engineering company active in acquiring orders for the construction of naval vessels. The company was founded mainly to participate in the tendering procedure for the German 'F 124' frigate programme. This company was not sub-

[141] Cornish, p. 38.

ject to bankruptcy proceedings in connection with the break up of the group.

Taking into account the prospects of BVM for engagement in the construction of the new frigates, the Lürssen Maritime Beteiligungen GmbH & Co. KG (LMB) decided to acquire the company's shares. LMB is the holding company for Freidrich Lürssen Werft GmbH (Lürssen), a shipyard located north of Bremen. Lürssen is a medium-sized shipyard, primarily active in naval shipbuilding, specialising in smaller naval vessels (minesweepers, combat boats, and multipurpose boats). In the beginning of negotiations involving the Bremen authorities, LMB agreed to employ 100 former workers and up to 10 trainees, whom, it claimed, would only be needed to work on the F 124 project. Bremen then agreed to contribute DEM 4,6 million towards the costs of employing them. In addition, the Hanseatische Industrie Beteiligungen GmbH (HIBEG), a company solely controlled by the Federal State of Bremen, waived claims of DEM 5 million plus interest of an unknown amount arising from a loan granted to BVM. The amount was used to increase the equity capital of BVM so as to reduce its indebtedness. In addition, the Federal State of Bremen declared its willingness to grant aid of DEM 900 000 for intended investments (15 % of the total investment of DEM 6 million).

The Commission was of the opinion that all the financial measures taken by the Federal State of Bremen constituted State aid, and decided to initiate the procedure provided for in Article 93(2) of the Treaty (Article 88(2) EC). In this procedure, LMB and BVM supported comments submitted by Germany that all financial measures taken were to be considered as measures that Germany could take in accordance with Article 223(1)(b) of the Treaty (Article 296(1)(b) EC) for the protection of essential interests of its security.

In the decision closing this procedure, the Commission accepted that the scope of Article 223(1)(b) of the Treaty (Article 296 (1)(b) EC) covered the measures to be taken by the Federal State of Bremen for several reasons, including the fact that Lürssen was a yard almost exclusively engaged in naval shipbuilding. Moreover, BVM, which became a subsidiary of Lürssen after the acquisition, was a yard exclusively concerned with naval shipbuilding and was at the time engaged in the frigate programme. The 100 workers taken over by LMB were former workers of BVM and workers formerly employed in naval shipbuilding, which was implying that they had the experience and skill required in the field of naval shipbuilding. The loan granted by HIBEG was designed to enable BVM to continue to participate in the frigate programme. The investment aid was to be used exclusively for the upgrading of a dock bought by LMB from the former owner in order to make it suitable for naval

shipbuilding. The Commission thus considered all the measures related to naval shipbuilding and especially to the frigate programme of the German navy.[142]

3.3.3 The Council's authorisation of aid

It follows from Article 87(3)(e) EC, that it is not only the Commission that has the power to authorise aid, the Council, too, has been empowered with this authority. Article 87(3)(e) EC provides an opportunity for the Council to consider other categories of aid, i.e. a possibility for the Council to create other discretionary exemptions than those already mentioned in Article 87(3)(a) to (d) EC. In this context it should be emphasised that the application of these other categories of aid is entrusted to the Commission. The Council has no competence of its own to consider the compatibility of certain aid to the common market.[143] The decision of the Council requires qualified majority and must be based on a proposal from the Commission.

The Council has applied this Article in order to adopt various shipbuilding directives, as it has been considered impossible to authorise shipbuilding aid according to Article 87(3)(c) because of the operating character of the aid in question.[144]

Article 88(2) EC, sub-paragraph 3, provides for another possibility for the Council to authorise aid. According to this provision, however, it must be on the application of a Member State, the Council must act unanimously, and this decision must be justified by exceptional circumstances. In principle, this provision provides the Council with the possibility of restricting the Commission's power to refuse authorisation of State aid if representatives of the Member States agree that there are overriding political considerations. It follows from the wording of the Article that such an application is possible before the initiation of an Article 88(2) EC procedure. If an application is made after the Commission has already initiated the procedure provided for in Article 88(2) EC, the application will have the effect of suspending the Article 88(2) EC procedure until the Council has made its opinion known. There is a time limit of three months, within which the Council must make its attitude known; otherwise the Commission shall give its decision on the case.

[142] Commission Decision 1999/763/EC of 17 March 1999 on the measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG, OJ L 301, 24.11.1999, pp. 8–12.

[143] Hancher, Ottervanger and Slot, p. 80.

[144] Ibid.

An interesting question, put forward by Schina, is whether an application would be possible after the Commission has already refused its authorisation. However, as Schina concludes, it seems most likely that it would not be possible. First, the provision regarding suspension of Article 88(2) procedure would be meaningless if the Member States could still apply to the Council after the Commission has reached its final decision. Second, there could be a conflict between the Council's intervention and the right of the Commission to apply to the Court for a declaration that the State concerned had failed to comply with its obligations under the Treaty. Apparently, the few existing cases in which the Council has acted according to this provision seem to be taken before the Commission has reached its final decision.[145]

According to Schina, "exceptional circumstances" have, in the past, been considered to be, for example, the disruption of prices in agricultural markets because of exceptionally abundant harvests or the need to compensate for the loss of income suffered by producers of agricultural products because of the introduction of common price in a given sector.[146]

3.4 Summary

The classification of a measure as State aid according to Article 87(1) EC triggers several procedural rules, of which the most important is the obligation to notify the Commission. The absence of a definition of State aid may make it difficult for the Member States to foresee when an aid measure falls within the scope of Article 87(1) EC. Therefore the Member States must keep themselves informed about the development of the notion of State aid in the Commission's case practice and in the case law of the ECJ and the CFI. However, the risk remains that the Commission or a national court will eventually decide that a certain aid measure is to be considered as State aid according to Article 87(1) EC. The only way for a Member State to provide certainty about the status of a measure, and thus to protect the interest of the beneficiaries, is to notify the Commission in advance.

[145] Schina, pp. 151–152.
[146] Ibid, p. 152.

Although Article 87(1) EC contains a prohibition, it is not absolute. The saving clause in the initial part of Article 87(1) EC opens for exemptions provided by the Treaty. The Treaty provides for exemptions in Article 87(2) and (3) EC, in Article 88(2) sub-paragraph 3, Article 86(2) EC, Article 120 EC and Article 296 EC. The exemptions provided for in Article 87(2) EC are automatic, whereas the exemptions provided for in Article 87(3) EC are discretionary. The Commission is embodied with wide discretionary powers in the assessment of Article 87(3) EC, however, within the boundaries of the principles of compensatory justifications.

In order for the Commission to assess the exemptions provided for in Article 87(3)(a) to (d) EC, the aid measure needs to be categorised in various ways. The measure may be horizontal or sectoral, it may be an investment aid or aid of operating character, and it may be a rescue or restructuring aid, and the conditions for exemption depend upon these categorisations. It is interesting to note that the application of Article 87(3)(d) appears to require a more stringent assessment of competition than Article 87(1) EC. The assessment of competition in the application of Article 87(3)(d) EC appears to be similar to the one required in the application of Articles 81 and 82 EC dealing with concerted practices and the abuse of a dominant position, at least with regard to the definition of the relevant product market. It seems that this conclusion would also be valid for the application of Article 87(3)(c) EC.

PART II

4 The derogation method

4.1 Introduction

In 1961 the ECJ held that the concept of aid is wider than that of a subsidy because it embraces not only positive benefits such as the subsidies themselves, but also various forms of interventions that mitigate the charges which are normally included in the budget of an undertaking. Furthermore, although the interventions may not be subsidies in the strict meaning of the word, they are similar in character and have the same effect.[1] This conclusion, as noted in Section 2.4.2, has been of major importance for the continuing application of the EC State aid rules. To date, all sorts of indirect aid measures have been embraced by Article 87(1) EC.

In the case at issue, Case 30/59, De Gezamenlijke Steenkolenmijnen in Limburg *v* High Authority, Germany had introduced a miner's bonus, according to which all underground workers in the mines were granted a tax-free shift bonus paid by the undertakings through deductions from taxes paid on wages. The Court held that this shift bonus relieved the undertakings from an expense which they would otherwise have had to bear. The Court further held that, although the miners' bonus did not reduce present costs to the undertaking, it reduced costs which it would inevitably incur. Thus the Court found that the miners' bonus constituted State aid according to Article 4 (c) of the ECSC Treaty. Because the wording of Article 4(c) of the ECSC was almost identical to the wording of Article 87(1) EC, the principle that aid is a wider concept than a subsidy and that the concept of State aid also embraces indirect forms of aid has been extended to apply to the State aid rules in the EC Treaty. Consequently, it has been common knowledge since the beginning of the 1960s that the concept of aid in Article 87(1) EC also embraces meas-

[1] Case 30/59 De Gezamenlijke Steenkolenmijnen in Limburg *v* High Authority of the ECSC [1961] ECR 1, p. 19.

ures relating to taxation. This common knowledge has now been articulated in paragraph 8 of the Commission notice on tax measures, which states that '... [i]n applying the Community rules on State aid, it is irrelevant whether the measure is a tax measure, since Article 92 applies to aid measures "in any form whatsoever"...'.

One of the characteristic features of the application of Article 87(1) EC to taxes is that the measure must constitute a derogation from a generally applied tax system. This rule follows from paragraph 16 of the Commission notice on tax measures, which reads: 'The main criterion in applying Article 92(1) to a tax measure is therefore that the measure provides in favour of certain undertakings in the Member State an exception to the application of the tax system ...'.

These conclusions are a result of the Court's judgment in Case 173/73, Italy *v* Commission, delivered in 1974, which is described in Section 1.1.[2] To repeat, the Court held that any measure intended partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general system without there being any justification for this exemption on the basis of the nature or general scheme of this system constituted State aid.

The rule that the measure must constitute a derogation from a tax system is often referred to as the "derogation method". This method is the focus of this chapter. The discussion includes a description of the establishment of the derogation method and how it is currently applied. In this context, this chapter examines the tax expenditure debate held in the 1970s and 1980s and analyses its contribution to an understanding of the conditions under which a measure constitutes a derogation according to Article 87(1) EC. Also discussed are the reasons why the application of the derogation method has been criticised and if there are any options to the derogation method. The final issue dealt with in this chapter is the relationship between the derogation method and the selectivity criterion of Article 87(1) EC.

4.2 The derogation method – a well tried method

4.2.1 Introduction

As noted, paragraph 16 of the Commission notice on tax measures provides that the main criterion in applying Article 92(1) (Article 87(1) EC) to a tax measure is that the measure provides in favour of certain under-

[2] Case 173/73 Italian Government *v* Commission [1974] ECR 709.

takings in the Member State, *a derogation* to the application of the tax system. As mentioned, this rule is sometimes referred to as the "derogation method", a term coined by AG Darmon, the first person to recognise the method, in his opinion in joined Cases C-72 and 73/91, Sloman Neptun. AG Darmon concluded, after having read the Court's case law, that '... the only fundamental precondition for the application of Article 92(1) is that the measure should *constitute a derogation*, by virtue of its actual nature, from the scheme of the general system in which it is set'.[3]

As early as the report of the First Survey on State aid, it has been clarified that both the Court and the Commission recognised the application of a derogation method when the State aid rules were applied to tax measures. Furthermore, the survey stated that an OECD concept had been used as a starting point in order to identify State aid in the form of tax expenditures.[4] The OECD concept stated that '[a] tax expenditure is usually defined as a departure from the generally accepted or benchmark tax structure, which produces a favourable tax treatment of particular types of activities or groups of taxpayers'.

Thus the application of the derogation method has long been recognised, although it was not articulated until 1998 when the Commission issued its Commission notice on tax measures.

4.2.2 Derogations

4.2.2.1 Introduction

One of the first questions that comes to mind in an analysis of the derogation method is: What is a derogation? Derogations come in different shapes some of which are discussed in Sections 4.2.2.2 and 4.2.2.3.

[3] Joined cases C-72 and 73/91 Sloman Neptun Shiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887, at I-915. AG Darmon based his conclusion on the application of a 'derogation method' on three Court cases. The first was the Court's judgment in joined Cases 6 and 11/69, Commission *v* French Republic [1969] ECR 523. The second case was the judgment in Case 203/82 Commission *v* Italian Republic [1983] ECR 2525, and the third and last judgment was the judgment in Case 173/73 Italian Government *v* Commission [1974] ECR 709.

[4] First Survey on State Aids in the European Community, Commission of the European Communities, Luxembourg: Office for Official Publications of the European Communities, 1989, pp. 6–8 and 13. The survey covers 10 Member States between 1981 and 1986.

4.2.2.2 The characteristics of derogations

Paragraph 9 of the Commission notice on tax measures mentions that one advantage, in the context of applying Article 87(1) EC to taxes, is that the measure relieves the recipients of charges that are normally borne from their budgets. In this context, paragraph 9 mentions the following examples of measures constituting State aid:

- a reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements, or the entering of reserves on the balance sheet),
- a total or partial reduction in the amount of tax (such as tax exemption or tax credit),
- deferment, cancellation, or even special rescheduling of tax debt.

Although it follows from this wording that the items on the list should be perceived merely as examples, it seems that the Commission has tried to categorise various types of tax measures. This categorisation, in large part seems to coincide with the categorisation suggested by Pinto. He considers it appropriate to make a distinction between tax measures that relate to the taxable base, to the tax liability, or to the enforcement of tax claims.[5]

4.2.2.2.1 A reduction in the tax base

According to Pinto, the category "reductions in the tax base" embraces all measures having the effect of modifying the standard method of determining the final taxable income. It includes any measures affecting the calculation of an item to be taken into account for the purpose of determining the final taxable income: the granting of special exemptions for particular items of income from the tax base, the possibility of making certain deductions not normally allowed, the possibility of establishing certain tax-free provisions, and permission to claim accelerated depreciation and to employ theoretical methods of calculation of the taxable base.[6] Luja mentions transfer pricing as a further example of a measure that may lead to income exclusion. If a Member State uses the "at arm's length" principle in order to determine the transfer price of goods and services delivered between companies that are related to each other, a common standard for determining transfer pricing, the incidental setting of a price that is below an "arm's length" determination could result in a benefit.[7]

[5] Pinto, p. 119.
[6] Ibid.
[7] Luja, p. 30.

As mentioned, Pinto is of the opinion that this category embraces all measures having the effect of modifying the standard method of determining the final taxable income. As the Commission emphasised in its 2003 implementing report, the principles set out in the notice apply both to traditional analytical tax methods in which the taxable income is determined by the difference between the company's revenues and expenses, and to alternative tax methods such as the cost-plus method. Therefore it appears appropriate to include a discussion of the cost-plus method in this context. It is one of the methods recommended by the OECD for cross-border, intra-group transactions, and involves an accounting of the costs incurred by the supplier of goods or services in a transaction between associated companies. The supplier then bills the company receiving the goods or services with the cost plus an agreed-upon mark-up, usually a percentage of the costs, in order to obtain an appropriate profit in light of the functions performed, assets used, risks assumed, and market conditions.[8]

It follows from paragraph 11 of the Commission's 2003 implementing report that the advantage may be present in the calculation of the tax base if, for example, certain expenditures are excluded from the calculation base. The report indicates that the expenditures excluded were closely linked to the business of the undertaking concerned. The report includes a list of measures: for example, staff-costs, costs relating to sales promotion, costs for carriage of goods and granting of credit, certain subcontracting costs, and financial costs. Because, under the cost-plus method, the tax base is established by applying to the costs borne a predetermined percentage corresponding to the company's estimated profit margin, the underestimation of expenditures necessarily results in a tax reduction. It follows from the report that in some cases the advantage was present in the profit margins, which apparently could be set arbitrarily without any consideration of the real nature of the activities carried out. Examples include the situation in which a mark-up had been established without any checks to determine if it corresponded to economic reality.[9]

In this context, it should also be noted that, according to the report, the Commission was faced with an Irish scheme exempting certain categories of foreign income from national tax in cases in which this income

[8] Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C, paragraphs 8–10.

[9] Ibid, paragraphs 10–13.

is repatriated for investment aimed at creating or safeguarding employment in Ireland.[10] This Commission Decision is discussed in more detail in Section 4.3.3.5.

4.2.2.2.2 A total or partial reduction in the amount of tax

A total or partial reduction in the amount of tax refers to total or partial reductions in the tax rate or to the granting of tax exemptions for activities pursued in special tax-free areas. According to Pinto, tax credits linked to investments of certain business assets have the effect of reducing the taxpayer's tax liability.[11] A tax credit is received when amounts are subtracted from the tax liability.[12]

4.2.2.2.3 Deferment, cancellation, or special rescheduling of tax debt

The category of deferment, cancellation, or special rescheduling of tax debt concerns the actual collection of tax. Pinto gives examples of this category, which includes lax enforcement of tax rules, exercise of leniency in recovering tax claims, cancellation of tax debts, and tax deferrals granted by the national tax authority.[13]

4.2.2.3 Derogations from taxes in general

4.2.2.3.1 Introduction

It follows from the case law of the ECJ and the CFI that Article 87(1) EC applies to all types of taxes of relevance to economic operators, such as corporate income tax, other corporate taxes, social security contributions, excise duties, and to a certain extent also VAT, although application of this Article to VAT appears to be uncommon.

4.2.2.3.2 VAT

As mentioned in Section 1.4.3, VAT reductions are subject to strict Community rules and conform to the principle of equality of taxation for similar products and consequently they are not usually caught by Article 87(1) EC. Nonetheless, the question of exemption from VAT is described in Case T-67/94, Ladbroke Racing, which was discussed briefly in Sec-

[10] Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, available at http://europa.eu.int/comm/competition/state_aid/legislation/aid3.html#C, paragraph 16.

[11] Pinto, p. 119.

[12] 1984 OECD Report on tax expenditures, p. 9.

[13] Pinto, p. 119.

tion 2.6.3. The background to the case at issue was that the PMU, consisting of the principal racecourse undertakings in France, had been established to manage the organisation of off-course totalisator betting on behalf of its members.

A competitor, the Ladbroke Group, submitted a complaint to the Commission with respect to several forms of aid which the French authorities were allegedly granted to the PMU. The Ladbroke Group claimed that the exemption from the one-month delay rule for the deduction of VAT constituted aid. In its subsequent decision, the Commission found that some of the measures fell outside the scope of Article 92(1) of the Treaty (Article 87(1) EC) and that the remaining measures, among them the exemption from the one-month delay rule for the deduction of VAT, constituted State aid. The Commission held that, although the measure could be considered a cash-flow benefit equivalent to State aid, it had been offset between 1989 and its abolition by a permanent deposit lodged with the French Treasury.[14]

In Case T-67/94, Ladbroke Racing, Ladbroke Racing had raised an action for the annulment of the Commission's decision. At the hearing it became clear that the permanent deposit which PMU had lodged in return for the exemption from the one-month delay rule for VAT deductions had existed, not since 1989 as claimed in the Commission Decision, but since 1969. This fact was important in determining if the permanent deposit could be considered to offset the exemption from the one-month delay rule for VAT deductions, with the result that the measure in question never constituted State aid. The Court consequently held that the Commission's assessment of the measure was vitiated by error; therefore, the Court annulled that part of the decision.

Although, for procedural reasons, the CFI never dealt with the reduction from VAT in substance, there is reason to believe that a reduction like this would be classified as State aid according to the Commission.

4.2.2.3.3 Corporate income tax

Recent examples of cases in which corporate income tax was relevant include joint Cases T-127/99, T-129/99, and T-148/99, Territorio Histórico de Álava – Deputacíon Foral de Álava and Others *v* Commission, as well as joint Cases T-92/00 and T-103/00, Territorio Historíco Álava – Diputación Foral de Álava and Others *v* Commission. In these cases, a

[14] Case T-67/94 Ladbroke Racing Ltd *v* Commission [1998] ECR II-1, paragraph 20. This case was appealed to the Court of Justice in Case C-83/98P French Republic *v* Ladbroke Racing Ltd [2000] ECR I-3271. The appeal did not, however, lead to any change in substance.

sum equivalent to 45 % of the investments in fixed assets was to be credited, under certain conditions, toward the corporate income tax due to be paid.[15] An example in which a corporate tax other than corporate income tax was at stake is Case C-387/92, Banco de Crédito Industrial. In this case, the national Court asked the ECJ, in essence, if an exemption from a municipality establishment tax that was charged on the use or enjoyment of premises situated on the territory of local authorities and used for industrial or commercial purposes or for the exercise of professional activities could constitute State aid according to Article 92 of the Treaty (Article 87 EC).[16]

4.2.2.3.4 Social security charges

Reduced social security contributions have been interpreted as State aid in several judgments, following the ECJ's first conclusion in its 1974 judgment in Case 173/73, Italy *v* Commission, that a reduction from social security charges constituted State aid.[17] This case is described in Section 1.1. More recent examples that confirmed this initial ECJ judgment are Case C-75/97, Maribel bis/ter,[18] and Case C-256/97, DM Transport. The Maribel bis/ter case is described in Section 2.5.3.1.1. In Case C-256/97, DM Transport, however, the Tribunal de Commerce made a reference to the ECJ for a preliminary ruling under Article 234 EC.

The two questions articulated by the national court were raised in national proceedings in which the Court was to determine if DM Transport was insolvent. DM Transport had had financial problems. The debts for taxes, wages, and social security contributions were substantial, most of them owed to the Office National de Sécurité Sociale (ONSS), a public body guaranteed by the Belgian State to which the State had delegated responsibility for collecting mandatory employers' and workers' social security contributions. The ONSS was also responsible for the financial management of the social security system for ensuring efficient financing for it.

The contribution payable by a worker was to be withheld from each wage packet by the employer who had to forward those withholdings to

[15] Joined Cases T-127/99, T-129/99, and T-148/99 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1275, Joint Cases T-92/00 and T-103/00 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1385.

[16] Case C-387/92 Banco de Crédito Industrial SA, now Banco Exterior de España SA *v* Ayuntamiento de Valencia [1994] ECR I-877.

[17] Case 173/73 Italian Government *v* Commission [1974] ECR 709.

[18] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

ONSS within a certain period. Employers who failed to comply with this obligation were liable to criminal and other sanctions such as liability to ONSS of additional contributions plus interest at a rate fixed by law. However, it was clear that ONSS had the authority and the responsibility to grant periods of grace to employers and to vary the length of these periods. It was in exercising these duties that the Tribunal de Commerce considered that ONSS had displayed "exceptional patience" towards DM Transport and stayed the proceeding in order to refer questions to the ECJ.[19] The Tribunal de Commerce put two questions to the ECJ asking, in essence, if it was considered as incompatible State aid for a body like ONSS to refrain from collecting all the social contributions due to an undertaking, with the result that the company could use the sums collected from staff in support of its commercial activities, especially when that undertaking was unable to obtain funding under normal market conditions.

The Court held that payment facilities in respect of social security contributions granted in a discretionary manner to an undertaking by the body responsible for collecting these contributions constitutes State aid in the meaning of Article 92(1) of the Treaty (Article 87(1) EC), 'if, having regard to the size of the economic advantage so conferred, the undertaking would manifestly have been unable to obtain comparable facilities from a private creditor in the same situation *vis-à-vis* that undertaking as the collecting body.'[20]

4.2.2.3.5 Excise duties

Reduction from excise duties, particularly for energy tax, is dealt with, for example, in Case C-143/99, Adria-Wien Pipeline. In this case, the Verfassungsgerichtshof referred two questions to the ECJ for preliminary ruling under Article 177 (Article 234 EC). In essence, the Verfassungsgerichtshof asked if a rebate from energy tax granted only to undertakings manufacturing goods and not to undertakings supplying services constituted State aid. The ECJ confirmed that this differentiation would constitute State aid if the measure could not be justified on the basis of the nature and general scheme of the system. In the case at issue the ECJ could not find any justifications.[21]

[19] Case C-256/97 Proceedings concerning Déménagements-Manutenation Transports SA (DMT) [1999] ECR I-3913.

[20] Case C-256/97 Proceedings concerning Déménagements-Manutenation Transport SA (DMT) [1999] ECR I-3913, paragraphs 8 and 30.

[21] Case C-143/99 Adria-Wien Pipeline GmbH, Wietersdorfer & Peggauer Zementwerke GmbH *v* Finanzlandesdirektion für Kärnten [2001] ECR I-8365.

4.2.2.3.6 Personal income tax

Because one of the conditions applied under Article 87(1) EC is that the beneficiary must be an economic operator, it is more relevant to discuss taxes addressed to undertakings from an Article 87(1) EC point of view than to discuss taxes addressed to individuals. However, it would be possible to imagine situations in which tax exemptions are granted to individuals but with the intentional or unintentional effect of benefitting a certain undertaking or a certain group of undertakings. Take, for example, a hypothetical situation in which individuals were offered the opportunity to deduct for tax reporting purposes the costs of repairing their houses. Deductions could be for the cost of building materials or labour, but under the condition that the work be done by undertakings that pay their taxes. In this example, the individual obviously benefits from the tax relief. Whether the effect is intentional or not, however, this measure undoubtedly also benefits the building industry. Would this tax deduction scenario constitute State aid according to Article 87(1) EC? It may of course, but it may also be a situation of ancillary effects. Presumably, the question of what was the intended effect will be a question of what can and cannot be proved.

4.3 A parallel analysis of derogations in the tax expenditure debate

4.3.1 Introduction

Several scholars have criticised the application of the derogation method. Bacon believes that the primary problem with the derogation method is that 'it is descriptive rather than prescriptive'. The problem, according to Bacon, is that '[n]either the Commission nor the Court have defined what is a "derogation" from the norm, nor even what constitutes "the norm" or a "general system".' With regard to the concept of derogation, Bacon argued that this concept, without greater specificity of definition, does not adequately distinguish between a general measure and State aid.[22] This statement was, however, made prior to the 1998 issuing of the Commission notice on tax measures. Before 1998, there was no documentation clarifying the type of tax measures that the Commission considered to constitute State aid. Thus predictability was rather poor. One might ask, therefore, if the 1998 issuing of the Commission notice on tax measures solved this problem. The answer seems to be yes and no.

[22] Bacon, p. 298.

Although the list of examples of measures that constitute State as provided for in paragraph 9 of the Commission notice on tax measures is elucidating, it is not exhaustive. Would it be possible to improve the understanding of what constitutes a derogation?

As was mentioned in Section 1.1 in the Introduction, it is interesting to note that a method similar to the derogation method was and is applied to identify tax expenditures, according to which the main aim is to identify deviations from a normative tax structure. Thus it appears that a reference to the tax expenditure debate may be fruitful in the analysis of what constitutes a derogation according to Article 87(1) EC.

4.3.2 Norm elements in the tax expenditure debate

4.3.2.1 Introduction

As mentioned in Section 1.4.4, the tax expenditure debate began in the United States in the late 1960s, at the time Surrey established the concept of "tax expenditure" and articulated a wish to make expenditures previously hidden in the tax system visible in the Federal Budget. In the beginning and middle of the 1970s, the interest in tax expenditures started to spread to other countries and the issue of tax expenditure internationally seems to have reached a climax in the 1980s. The debate about tax expenditure not only caused countries all over the world to begin to account for tax expenditures in their yearly budgets, but also triggered several projects at the international level. Sections 4.3.2.2 to 4.3.2.5 present accounts of some of the most important international projects related to tax expenditure issues.

4.3.2.2 The 1984 OECD report[23]

In 1984, a report was published in which the use of the tax expenditure concept and of consolidated tax expenditure accounts in 11 OECD member countries was examined: Australia, Austria, Canada, France, Germany, Ireland, the Netherlands, Portugal, Spain, the United Kingdom, and the United States. The report is based on a discussion of a series of country notes submitted to the OECD's Working Party on Tax Analysis and Tax Statistics of the Committee on Fiscal Affairs. These discussions focused primarily on personal and corporate income tax, although some references were made to tax expenditures in relation to property and consumption. Tax expenditures with regard to social security were not covered, however.

[23] 1984 OECD Report on tax expenditures.

In the 1984 report, it was held that tax expenditures may be described as Government expenditures made through the tax system to achieve economic and social objectives.[24] The tax expenditure concept, first advocated by Professor Surrey, who divided the income tax structure into two components, was also cited:

> The first element combines the structural provisions necessary for the application of a normal income tax, such as the determination of income, the use of annual accounting periods, the determination of the entities subject to tax, and the rate schedule and exemption levels. The second structural element consists of the special preferences found in every income tax. These special preferences, often called tax incentives or tax subsidies, are departures from the normal tax structure designed to favour a particular industry, activity or class of persons. (Surrey and Sunley, 1976, page 16).

As concluded in the 1984 report, this approach assumes that it is possible to define a normal tax structure, '... ,even though such a norm may differ as between countries and within a country over time'.[25]

It follows from the report that different OECD member countries, which at the time had published official tax expenditure accounts, used different definitions of tax expenditures. The United States, for example, had, since 1982, defined tax expenditures as 'departures from the basic structure of the existing tax laws which were expenditure programmes implemented through the tax system and which apply to a sufficiently narrow class of transactions or taxpayers so that their differential effects on particular markets can be identified and measured.'[26]

The Canadian Government used a similar definition, but placed greater emphasis on neutrality than on the basic tax structure. The Canadian definition thus stated that 'the benchmark tax structure is one that provides no preferential treatment to taxpayers on the basis of demographic characteristics, sources or uses of income, geographic location, or any other special circumstances applicable only to a given taxpayer or to a particular group of taxpayers.'[27] However, the Canadian Government added that the benchmark structure should not depart dramatically from the public perception of the current tax system and that tax expenditures should form a clear expenditure equivalent to a direct spending programme.

[24] 1984 OECD Report on tax expenditures, p. 16.

[25] Ibid.

[26] Ibid.

[27] Ibid, p.16–17.

In France the following definition was used to describe tax expenditures: 'Any legislative or administrative measure may be called a tax expenditure if its application entails a loss of revenue for the State and hence lessening of taxpayers' burden in comparison to that which would have resulted under the "norm", that is, the general principles of French tax law.'[28]

Regardless of the definition used, all countries seem to have had definitional problems. As stated by the Canadian Government: 'Since the benchmark tax structure is an abstraction there will always be room for legitimate disagreement about its nature and, thus about whether certain tax provisions are properly characterised as tax expenditures'.[29] It is also important to note that the norm may change over time, a fact recognised by the French Government, which stated that, in practice, the norm depends on the generally accepted principles of taxation and departures from a neutral structure. In order to by-pass these definitional problems, other countries, including Ireland, Portugal, and the United Kingdom, provided a list of tax relief instead.

It was found in the 1984 OECD report that the implementation of the criteria used to identify tax expenditures involved a number of conceptual issues, of which the most important were:

1) The tax unit – Should it be the individual, the couple, or the family that should form the unit for personal income tax?
2) What degree of integration between individual and corporate taxes should be taken as the norm? – It could be argued that the benchmark tax system should be a fully integrated individual and corporate tax system or that the corporate and individual tax systems should be treated separately. Decisions on this issue will determine how to treat lower taxation rates for distributed profits under split-rate systems or payments to shareholders in respect of corporation tax paid under imputation systems.
3) Tax base and inflation adjustment – A decision must be made about the tax system being based predominantly on real or on nominal income. If the latter, any ad hoc or partial adjustment for inflation may be treated as tax expenditures.
4) Tax penalties and negative tax expenditures – Consistency requires that tax penalties should also be identified.
5) Accounting period
6) Realisation versus accruals – Tax theory suggests that under the normal tax structure income should be taxed on accrual rather

[28] 1984 OECD Report on tax expenditures, p. 17.
[29] Ibid.

than on realisation. If this view is accepted, tax expenditures may arise, for example, when taxpayers are not required to pay tax on a capital gain until it is realised (i.e. a form of interest-free loan).

The report also reveals technical difficulties that are involved in evaluating tax expenditures. As evaluation technicalities are of no particular importance for the purpose of this dissertation, these difficulties are not discussed further.

4.3.2.3 The McDaniel/Surrey report[30]

In 1985 a comparative study was published by McDaniel and Surrey. It was a comparative study of personal and corporate income tax, value added tax (including national retail and manufacturers' sales tax), and wealth taxes (including estate, gift, and inheritance taxes) in six industrialised countries: Canada, France, the Netherlands, Sweden, the United Kingdom, and the United States. The aim of the study was twofold: 1) to develop a tax expenditure list in the countries using uniform criteria and 2) to make an international comparison of the purposes for and the extent to which the countries in question employed tax expenditures.

The researchers questioned if comparisons among the various countries would be possible against a background of differing tax histories and philosophies. It was concluded, however, that all six countries proceeded in a similar manner in preparing their lists. They all employed a concept of a normative income, value added, or wealth tax to serve as a general standard with which the existing tax legislation was compared. Deviations from this standard or norm that achieved non-tax social or economic objectives were then identified and classified as tax expenditures. Thus measures with social and economic objectives may be considered to be deviations from the norm and may constitute tax expenditures, but only if they aim to achieve *non-tax* social or economic objectives.[31]

Accordingly, provisions with social and economic objectives are apparently part of the normative income unless they aim to achieve non-tax objectives. What is meant by "non-tax objectives"? It seems that non-tax objectives are arguments that are not about tax structure arguments, but about such issues as public spending. It was added, however, that borderline cases may cause difficulties and that matters like history, the present stage of tax development, the sophistication of the tax administration, and the attitude of the country's citizens must be taken into account in

[30] McDaniel and Surrey.

[31] Ibid, p. 5.

the process of determining if a measure is part of the norm or constitutes a deviation from the norm.

The difficulties envisaged in the 1996 OECD report and further discussed in Section 4.3.2.5 – that countries use different methods in reporting their tax expenditures – seem to have been of lesser importance in the McDaniel/Surrey study. That study emphasises the fact that there are broadly shared views among the participating countries as to the elements that constitute a normative income, value added, or wealth tax.

In the McDaniel/Surrey study, a uniform set of guidelines was developed for each major type of tax. The guidelines were designed to provide a commonly applicable set of principles by which provisions in the respective countries could be classified either as part of the normative structure of the tax system or as deviations from it.

It follows from the study that the tax expenditure concept recognises two components in a tax system. The first component contains provisions that are necessary for implementing the normative tax structure. The second component contains provisions, the function and effect of which are to implement Government spending programs. The latter are referred to as tax expenditures. According to the study, the identification of the normative tax structure can best be managed by answering a set of questions. The provision is probably part of the normative structure if the answer is affirmative to at least one of the questions:

(1) Is the provision necessary to determine the base of the tax, normatively defined, in accordance with the fundamental nature of the tax?
(2) Is the provision part of the generally applicable rate structure?
(3) Is the provision necessary to define the taxable units liable for the tax?
(4) Is the provision necessary to assure that the tax is determined within the time period selected for imposition of the tax?
(5) Is the provision necessary to implement the tax in international transactions?
(6) Is the provision necessary to administer the tax?

It is emphasised in the McDaniel and Surrey study that the answer to each of these questions is based on policy decisions. It is stressed that it is the politicians, operating in the context of such factors as national politics, history, philosophy, and various sociological factors that determine, among other things, the content of the tax, its base, and its rate (the level of tax and whether it should be progressive, proportional, or regressive). Hereafter the tax experts proceed to provide the rules necessary to implement the normative elements of the tax. If a provision does not form part of the normative tax structure, but is responsive to questions asked of Government expenditure programmes, in most cases the provision con-

stitutes a tax expenditure provision. An example mentioned by McDaniel and Surrey is an income tax credit for investment in particular types of property or in particular regions of a country.

It is emphasised that not all deviations from the normative structure constitute tax expenditures. Sometimes it may be difficult to distinguish between, for example, items that should be included in the tax base and items that should be excluded. Sometimes mechanical rules are adopted in individual cases in order to cope with administrative difficulties. These mechanical rules may not properly provide the precise conceptual result. Hence, it is important to examine deviations against this background. And, as stated by McDaniel and Surrey, sometimes common sense must be used in order to establish what is and is not part of the normative structure.

According to McDaniel and Surrey, not only tax theory, but also tax history, is of decisive importance in classifying a particular provision as part of the normative structure or a tax expenditure.[32]

4.3.2.4 The Nordic Council of Ministers' Report[33]

The Nordic Council of Ministers' Report from 1987 contains an attempt by a working group established by the Nordic Council of Ministers to develop guidelines for identifying tax expenditures. The work of this group was, with some modifications, based on the outcome of the comparative McDaniel and Surrey study from 1985. The working group attempted to present as coherently and broadly as possible the type of questions and problems that could arise in a systematic report of tax expenditures and tax sanctions. The group also provided some solutions to these problems. The study is based on conditions in Denmark, Finland, Iceland, Norway, and Sweden, and primarily covers income taxes and value-added taxes.[34] The report concludes that the concepts of tax expenditures and tax sanctions may be determined in various ways. It states that the outcome of a comparative study illuminates the fact that different countries use different concepts. In some countries provisions with political or social purposes constitute tax expenditures. In other countries provisions that deviate from a certain norm are considered to be tax expenditures.

In the report, two extremes were mentioned as possible solutions to the determination of a normative system. One extreme was to define the normative system as a particular tax system at a certain time. It was noted

[32] McDaniel and Surrey, pp. 5–11.

[33] Skatteutgifter.

[34] Ibid, pp. 19–20.

that the most obvious drawback to this type of solution was that only tax expenditures introduced after this time would be registered. The other extreme was to determine the normative system as an optimal tax system, defined in this context as being an economically ideal tax system.

Most countries, however, derive their tax systems from certain tax provisions and tax principles which aim to achieve purposes other than creating the optimal tax system from an economic point of view. It was stated in the report that experiences from other countries that had compiled their tax expenditures showed that the solution is usually to be found somewhere in between, and that it is impossible to determine a unified definition of a normative system. Depending on the circumstances, the normative system may be close to the existing system or may be based on more theoretical points of views. It is concluded that the determination of a normative system must be done tax by tax and country by country.

The report states that in order to determine a normative system, non-objective considerations are required. If the system is based on theoretical points of views, it may be of interest to take into account what is publicly considered to be part of a particular type of tax. It is also important to consider the country's legislative history.

4.3.2.5 The 1996 OECD report[35]

In 1996, the OECD published an update of the 1984 OECD report containing a survey of 14 OECD member countries: Australia, Austria, Belgium, Canada, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain, the United Kingdom, and the United States. It is stressed in the report that even though it contains a survey of tax expenditures in a number of countries, this does not imply that different estimates of individual tax expenditures are comparable across countries, as these 14 countries used widely differing implicit or explicit benchmarks against which they measured their tax expenditures. It is emphasised in the report that even if the notion of tax expenditure was familiar at the time, the definition could, in practice, be controversial.

According to the 1996 report, the definition of tax expenditure is 'a classification exercise: dividing the provisions of the tax system into a benchmark or norm and a series of deviations from that norm'.[36] Furthermore, it is stated that, in general, the norm includes the rate structure, accounting conventions, deductibility of compulsory payments, provi-

[35] 1996 OECD Report on tax expenditures.

[36] Ibid, p. 9.

sions to facilitate administration, and provisions relating to international fiscal obligations. Where the tax system deviates from this benchmark, a tax expenditure is said to exist.

Other distinctive characteristics are often added to this definition of a tax expenditure, although opinions vary over whether or not to account for these factors: e.g. the tax concession must benefit a particular industry, activity, or class of taxpayer; it must serve a particular purpose (other than the efficient operation of the tax system) that is readily identifiable with an objective that could alternatively be achieved by other instruments; the tax must be sufficiently broad that an appropriate benchmark can be determined against which the value of the concession may be measured; it must be administratively feasible to alter the tax system to eliminate the tax expenditure; and there must be no provisions elsewhere in the tax system that largely offset the benefit of the tax expenditure.

Although these relatively formal guidelines seem to exist in order to define what constitutes tax expenditures, the countries represented in the survey appear to have applied different methods in order to determine what constitutes tax expenditures. Some countries used a formal definition, according to which a tax expenditure is a deviation from a benchmark. This method leaves it up to the reader to classify what provisions may be defined as tax expenditures. Another group of countries defined tax concessions as part of either the benchmark or a tax expenditure. This method gives the reader more straightforward information but says little about the background behind the reasoning. Also, within the two groups, the method of interpreting and defining tax expenditure seems to differ substantially.[37]

The 1996 report covers tax expenditures in all 14 countries with regard to personal income tax. Every country except the Netherlands also reported corporate income tax expenditures and, with the exception of Ireland and the Netherlands, they all reported accounts for indirect and other direct taxes. The United States' report included estate and gifts taxes, but did not cover indirect taxes or payroll taxes. Some of the country reports covered only central Government taxes. There may be more than one reason why the various countries reported tax expenditures within different types of taxes and those reasons may vary from country to country. Some types of taxes may have been omitted because of the method used to define tax expenditures. Or it may have been difficult for political reasons to reveal this type of information. The differences could also be a function of administrative problems.

[37] For further reading, see 1996 OECD Report on tax expenditures, p. 10 and pp. 19–116.

4.3.2.6 Norm elements

It is interesting to note that in its 1996 report the OECD considered that a norm, in general, includes a certain set of elements: rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate administration, and provisions relating to international fiscal obligations. A deviation from any of these elements was considered to constitute tax expenditures. This opinion coincides, at least in part, with the conclusions in the 1985 McDaniel and Surrey study, in which it was concluded that a norm usually contains a tax base, a generally applicable rate structure, definitions of taxable units liable for the tax, rules about the period within which tax shall be paid, rules that regulate international transactions, and/or administrative rules, and that it is deviations from these elements that constitute tax expenditures.

What do the various norm elements mean? A more detailed analysis is presented in the next section, addressing the different norm elements mentioned by the OECD and in the McDaniel and Surrey study.

4.3.2.6.1 Provision referring to the tax base

Provision referring to the tax base was mentioned explicitly in the McDaniel and Surrey study and implicitly in the 1996 OECD report, in reference to the deductibility of compulsory payments.

The tax base determines what shall be taxed. In the McDaniel and Surrey study, for example, the personal income tax base is considered to include a taxpayer's increase (or decrease) in net worth plus consumption expenditures for the appropriate tax period.[38] According to the same study, the normative corporate income tax base consists of the increase in a corporation's net worth for the taxable period. The increase in net worth figure is essentially a balance sheet figure, yet although accounting principles employ cost, they typically do not employ accrued gains. This difference reflects the conservative principle of accounting, which is to recognise losses (or expenses) at the earliest time they can reasonably be anticipated, but to defer recognition of income (or gain) until it is assured.[39] Each country, however, has its own interpretation of how different types of income shall be treated. Usually, costs of producing the income and losses with respect to income-producing assets or assets held for investment are deductible from personal income.[40] With respect to corporate income tax, costs of earning the corporate income, including

[38] McDaniel and Surrey, p. 23.

[39] Ibid, p. 43.

[40] Ibid, p. 34.

depreciation and obsolescence, are usually considered to be deductible.[41] However, each country has its own view on how to treat different kinds of deductions.

The tax base of a VAT is, according to the McDaniel and Surrey study, considered to include all retail supplies of goods and services for consumption.

Consequently, the tax base provides information about what should be taxed. The content of the tax base, however, varies from country to country. The tax base, of course, varies from tax to tax as well.

An example of a derogation from a country's normative decision of what constitutes the tax base may be that a certain income is excluded from the tax base, either directly through exemptions or in the form of allowances or credit (amounts deducted from the gross income to arrive at the taxable income).

4.3.2.6.2 Rate structure

Rate structure is an element mentioned in both the 1996 OECD report and the 1985 McDaniel and Surrey study. A tax rate structure is essential to the imposition of tax; thus the rate schedule forms part of the normative structure of the tax. Tax theory does not, however, prescribe any particular type of rate schedule as normative for income tax, VAT, or any other type of tax. A tax rate structure may be progressive, flat, or even regressive.

With regard to personal income tax, it is common to have progressive rate structures. With regard to corporate income tax, apparently, most countries with classical system for treating corporations as taxable units separate and distinct from the shareholders have adopted a single flat rate of tax applicable to corporate income.[42] Regarding retail taxes or VAT-taxes, it is emphasised in the McDaniel and Surrey study that these are *in rem* taxes, which do not account for the personal or family circumstances of the consumer. Furthermore, it is stated that, in order to satisfy the neutrality principle (in the sense that the tax shall not influence the consumer's decision), only a single flat rate may be employed.[43]

A country may also apply different rate schedules to different taxable units without creating deviations from the norm. According to McDaniel and Surrey, '*ad hoc* changes in tax rates and tax brackets' are considered to constitute changes in a normative element of, in their case, the personal income tax. Automatic changes, however, form part of the normative

[41] McDaniel and Surrey, p. 43.
[42] Ibid, p. 50.
[43] Ibid, p. 90.

structure. In the McDaniel and Surrey study, it is held that once the general rate schedule has been established, a deviation from that schedule to provide special lower rates to a particular type of income constitutes a derogation.[44] According to McDaniel and Surrey, particular care is required in this kind of situation in order to determine the appropriate classification of rules that apply differing rates to different types of income, for example. However, this classification does not appear to be easily achieved.

The most obvious example of derogation from the rate structure occurs when a reduced rate of tax is being applied to certain taxpayers or to certain behaviour. As stated in the McDaniel and Surrey study, difficulties may appear if a country applies what nominally appears to be a progressive corporate income tax rate, whereas the lower rate may, in fact, apply only to a small percentage of corporate sector taxable income – a lower rate to benefit small businesses, for example.[45]

4.3.2.6.3 Definitions of taxable units liable for the tax

Definition of taxable units was mentioned as an element in the McDaniel and Surrey study. The taxable unit provides information about whom to tax. With regard to personal income tax, the unit of assessment in some countries is the family; in others it is the individual. However, in the latter case there may be a degree of integration of taxation of spouses and children, for example.[46] With regard to corporate income tax, a country may take the view that the corporation is the taxable unit, independent of its shareholders. Other countries may disagree with this view and apply other options.[47] However, a sales tax like VAT does not encounter the taxable unit questions raised in an income tax: Rather, VAT is an *in rem* transaction which invokes the tax instead.[48]

4.3.2.6.4 Accounting methods or accounting conventions and timing

Accounting conventions were mentioned as an element in the 1996 OECD report. Because "accounting conventions" in this context primarily determine the time when items are to be taken into account, the concept is treated here along with the element of timing.

The element of timing was referred to in the McDaniel and Surrey study, with particular emphasis on the taxable period. Above all, the de-

[44] McDaniel and Surrey, p. 49.
[45] Ibid, p. 50.
[46] 1996 OECD Report on tax expenditures, p. 11.
[47] McDaniel and Surrey, pp. 51–52.
[48] Ibid, p. 66.

termination of the taxable period provides information about the period within which the tax shall be paid. Examples of deviations from the taxable period are different types of averaging rules and carry-over and carry-back provisions.[49]

Another example may be the granting of respite in the collection of the tax (tax deferral). In this context, it can be mentioned that the postponement of tax liabilities, whether or not the postponement has to do with accounting conventions, collection of tax, or something else, is often compared to an interest-free loan by the Government to the tax payer. On the one hand, this postponement ought not to be considered as tax expenditure if the tax payer pays an interest rate corresponding to the interest rate applied by commercial banks or non-governmental credit institutes. On the other hand, there are other factors that could and perhaps should be taken into account.

As mentioned by Bittker, loans from banks and other non-governmental lenders can be procured only if the lender is satisfied with the debtor's financial ability, and they are often accompanied by restrictions on the borrower's freedom. Loans that result from a postponement of tax liabilities, however, are obtainable at the will of the borrowers, regardless of their financial situation and without restrictions on their freedom. Moreover, as Bittker suggests, an ordinary loan carries a fixed maturity date imposed by the lender, and is subject to extension only if the lender agrees. Postponed tax liabilities do not have a fixed maturity date, however, but are due when the tax is collected or the taxpayer is required to realise the income at issue or to apply the ordinary accounting methods – that is to say when postponement of the tax liability no longer applies.[50]

However, in the McDaniel and Surrey study, rules necessary to assign receipts and expenditures to the proper tax period were also treated under the heading "The Taxable Period".[51] This aspect of timing is important for cash receipts and disbursements, accrual, installments, and completed contracts.[52] Further examples could be deviations from installment reporting of gains, deferred compensation rules, employee retirement plans, and derogation from valuation techniques used to assess the tax – for example depreciation allowances in corporate income tax. Different countries may base their depreciation allowances on different views of what constitutes the correct economic depreciation. As long as the allowance is designed to approximate roughly the economic depreci-

[49] McDaniel and Surrey, p. 22.
[50] Bittker, (1967), pp. 960–961.
[51] McDaniel and Surrey, p. 22.
[52] Bittker, (1967), p. 964.

ation, it seems appropriate to threat it as part of the normative structure.[53] If depreciation allowances are designed to be more generous, however, in order to encourage investments, for example, or if special allowances are introduced to support particular sectors or types of investment, this may well constitute tax expenditure.

According to the McDaniel and Surrey study, a sales tax like VAT does not typically raise questions regarding taxable periods and timing. It is stated that it is not conceptually important to establish a time frame within which tax liability is to be measured.[54]

4.3.2.6.5 Provisions relating to international fiscal obligations

The element of provisions relating to international fiscal obligations was referred to in both the 1996 OECD report and the 1985 McDaniel and Surrey study.

In applying personal income tax and corporate income tax systems to persons and businesses engaged in transactions across its borders, a country must establish jurisdictional principles in order to define its tax nationals and tax foreigners. In the McDaniel and Surrey study, the definition of tax nationals in terms of citizenship, residency, domicile, or any combination of these factors, is viewed as normative. Similarly, the definition of a national corporation in terms of place of legal incorporation, seat of management, place of principal business activity, or any combination of these factors, is considered normative.[55] One deviation from this element could occur if an undertaking, even if classified as a national corporation, is treated differently than other national corporations with regard to its foreign income, for example. VAT, on the other hand, is a global tax and, as stated in the McDaniel and Surrey study, the method by which VAT is to be applied must be resolved for any tax of global scope.

According to McDaniel and Surrey, only two jurisdictional bases for asserting the tax would be theoretically available – the origin and the destination principles. Under the origin principle, a country would tax all supplies for consumption, including those destined to be consumed in another country. Consequently, exports but not imports should be taxed. Under the destination principle, the theory is that a sales tax is intended to be levied on domestic resources which are expended for consumption. According to this theory, only imports would be taxed, whereas exports are excluded from the tax base.[56]

[53] 1996 OECD Report on tax expenditures, p. 13.

[54] McDaniel and Surrey, p. 67.

[55] Ibid, p. 59.

[56] Ibid, p. 94.

4.3.2.6.6 Tax Administration

The element of tax administration was mentioned in both the 1996 OECD report and the 1985 McDaniel and Surrey study.

Most countries have established sets of rules and procedures for administering their taxes. It seems that the distinction between substantive rules and administrative rules is not always easy to make. With reference to VAT tax administration, however, the McDaniel and Surrey study refers to provisions by which the tax is assessed, collected, and audited.[57] Thus deviation from these rules would constitute tax expenditures.

4.3.3 Norm elements – a method to establish derogations according to Article 87(1) EC?

4.3.3.1 Introduction

A reference to the norm elements mentioned in the 1996 OECD report and in the McDaniel and Surrey study seems to provide a systematic structure for identifying tax expenditures. The analysis of the norm elements is based primarily on an income tax structure and a VAT structure, and it clearly follows that not all norm elements mentioned by the OECD and by McDaniel and Surrey are relevant to all type of taxes.

It is interesting to note that an examination of several State aid judgments and Commission decisions show that most measures considered to constitute State aid are measures derogating from elements similar to the norm elements mentioned in the 1996 OECD report and in the McDaniel and Surrey study. As described in Section 4.3.3.2 and 4.3.3.3, most measures classified as aid seem to constitute derogations from the tax base or the rate structure, whereas some aid measures constitute derogations from accounting conventions or timing or international fiscal obligations.

4.3.3.2 Derogation from the tax base

Joined Cases T-127/99, T-129/99, and T-148/99, Territorico Histórico de Álava – Deputacíon Foral de Álava and Others *v* Commission, as well as joined Cases T-269/99, T-271/99, and T-272/99, Diputación de Guipúzcoa and Others *v* Commission, of which the former is discussed in greater detail in Section 5.6.1, dealt with the same type of measure. In both cases it was possible, according to provincial law, to receive a tax credit of 45 % of the cost of new investment (costs to be determined by

[57] McDaniel and Surrey, p. 68.

the provincial authorities), to be applied to the final amount of the corporate tax payable. In order to be eligible, the investment had to be made in new fixed assets within a certain period and had to exceed a certain amount.[58]

In two other cases, joined Cases T-346/99, T-347/99, and T-348/99, Diputación Foral de Álava and Others *v* Commission, and joined Cases T-92/00 and T-103/00, Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission, both of which are described in Section 5.6.2, the Spanish provinces of Álava, Guipúzcoa and Vizcaya provided, in their regional regulations, for a reduction in the tax base for newly established undertakings. Thus the regional regulation stated that if a new firm records an operating profit within four years of commencing business, its taxable base shall be reduced by 99 %, 70 %, 50 %, and 20 % in each of the four consecutive years beginning with the year in which the operating profit is recorded. In order to benefit from the reduction, the tax payer had to start the business with paid-up capital of at least ESP 20 million, and could not have conducted that particular business activity previously. Moreover, during the first years of business, the firm had to invest at least ESP 80 million in fixed assets and had to create at least ten jobs in the first six months and ensure that that average number of employees was kept in their employment. Furthermore, their business plan had to extend to at least five years duration.

In Case C-6/97, Italy *v* Commission, the Italian Republic had introduced a tax credit scheme for Italian road hauliers and a compulsory payment for non-Italian hauliers from within the Community based on fuel consumption over the distance covered on Italian territory. The tax credit took the form of a bonus that the Italian road hauliers were able to deduct, at their choice, from the sums they owed by way of income tax on natural persons, income tax on legal persons, municipal income tax, and VAT; and from sums deducted at source from the income of employees and compulsory payments for self-employed work. The tax credit applied only to road hauliers registered in a particular register. The amount of the tax credit was fixed at a percentage of the actual cost of fuel and lubricants, net of VAT, but could not exceed certain ceilings, fixed according to the weight of the vehicle and its load.[59]

[58] Joined Cases T-127/99, T-129/99, and T-148/99 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1275; joined Cases T-269/99, T-271/99, and T-272/99 Diputación de Guipúzcoa and Others *v* Commission [2002] ECR II-4217; joined Cases T-92/00 and T-103/00 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1385.

[59] Case C-6/97 Italian Republic *v* Commission [1999] ECR I-2981.

4.3.3.3 Derogation from the rate structure

Derogations from the rate structure seem to be the most common type of tax reduction. Most, if not all, the cases dealing with reduction from the contribution of social charges are examples of derogation from the rate structure. The derogation can be total (zero rate) or partial.

One example in which the derogation must be considered as a total exemption from the rate structure – that is to say where the beneficiary benefitted from a zero rate – was in the case subject to Commission Decision 2003/193/EC on State aid granted by Italy in the form of tax exemption and subsidised loans to public utilities with a majority public capital holding. This example is discussed further in Section 5.3.3.

Case C-75/97, Maribel bis/ter, discussed in Section 2.5.3.1.1, is an example of partial reduction in social security contributions. Another example of partial derogation from the rate structure was a tax advantage introduced in Italy for the consolidation of the banking sector. Accordingly, banks that merged or engaged in similar restructuring were granted a reduction to 12,0 % of the rate of income tax for five years after the operation, provided that the profits were placed in a special reserve which could not be distributed for three years. All reductions at issue were considered to constitute State aid.[60]

4.3.3.4 Derogation from accounting conventions or timing

An example that seems to illuminate the timing aspect of accounting conventions well is the case of the French Government granting several aid measures to the PMU and to other racecourse undertakings – the background to Case T-67/94, Ladbroke Racing, described in Section 4.2.2.3.2. Of the seven measures at issue in the Commission Decision preceding the Court case, the Commission considered three of them to constitute State aid, of which the measure of interest in this context is the exemption for the racecourse undertakings that made up the PMU from the one-month delay rule for VAT deductions as of 1 August 1969.[61]

An illuminating example of a measure being considered to derogate from valuation techniques is Commission Decision 96/369/EC concerning fiscal aid given to German airlines in the form of a depreciation

[60] Commission Decision 2002/581/EC of 11 December 2001 on the tax measures for banks and banking foundations implemented by Italy, OJ L 184, 13.7.2002, pp. 27–36.

[61] Commission Decision 93/625/EEC of 22 September 1993 concerning aid granted by the French Government to the Pari mutuel urbain (PMU) and to the racecourse undertakings, OJ L 300, 7.12.1993, pp. 15–21; Case T-67/94 Ladbroke Racing Ltd *v* Commission [1998] ECR II-1.

facility. This case is also discussed in Section 5.2. In this case Germany had introduced a particular system of depreciation which applied to aircraft used for commercial purposes for the international transport of goods or passengers or for other service activities performed on board. The system related only to aircraft registered in Germany, which could not be disposed of for six years following acquisition. If all these requirements were met, the owner of the aircraft had the possibility of proceeding with special depreciation of not more than 30 % of the purchase price during the year following acquisition and the four subsequent years. The special depreciation amount could be used entirely during the first year or spread over the first five years at the airline's discretion. The Commission concluded that the measure in question constituted State aid.[62]

4.3.3.5 Derogation from the rules on taxation of foreign income

Recently, in Decision 2003/601/EC on aid scheme C 54/2001(ex NN 55/2000), Ireland-Foreign Income, the Commission considered an Irish tax measure to derogate from the generally applied rules on taxation of foreign income. In order to avoid double taxation, Ireland normally used the credit system under which Irish tax on income and gains taxed double was reduced by the foreign tax incurred on that income or those gains. The tax credit could not exceed the amount of tax due in Ireland on that foreign income or gains. However, Ireland had a Foreign Income Scheme, under which relief was provided instead by exempting the foreign source income or gains from Irish corporation tax. The scheme consisted of two measures. One dealt with foreign dividends and one with foreign branch profits and gains.

According to Section 41 of the Finance Act 1988, dividends received by an Irish resident company from its foreign subsidiaries were exempt from Irish corporation tax in cases in which those dividends were applied to an investment plan. The definition of a foreign subsidiary was a company resident in a State with which Ireland had a double taxation treaty and which was a 51 % subsidiary of the Irish resident company. The investment plan had to be submitted in advance to the Irish authorities, who, if they were satisfied that the investment was directed towards the creation or maintenance of employment in Ireland, then issued an exemption certificate for a specified amount of dividends. The exempted dividend had to apply, for the purposes of the investment plan, within three

[62] Commission Decision 96/369/EC of 13 March 1996 concerning fiscal aid given to German airlines in the form of a depreciation facility, OJ L 146, 20.6.1996, pp. 42–48.

years, beginning from one year before and ending two years after their receipt in Ireland. These rules were amended by Section 40 of the Finance Act 1991, according to which the submission of an investment plan was allowed within one year of its commencement and the Irish authorities were allowed to extend the three-year period in which the dividend had to be applied. There were no particular requirements with regard to the kind of investment that must be made or the number of jobs to be created or maintained.

According to Section 29 of the Finance Act 1995, in order to qualify for an exemption, a company had to submit in advance an investment plan, in which the details were articulated and which included, for example, a background note on the company, details and nature of the initial and planned activities, level and type of investment, time scale, funding arrangements, final forecast, projected employment, and location of the proposed activities.

The Irish authorities could certify that a company qualified if they were satisfied that the plan was directed at the creation of substantial new employment in Ireland, that the investment would be made, that the creation of employment would be achieved, and that the maintenance of the employment in Ireland was dependent on engaging in the foreign trading activities involved in the plan. The minimum level of sustainable employment created had to be of the order of 40 new, incremental jobs and had to be achieved at the latest by the end of the three-year period specified in the exemption certificate. The income and gains from foreign trading activities were exempt from tax only where they were carried out in the countries specified in the exemption certificate.

The Commission held that by exempting the foreign source income and gains from any taxation in Ireland, the companies concerned and the groups to which they belong were relieved of the additional tax liability, to the extent to which it would otherwise occur, after the application of the generally applied tax credit. Thus the Commission considered both measures to constitute State aid according to Article 87 EC.[63]

4.3.4 Concluding remarks

In summary, it seems that the classification of State aid departs from a similar systematic structure that was reported in the 1996 OECD report and the McDaniel and Surrey study. Because the discussion in the literature on tax expenditure regarding the question of the characteristic of a

[63] Commission Decision 2003/601/EC of 17 February 2003 on aid scheme C 54/2001 (ex NN 55/2000) Ireland – Foreign Income, OJ L 204, 13.8.2003, pp. 51–59.

deviation that departs from a certain set of norm elements appears to be more sophisticated than the discussion in the EC State aid law literature, the Commission notice on tax measures, the Commission decision practice, or case law of the ECJ and CFI, it seems that the former discussion, reported in Section 4.3.2 and more in particular the discussion in Section 4.3.2.6, could contribute to improving the understanding of what constitutes a derogation from tax that would be classified as State aid according to Article 87(1) EC.

4.4 The necessity of the derogation method

4.4.1 Introduction

In Section 4.3.1, it was mentioned that several scholars have criticised the application of the derogation method. These criticisms are analysed in this section, together with a discussion on whether or not there are options to the derogation method and the consequences thereof.

4.4.2 Criticism of the derogation method

It seems that the derogation method has been criticised on three grounds: 1) a lack of definition of what constitutes a derogation, 2) a lack of a definition of a norm or a benchmark, and 3) the method itself. It was mentioned in Section 4.3.1 that Bacon was critical of the fact that neither the Commission nor the Court had defined what constitutes the "norm" or a "general system". Also, Schön has emphasised the difficulty of determining the "normal" tax rate in order to identify whether or not a certain tax rate reduction deviates from a tax burden "normally borne": in Thailand, for example, each region has its own tax rate, and in Germany each municipality has the right to set its own tax rate with respect to business tax.[64]

The question of what constitutes a derogation has already been dealt with in Sections 4.2 and 4.3.The question of what constitutes the norm or benchmark in the application of the derogation method is not examined here, but is discussed in Chapter 6.

With regard to criticism of the derogation method itself, Nicolaides concludes in a 2001 article, that the Advocate Generals in three different landmark State aid cases have applied different tests to distinguish between

[64] Schön, p. 930.

general tax measures and specific tax measures. The derogation method was one of these tests. Nicolaides criticises all three tests and proposes an alternative.[65]

Further discussion of the three tests is necessary at this point. 1) A derogation test was described by AG Darmon in his opinion of Case C-72 and 73/91, Sloman Neptun.[66] 2) Nicolaides mentions a test proposed by AG Ruiz-Jarabo Colomer in Case 6/97, Italy *v* Commission,[67] in which he concluded that a measure is general when it follows from or is compatible with the internal logic of the tax system. 3) Nicolaides further discusses the test that appeared in Case C-75/97, Maribel bis/ter,[68] in which AG La Pergola held that a measure is general when it aims to achieve equality among businesses and that it should apply to all undertakings to which it is capable of being applied. With regard to the latter test, Nicolaides rightly questions the concept of equality. The two former tests are criticised because of the implied assumption that a benchmark or a norm can be established by examining the tax system, and that certain measures can be classified as being or not being derogations from that norm.

Nicolaides' point of departure in proposing a new test is that economic policy measures are general as long as any undertaking in any sector can, at least in theory, claim eligibility. This point of departure is transferred to a two-stage test. The first stage concerns the identification of what the author refers to as the 'revealed potential targets' of the fiscal measure. The second stage concerns the identification of the 'revealed potential scope' of the measure. When neither the revealed targets nor the revealed scope prevent the entry of any firm from any sector, region, or type of activity that is potentially eligible, the measure must be considered general.

Nicolaides provides an illuminating example according to which a Government adopts a new policy of encouraging the use of environmentally friendly technologies and as part of that policy offers tax incentives to undertakings for the purchase of new, low-polluting, heavy lorries and buses. A low-polluting vehicle means a vehicle in which the use of fuel does not result in the production of a certain chemical considered to be extraordinarily damaging to the environment. It is added that the incentives are open to all companies, from any sector, in any region. Is this a

[65] Nicolaides.

[66] Joined Cases C-72 and 73/91 Sloman Neptun Shiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887.

[67] Case C-6/97 Italian Republic *v* Commission [1999] ECR I-2981.

[68] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

general measure or not? The purpose of the first stage of the test is to decide if there are any revealed targets – that is to say, are there other means of transport or other machineries producing the same damaging pollution? If there are, are they, too, eligible for the same incentive? In the example provided by Nicolaides, the author prefers to assume that there are no other types of vehicles or machineries producing the same damaging pollution. Thus all potential targets are covered and so far the measure must be considered general.

However, many Member States occasionally provide for arbitrary measures that may appear general in their application but, as a result of the narrowly defined conditions under which the measure applies, are revealed as having effects similar to those of State aid measures. For this reason, Nicolaides suggests a second stage of the test according to which the revealed scope of the measure should be identified. In the example provided by Nicolaides, this second stage of the test aims to provide an answer to the question: What is the reason for granting incentives for the reduction of the particular chemical considered to be damaging to the environment? If the reason is that the particular chemical has a certain impact on the environment but there are other chemicals with the same effect and the undertakings producing these chemical are not offered any incentives, Nicolaides is of the opinion that that measure, being narrow in scope, would constitute State aid. If, however, the incentive was also addressed to other undertakings producing these chemicals, the measure ought to be considered to be general.

4.4.3 Consequences of the derogation method that blur the logic of the State aid rules

4.4.3.1 Introduction

Although the application of the derogation method has been and will continue to be questioned on various grounds, its application appears to be the necessary consequence of the divided authority between the Member States and the Commission regarding taxation. As emphasised by Wishlade,[69] the Member States have retained a great deal of their sovereignty within the area of taxation – more within the area of direct taxation than within the area of indirect taxation. This means that the Member States have retained their right to design the tax structure, decide on systems of local taxation, regulate the balance between taxes on capital and on labour, and set rates of taxation. Consequently, it is up

[69] Wishlade, p. 22.

to the Member State to determine what to tax, whom to tax, and what tax rate to set.

This conclusion is consistent with the Court's statement in paragraph 37 of the judgment in Case C-75/97, Maribel bis/ter,[70] discussed in Section 2.5.3.1.1. In paragraph 37, the Court argued that

> ..., as Community law stands at present, the Member States retain their powers to organise their social security systems (Case C-238/94 *García and Others* [1996] ECR I-1673, paragraph 15). They may therefore pursue objectives of employment policy, such as those relied on by the Kingdom of Belgium, amongst which are, in particular, the maintenance of a high level of employment amongst manual workers and the maintenance of an industrial sector in order to balance the Belgian economy.

Accordingly, the authority of the Commission to consider a tax measure as State aid must be restricted to measures which constitute a derogation from a generally applicable system.

Thus although Nicolaides' proposal as reported in Section 4.4.2 provides food for thought, the view that this suggestion would be an alternative to the application of the derogation method does not appear feasible. Nonetheless, Nicolaides' proposal may contribute to improvements in the way in which to view the assessment of the selectivity criterion discussed in Sections 2.5.3.2.2 to 2.5.3.2.4.

The fact that the authority of the Commission is restricted to measures that constitute a derogation from a generally applicable system has caused confusion with regard to the logic of the State aid rules. Wishlade helps to resolve this confusion by providing two examples. One deals with regional taxes compared to regional aid and one involves special tax regimes for certain sectors compared to sectoral aid.

4.4.3.2 Regional taxes

In many Member States, the authority to tax belongs not only to the Government but also to regions and municipalities. According to Wishlade, the internal institutional and constitutional arrangements vary widely among Member States. In Spain, for example, País Vasco and Navarra apparently had greater autonomy in their taxation systems than did the rest of the Spanish regions, to the extent that these regions levied some of their own taxes in place of the national taxation. As pointed out by Wishlade, these situations can result in widely differing rates of corporation tax in different parts of Spain.

[70] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

Another example that Wishlade believes leads to the same result is the case of the exercise of local tax autonomy by municipalities in Germany. The municipalities in Germany levied, amongst other taxes, a municipal trade tax on income. The parameters within which the rate was to be set were specified in Federal legislation, but it was up to the municipalities to determine the actual rate within those boundaries. The rate varied from zero (chosen by 20 municipalities, of which 16 were in the new Länder) to 515 %. Thus the effective rate of trade tax on income varied between 5 % and 25.75 % from one municipality to another. In France, apparently, rates of local business tax tend to be higher in communities that are primarily residential and involve high social costs; whereas the rates of local business tax tend to be lower in industrial areas because there are more businesses to share the burden and the social costs are lower.[71]

Viewed from a tax perspective, these examples may not raise questions. The lower rates applied in some regions or municipalities may be applied because each region or municipality has the authority to determine the tax structure. However, viewed from a State aid perspective, the problem is more complex. According to the current interpretation of the derogation method, all examples would be viewed as general measures on a regional level. At the same time, however, they are also examples of measures with an effect equivalent to a regional grant. Had all the undertakings in the 20 municipalities in Germany been exempted from a generally applicable trade tax, the measure most probably would have been considered to constitute State aid.

The effect of the French example is particularly controversial in a State aid perspective. Not only did the measure avoid the classification of State aid, but it was contrary to the regional policy determining if regional aid could be exempted. In the example at issue, it seems that regions without many social problems had a low rate of local business tax, whereas regions with many social problems had high rates of local business tax. Had the measure in question been classified as State aid, it is reasonable to believe that it would probably not have been accepted with regard to Article 87 (3)(a) or (c) EC.

It must be noted however that, according to the Commission, regional taxes that appear to be the result of the financial autonomy of a certain region may also be classified as State aid, depending on their connection to the central tax legislation. This conclusion follows from a recent Commission Decision 2003/442/EC dealing with the part of the

[71] Wishlade, pp. 16–17.

scheme for adapting the national tax system to the Azores that involves reductions in the rates of income and corporation tax. Under the Constitution of the Portuguese Republic, the Azores and Madeira are autonomous regions which have administrative and financial autonomy. A certain law precisely defined the conditions of the financial autonomy. According to these conditions, the region itself could determine whether or not personal income tax and corporation tax should constitute revenue of the autonomous regions. Moreover, it was stated that the regional legislative assemblies were authorised to reduce the rates of income and corporation tax applicable in their regions, up to a maximum of 30 % of those laid down by national legislation. The tax reductions applied automatically to all economic operators.

Although the reductions applied automatically to all economic operators liable for tax in the Azores without introducing any difference in treatment in favour of one or more sectors of activities, the Commission considered that the measures were intended exclusively for undertakings situated in a particular region of Portugal. Moreover, the Commission considered that these measures constituted an advantage for the undertakings in the Azores, which undertakings intending to carry out similar economic operations in other areas of Portugal could not enjoy. Thus the Commission considered that the measures, in fact, favoured undertakings taxed in the Azores in comparison with all other Portuguese undertakings.

The Portuguese authorities and the interveners disagreed with the Commission's view that the measures were selective. First they considered that the treatment of the undertakings in the Azores should not be compared with the treatment of all other undertakings in Portugal. Furthermore, they were of the opinion that the measures did not constitute State aid, as the benefits were granted by an intra-State regional authority for the part of the territory that fell within the jurisdiction of the Azores. To the first argument, the Commission responded that settled practice of the Commission, confirmed by the ECJ, consists of classifying as State aid tax aid measures applicable in certain regions or territories which are favourable in comparison to the general scheme of the Member State. With regard to the second argument, the Commission emphasised that it was the national legislator who had authorised the regional authorities to grant the tax reductions concerned and that it was on the basis of this authorisation that the regional legislator actually introduced the reductions. The Commission continued to hold that if this behaviour was not considered contrary to Article 87(1) EC simply because the measures had been established by the regional authorities, a Member State could easily avoid the application, in part of its own territory, of provisions of

Community law on State aid, simply by making changes to the internal allocation of authority over certain measures.

Moreover, the Commission argued that the mechanism in the current case was not one that would allow all local authorities of a particular level (regions, districts, or others) to introduce and levy local taxes without reference to national taxation. On the contrary, the mechanism involved a reduction, applicable solely in the Azores, in the rate of tax that was established by national legislation and applicable on the mainland of Portugal. Thus the Commission found the measure adopted by the regional authorities to clearly constitute a derogation from the national tax system.[72]

The fact that regional taxes introduced by regions or municipalities on the basis of their regional financial autonomy must be distinguished from centrally decided reductions from tax for certain regions is not mentioned in the Commission notice on tax measures. It is only mentioned *obiter dictum* in paragraph 2.1 of the DG IV working paper on the difference between State aid and general measures.[73]

4.4.3.3 Special tax regimes

A second example provided by Wishlade to illustrate the blurring consequences of the application of the derogation method with regard to the logic of the State aid rules involves special tax regimes. Because it falls within the authority of the Member States to determine what or whom to tax, and at what rate, a number of countries operate different and separate taxation regimes. For example, there may be separate tax regimes for the banking and insurance sectors, an additional form of corporation tax on oil production as in the UK (an example mentioned by Wishlade), or special tax arrangements applicable to the horse-racing sector (as was the case in Case T-67/94).[74] What is confusing, however, is that if, for example, the additional form of corporation tax on oil production in the UK had been organised as an exemption for the oil production industry from the general corporation tax system, it probably would have been considered as sectoral State aid according to Article 87(1) of the EC

[72] Commission Decision 2003/442/EC of 11 December 2002 on the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax, OJ L 150, 18.6.2003, pp. 52–63, paragraphs 26–29 and 31.

[73] DG IV working paper on the difference between state aid and general measures, IV/310/95-EN Rev.1.

[74] Case T-67/94 Ladbroke Racing Ltd *v* Commission [1998] ECR II-1, paragraph 76.

Treaty.[75] The effect of the two ways of organising the system is the same; still the former way would probably not be considered a problem from a State aid point of view; whereas it is likely that the latter would. According to Wishlade, the two examples illuminate the Commission's formalistic approach to define State aid, an approach that disregards measures with equivalent effect.[76]

Thus it is clear that the derogation method does cause confusion with regard to the logic of the State aid rules.

4.5 The relationship between the derogation method and the selectivity criterion

4.5.1 Introduction

It is often argued that the assessment of the selectivity criterion in general (that is to say, the criterion in Article 87(1) EC requiring that the measure must favour a certain undertaking or a certain production), aims to distinguish State aid measures from general measures. Thus general measures (that is to say, measures open to all firms on equal access basis), are not considered to constitute State aid according to Article 87(1) EC. Recognising that the application of the derogation method contains the identification of derogations from a general system, which, if effectively open to all firms on an equal access basis, is, in principle, considered to be a general measure, and that the aim of the selectivity criterion is to distinguish between selective and general measures, one might questioned if the application of the derogation method is simultaneously fulfilling the requirements of selectivity. This section focuses on the relationship between the application of the derogation method and the assessment of the selectivity criterion. In order to establish the relationship between the application of the derogation method and the assessment of the selectivity criterion, various views on the nature of the assessment of the selectivity criterion to taxes are analysed. This analysis is followed by an examination of the application of the derogation method to determine if it simultaneously fulfils the requirements of the selectivity criterion.

[75] Wishlade, p. 19.
[76] Ibid, p. 18.

4.5.2 Various views on the assessment of selectivity applied to taxes

Views about the characteristics and content of the assessment of the selectivity criterion applied to taxes seem to vary. Nicolaides (see Section 4.4.2) seems to be of the opinion that there are three different tests applied to assess the selectivity criterion as it applies to taxes. Schön, however, together with Kube and Pinto, appears to be of the view that there is only one method, but the views of the character and content of this method seems to vary. According to Schön, the Court and the Commission make use of a strictly objective criterion as they scrutinise the effects of a tax rule rather than its aims or causes. To find objective qualities which make it possible to identify tax incentives, the Court and the Commission have tried to distinguish between a preferential and a "normal" tax regime.

Moreover, Schön has emphasised that the Commission, in its then recently issued notice on tax measures, had pointed out that 'firstly, the measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets'.[77] Thus according to Schön, it appears essential in the identification of State aid to fix a normal level of tax burden against which it can be said that special tax treatment of certain transactions or enterprises must be labeled advantageous or disadvantageous.

Moreover, it seems that Schön comes to the conclusion that, in this context, it is a matter of determining if the beneficiary is put at an advantage in relation to other taxable persons according to the tax system of the respective Member State.[78] It seems to follow that Schön recognises the advantage criterion as well as the application of the derogation method. Moreover, by stating that it is really a matter of determining if the beneficiary is put at an advantage in relation to other taxable persons, according to the tax system of the respective Member State, it seems that Schön is suggesting the application of the advantage criterion is connected with the selectivity criterion as described in Sections 2.5.3.2.2 to 2.5.3.2.4.

Kube considers that the Commission, in its notice on tax measures, has provided for yet another criterion in addition to the differentiation between State aid and general measures. According to Kube, this additional criterion is concretising which charges are "normally borne" by the undertakings. According to Kube, the two different standards reflect the practice of the Commission and the Court, which employ the criterion

[77] Schön, p. 923.

[78] Ibid, pp. 922–923.

of the "nature and general scheme" on an abstract level, but the criterion of "general" and "specific" *in concreto*. Moreover, Kube argues that these two criteria are, to a certain extent, 'incoherent'. Kube's reasoning is not altogether clear, but it appears that the additional criterion to which he refers may be the application of what is referred to as the derogation method in this dissertation, but it may also be a reference to the assessment of the advantage criterion, for the expression "normally borne" is used. Thus it seems that Kube is of the opinion that either the derogation method or the assessment of the advantage criterion, or both, are part of the assessment of the selectivity criterion to taxes and that there is a lack of coherence between the two.[79]

Also, Pinto has presented his views on the assessment of the selectivity criterion applied to taxes. According to Pinto, on the face of it, justifications which are addressed in detail in Chapter 5 may not seem to be new or different from the selectivity criterion, which also requires an analysis of the Member State's general tax system in order to determine if the measure in question forms part of the "benchmark" or is inherent to it, or if it constitutes a specific deviation from this benchmark. According to Pinto the distinction between specificity and the justification must be based on an objective and a subjective assessment of a possible fiscal State aid measure. Thus it must first be assessed whether or not the tax measure at issue objectively deviates from the "benchmark". If it does, the second stage is to assess the "nature" of the measure to see if it can be justified by taking account to the tax policy objectives pursued by this measure. It follows that Pinto is of the opinion that the assessment of the selectivity criterion contains one objective assessment, which corresponds to the derogation method; and one subjective assessment, which is the assessment of justifications on the basis of the nature or general scheme.[80]

Based on the above reasoning, it seems that some authors consider that there are several methods that can be used to assess the applicability of the selectivity criterion to taxes, whereas others appear to believe that there is only one method. The authors in the latter group, however, seem to have different views on the character and content of this method. Taken together, the assessment of the selectivity criterion applied to taxes seems to be a mixture of assessments containing the application of the derogation method, the assessment of the advantage criterion, the assessment of selectivity (in the way it is described in Section 2.5.3), as well as the assessment of the justifications on the basis of the nature or general scheme of the system (that are presented in Chapter 5). Thus all these

[79] Kube, pp. 18–19.
[80] Pinto, pp. 145–146.

assessments would appear to be part of the assessment of the selectivity criterion in Article 87(1) EC applied to taxes. Whether or not this assumption is plausible is examined in the following section.

4.5.3 The derogation method – part of the selectivity criterion

The view presented in the previous section that the assessment of the selectivity criterion includes an assessment of the advantage criterion does not seem plausible for the reasons described in Section 2.6.2. Furthermore, it follows from paragraph 12 of the Commission notice on tax measures, that the possibility of justifying the selective nature of a measure on the basis of the nature of a general scheme is part of the assessment of the selectivity criterion. Thus what seems to remain is to examine the relationship between the assessment of the selectivity criterion applied to taxes and the application of the derogation method, as well as the assessment of selectivity in the way it is presented in Section 2.5.3.

As mentioned in Section 4.4.3, the application of the derogation method seems to be the necessary consequence of the divided authority between the Member States and the Commission regarding taxation. The authority of the Commission to apply Article 87(1) EC to taxes must therefore be limited to measures constituting derogations to the application of the tax system. Consequently, and as concluded in Section 4.4.4, there can be no alternative to the application of the derogation method. As the application of the derogation method takes a tax system as the point of departure (which presumably is considered general, as tax measures open to all economic agents operating within a Member State in principle are considered as general measures), it may be assumed that the sole application of the derogation method simultaneously fulfils the requirement of selectivity. If this were to be true, there would be no need to establish selectivity the way it was described in Section 2.5.3. Is this assumption correct?

In Commission Decision 96/369/EC concerning fiscal aid given to German airlines, described in Section 4.3.3.4 and in Section 5.2, the Commission argued that because the criterion of specificity is the only criterion that the Treaty provides to the Commission for differentiating between State aid and general measures, the Commission, in light of the rulings of the Court of Justice, takes the general view that measures which derogate from the general rule constitute State aid, where this derogation is not justified by the nature and general scheme.[81] The court

[81] Commission Decision 96/369/EC of 13 March 1996 concerning fiscal aid given to German airlines in the form of a depreciation facility, OJ L 146, 20.6.1996, pp. 42–48.

case referred to by the Commission was Case 173/73, Italy *v* Commission[82]. Moreover, the Commission, in its Decision 2002/937/EC on the aid scheme implemented by Finland for Åland Islands' captive insurance companies, held, in paragraph 49, that 'in considering the benefits of the tax measure in question, a measure may be selective because it is granted either as an exception to general tax arrangements established by law, regulation, or administrative practice, or at the discretion of the tax administration'.[83]

It seems to follow from these decisions that the Commission considers the application of the derogation method in itself to satisfy the requirement of selectivity. This conclusion can, however, be valid only if the beneficiary is a body pursuing economic activities. If the exception were addressed to someone or something that is not an economic body, it would not automatically fulfil the selectivity criterion.

In this context, it is interesting to note that in several of its decisions the Commission has considered tax reductions to be general measures. In Case N 18/97, the Commission decided that a Dutch measure involving partially accelerated depreciation for R&D laboratories constituted general measures because the Dutch authorities had no discretionary powers in relation to the application of the measure and because the measure was neither sector-specific nor regional or local in scope. The measure was thus considered to be open to all companies on an equal access basis.[84] Similarly, in Case N 674/2001, the Commission decided that legislation in Italy providing for tax concessions and reductions in social security contributions constituted a general measure. The Commission found that the measure did not introduce any systematic discrimination in terms of the rules themselves (by identifying specific beneficiaries) and in the way in which the rules were applied (by conferring discretionary powers on the public authorities).[85] In another case, the Commission considered a Belgian measure that provided reductions in employers' social security contributions for firms that introduced shorter

[82] Case 173/73 Italian Government *v* Commission [1974] ECR 709.

[83] Commission Decision 2002/937/EC of 10 July 2002 on the aid scheme implemented by Finland for Åland Islands' captive insurance companies, OJ L 329, 5.12.2002, pp. 22–29.

[84] Commission Decision concerning Case N 18/97 of 14 June 1999 regarding *Gedeeltelijk vrije afschrijvingen voor R&D-laboratoria*, SG(99) D/4225, 29th report on competition policy, 1999, point 238, OJ C 225, 7.8.1999.

[85] Commission Decision concerning Case N 674/2001 of 13 November 2001 regarding *Misura per la regolarizzazione dell'economia sommersa*, C(2001)3455fin, 31st report on competition policy, 2001, point 368.

working hours to be a general measure. The Commission concluded that the rules applied automatically to all firms in Belgium and to all private-sector workers and all autonomous public enterprises and did not, therefore, fulfil the requirements of selectivity.[86]

Thus it appears that the application of the derogation method sometimes fulfils the requirement of selectivity automatically. On the other hand, a derogation from a tax system may sometimes be general and open to "all" economic operators. The latter situation suggests that the application of the derogation method does not always automatically fulfil the requirement of selectivity, but is sometimes supplemented by an assessment of whether or not the measure may be considered as a general measure.

In summary, the current assessment of the selectivity criterion applied to taxes seems to contain two elements: the application of the derogation method sometimes supplemented with an assessment of whether or not the measure may be considered as a general measure; and the assessment of justifications on the basis of the nature or general scheme of the system.

4.6 Summary

As early as 1961, the ECJ, in Case 30/59, De Gezamenlijke Steenkolenmijnen in Limburg *v* High Authority, held that the concept of aid is wider than that of a subsidy because it embraces not only positive benefits, such as subsidies themselves, but also interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without being subsidies in the strict meaning of the word, are similar in character and have the same effect.[87] Thus if the five criteria in Article 87(1) EC are fulfilled, tax measures could also constitute State aid. The method according to which Article 87(1) EC is applied to taxes is referred to as the derogation method. Using this method, only measures that constitute derogations from a generally applied tax system may be classified as State aid according to Article

[86] Commission Decision concerning Case N 232/2001 of 3 July 2001 regarding *Réduction de cotisations patronales de sécurité sociale en cas d'application d'une durée de travail hebdomadaire de 38 heures et en cas de réduction collective du temps de travail*, SG(2001)D/289530, 31st report on competition policy, 2001, point 369, OJ C 268, 22.9.2001.

[87] Case 30/59 De Gezamenlijke Steenkolenmijnen in Limburg *v* High Authority of the ECSC [1961] ECR 1.

87(1) EC. The character of a derogation may vary, but it follows from paragraph 9 of the Commission notice on tax measures that an advantage can take the form of a reduction in the tax base, a total or partial reduction in the amount of tax, and a deferment or cancellation or even a special rescheduling of tax debts.

The reductions mentioned apply to taxes in general, including direct and indirect taxes, except to a certain extent for VAT. And taxes addressed to undertakings are more relevant than taxes addressed to individuals, as Article 87(1) EC requires the beneficiary to be an economic operator. However, it may be debated whether or not tax exemptions addressed to individuals but with the effect of benefitting a certain sector or industry, for example the building industry, would be classified as State aid according to Article 87(1) EC.

In the application of the derogation method and the analysis of what constitutes a derogation, it seems that the classification of State aid departs from a systematic structure similar to the systematic structure used to identify tax expenditures. As the discussion in the literature on tax expenditure appears to be more sophisticated than the discussion in the literature in EC State aid law, the Commission notice on tax measure, Commission decision practice or case law of the ECJ and CFI, with regard to the question of the character of a deviation, departing from a certain set of norm elements, it seems that the tax expenditure discussion, presented in Section 4.3, could contribute to improving the understanding of what constitutes a derogation from tax that would be classified as State aid according to Article 87(1) EC.

The application of the derogation method has been criticised on several grounds, and it has even been suggested that it could be replaced by other methods. The question is: Are there any alternatives? The answer appears to be no, based on the reasoning that, although the application of the derogation method brings with it some confusion as to the logic of the State aid system, the necessity of the applying the derogation method appears to be the inevitable consequence of the divided authority between the Member States and the Commission in that the Member States have retained a great deal of their sovereignty within the area of taxation.

An important issue is the relationship between the application of the derogation method and the assessment of the selectivity criterion. It appears that different authors have different views on the nature and content of the assessment of the selectivity criterion applied to taxes. As well, views differ regarding the relationship between the derogation method and the selectivity criterion. An examination of the latter relationship appears to show that the present application of the derogation method is

sometimes considered automatically to fulfil the requirement of selectivity. This conclusion, however, presupposes that the beneficiary is an economic agent.

Moreover, it appears that the application of the derogation method is not always considered to automatically fulfil the requirement of selectivity, as the Commission has found in several decisions that the derogation is a general measure. Thus it seems that the Commission has applied the derogation method supplemented with an assessment of whether or not the measure may be considered a general measure. Consequently, the assessment of the selectivity criterion applied to taxes seems to contain two assessments: 1) the application of the derogation method, sometimes supplemented with an assessment of whether or not the derogation may be considered a general measure; and 2) an assessment of the possibility of justifying the selective nature of a measure on the basis of the nature or general scheme of the system.

Finally, it appears that the application of the derogation method is currently twofold: 1) It is used to determine which measures fall within and which measures fall outside the authority of the Commission and 2) it is applied, at least sometimes, automatically to fulfil the requirements of selectivity.

5 Justification of the selective nature of the measure

5.1 Introduction

According to paragraph 12 of the Commission notice on tax measures, the selective nature of a measure may be justified by 'the nature or general scheme of the system'. This chapter focuses upon three main questions:

1) What is meant by "justification on the basis of the nature or general scheme"?
2) What are the conditions under which the selective nature may be justified?
3) Need measures that may be justifiable on the basis of the nature or general scheme of the system be notified to the Commission in advance?

5.2 Justifications according to the Commission notice on tax measures

The possibilities of justifying the selective nature of a tax measure based on the nature or general scheme of the system is described in paragraphs 23 to 27 of the Commission notice on tax measures. Paragraph 23 emphasises that the differential nature of some measures does not necessarily mean that they must constitute State aid. For example, if a measure's economic rationale makes it necessary for the functioning and effectiveness of the tax system, it is not considered to constitute State aid. However, it states in paragraph 23 that it is up to the Member State to provide such justification.

Paragraph 24 indicates that the progressive nature of an income tax scale or profit tax scale is justified by the redistributive purpose of the tax. It notes that calculation of asset depreciation and stock valuation methods vary from one Member State to another, but that these types of measures may be inherent in the tax systems to which they belong. Sim-

ilarly, arrangements for the collection of fiscal debts can differ from one Member State to the other. Furthermore, it is argued that some conditions may be justified by objective differences between taxpayers. However, if the tax authority has discretionary freedom to set different depreciation periods or different valuation methods, firm by firm, sector by sector, there is a presumption of aid. As further noted in paragraph 24, this presumption also exists when the fiscal administration handles fiscal debts on a case-by-case basis with an objective other than that of optimising the recovery of tax debts from the enterprise concerned.

Paragraph 25 states that profit tax cannot be levied if no profit is earned. Thus according to paragraph 25, it may be justified by the nature of the tax system that non-profit-making undertakings such as foundations or associations are specifically exempt from taxes on profits if they cannot actually earn any profits. Furthermore, it follows that when cooperative organisations distribute all their profits to their members and the tax is levied at the level of members rather than at the corporate level, the non-taxing of the cooperative may be justified by the nature of the tax system.

Paragraph 26 states that a distinction must be made between, on the one hand, the external objectives assigned to a particular tax scheme (in particular, social or regional objectives) and, on the other hand, the objectives which are inherent in the tax system itself. As further noted in paragraph 26, the purpose of the tax system is to collect revenue to finance State expenditures, and each firm is supposed to pay tax only once. Therefore, it is inherent in the logic of the tax system that taxes that are paid in the State in which the firm is resident, should be taken into account for tax purposes. However, it is also noted in paragraph 26 that certain exceptions to the tax rules are difficult to justify based on the logic of a tax system. Among the examples cited are the case of non-resident companies being treated more favourably than resident companies and the situation of tax benefits being granted to head offices or to firms providing certain services (for example, financial services) within a group.

Finally, paragraph 27 indicates that specific provisions that do not contain discretionary elements (allowing, for example, that tax be determined on a fixed basis, as it may be in the agriculture or fisheries sectors), may be justified by the nature and general scheme of the system, where, for example they take account of specific accounting requirements or of the importance of land in assets which are specific to certain sectors. Provisions like these would not constitute State aid. Moreover, it is stated that the logic underlying certain specific provisions regarding the taxation of small and medium-sized enterprises (including small agricultural enterprises) is comparable to that underlying the progressiveness of a tax scale.

To my view paragraphs 23 to 27 of the notice on tax measures provide for confusing reading. Perhaps it is because of a lack of structure, the first sign of which occurs in paragraph 26. Although paragraph 26 emphasises that a distinction must be made between, on the one hand, the external objectives assigned to a particular tax scheme (in particular, social or regional objectives) and, on the other hand, the objectives which are inherent in the tax system itself, there is no definition of "external objectives" or "objectives inherent in the tax system" provided anywhere in paragraphs 23 to 27. Furthermore, there is no clarification in the notice to indicate if it is only measures based on objectives inherent in the system that are justifiable, or if measures based on external objectives can also be justified; nor is there clarification of the conditions for justification.

Paragraph 23, the initial paragraph under the heading '[j]ustification of a derogation by "the nature or general scheme of the system"', opens with the statement that the differential nature of some measures does not necessarily mean that they must be considered to be State aid, and notes that this may be the case when the economic rationale of measures makes it necessary for the functioning and effectiveness of the tax system. What type of measures are "measures whose economic rationale makes them necessary to the functioning and the effectiveness of the tax system"? And what does the Commission mean when it argues that measures derogating from the general rule do not qualify as State aid where they are economically justified in respect of the effectiveness of the system? The statement at issue is based on Commission Decision 96/369/EC concerning fiscal aid given to German airlines in the form of a depreciation facility, discussed in Section 4.3.3.4.

In this case, Germany had introduced a third system of depreciation in addition to the two more general systems of fixed assets depreciation: straight-line depreciation and accelerated depreciation. This third system of special depreciation applied to aircraft used for commercial purposes for the international transport of goods or passengers or for other service activities performed on board. It related solely to aircraft registered in Germany. In assessing whether or not the measure constituted State aid, the Commission stated that the Treaty had provided the Commission with the criterion of specificity, 'aid being defined in Article 92 of the Treaty as measures favouring certain undertakings or the production of certain goods'. According to the Commission, a comparison should therefore be made between the treatment of companies benefitting from the measure in question and the general system applied to companies in the same objective position.

The Commission argued that, in the light of the ruling by the Court of Justice, it would take the view that measures which derogate from the

general rule constitute State aid where this derogation is not justified by the nature or general scheme of the system, a conclusion discussed in Section 4.5.3. The Commission added that in its view taxation measures derogating from the general rule do not qualify as State aid if they are economically justified with respect to the efficiency of the system. The Commission continued to argue that this situation is usually reflected in the fact that this type of measure is not applied solely to specific sectors, is based on objective and horizontal criteria or conditions, and is not limited in time. The German depreciation system was not considered to be justified by the nature and general scheme of the system.[1] Thus it seems that an examination of the case on which the statement in paragraph 23 was based does not really shed further light on the statement in paragraph 23 of the Commission notice.

Moreover, the statements articulated in paragraphs 24 and 25 seem to be short policy statements made without any clear connection to paragraph 26. For example, what is the connection between the statements made in paragraph 26 and the statement that the progressive nature of an income tax scale is justified by the redistributive purpose of the tax? Another question arises from the statement in the last sentence of paragraph 24 indicating that some conditions may be justified by objective differences between tax payers: What is meant by "objective differences between tax payers"? Is this an example of a measure based on objectives inherent in the system or on external objectives referred to in paragraph 26? All these questions are elaborated on in the following sections.

5.3 Differentiation based on objectives inherent in the system

5.3.1 Introduction

Reference to measures that are based on objectives inherent in the system are mentioned in paragraphs 24 to 26 but, as mentioned, it does not clearly follow from these paragraphs what is really meant by differentiations based on objectives inherent in the system. In paragraph 24 of the notice, for example, it follows that calculation of asset depreciation and stock valuation methods vary from Member State to Member State, but that these methods may be inherent in the tax systems to which they belong. Similarly, it is stated that the arrangements for the collection of

[1] Commission Decision 96/369/EC of 13 March 1996 concerning fiscal aid given to German airlines in the form of a depreciation facility, OJ L 146, 20.6.1996, pp. 42–48.

fiscal debts may differ from one Member State to another. Moreover, in paragraph 26 of the notice it is stated that the entire purpose of the tax system is to collect revenue to finance State expenditures and that each firm is supposed to pay tax only once. It is therefore concluded that it is inherent in the logic of the tax system that taxes paid in the State in which the firm is resident for tax purposes should be taken into account. However, the meaning of these statements is not further explored. Is it relevant to question if it is always the entire purpose of the tax to collect revenue to finance State expenditures? This question is dealt with in Section 5.11 and not here. At present, it is the meaning of objectives inherent in the system that are further examined.

5.3.2 Objectives inherent in the system

The expression that a measure is considered to be inherent in the system was used in, for example, joined Cases C-72 and 73/91, Sloman Neptun.[2] In this case Sloman Neptun (a German shipping company) applied for the consent of the Seebetriebsrat to engage a Filipino Radio officer and five other Filipino seafarers on a vessel operated by it and registered in the International Shipping Register (ISR). According to German legislation dealing with the right to fly the flag and with ships flying the German flag in international trade, it was stated that the contracts of employment for crew members of a merchant ship registered in the ISR who have no abode or residence in Germany should not be governed by German law merely because the ship is flying the German flag. After the Seebetriebsrat had refused to give its consent, Sloman Neptun applied to the Arbeitsgericht Bremen to provide consent in lieu of the Seebetriebsrat. The Arbeitsgericht stayed the proceedings and referred the question to the ECJ, asking the ECJ to determine if it was compatible with Articles 92 (Article 87 EC) and 117 (Article 136 EC) with legislation that made it possible for foreign seafarers with no permanent abode or residence in Germany not to be covered by German collective agreements, and they could therefore be employed at lower "home country" rates and under less favourable working conditions than comparable German seafarers.

According to the national court, the rates of pay for seafarers whose contracts of employment were not governed by German law were not taken into account in fixing average rates of pay for the calculation of social security contributions. For these foreign seafarers, those contributions were apparently calculated according to their actual pay. In the

[2] Joined Cases C-72 and 73/91 Sloman Neptun Shiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887.

view of the national court, these circumstances led to an appreciable reduction in costs for the ship owners concerned, as the owners were not required to pay the difference between the contribution on such pay and the contribution on the average German pay. For its part, the Commission was of the opinion that the level at which rates of pay were fixed under contracts of employment not governed by German law resulted in a loss of tax revenue. Consequently, it seems that both the national court and the Commission were of the opinion that the German legal arrangements with regard to foreign seafarers employed on ships flying the German flag constituted State aid according to Article 92(1) of the Treaty (Article 87(1) EC).

In paragraph 21, however, the ECJ ruled that:

> The system at issue does not seek, through its object and general structure, to create an advantage which would constitute an additional burden for the State or the abovementioned bodies, but only to alter in favour of shipping undertakings the framework within which contractual relations are formed between those undertakings and their employees. *The consequences arising from this*, in so far as they relate to the difference in the basis for the calculation of social security contributions, mentioned by the national court, and the potential loss of tax revenue because of the low rates of pay, referred to by the Commission, *are inherent in the system and are not a means of granting a particular advantage to the undertakings concerned* (emphasis added).[3]

However, when this statement is read together with the statement in paragraph 20, it appears that the Court's reasoning in paragraph 21 regards the question of if the measure could be considered as having been granted through State resources rather than being part of the assessment of the selectivity criterion.

Measures inherent in the system were also at issue in Case C-200/97, Ecotrade. The undertaking Altiforni e Ferriere di Servola SpA (AFS) was engaged in manufacturing steel products and owed a debt to Ecotrade Srl (Ecotrade). This debt remained unpaid, and on 30 July 1992 Pretore di Trieste issued an enforcement order with the effect that AFS was obliged to pay to Ecotrade an amount corresponding to the debt from a claim that AFS had on a particular bank. On 28 August, AFS informed Ecotrade that, according to a Ministerial decree applying legislation number 95/79 of 3 April 1979, it had gone into receivership, but with permission to continue its activities. As a result, AFS requested that the amount paid to Ecotrade should be refunded, as the debt had been settled

[3] Joined Cases C-72 and 73/91 Sloman Neptun Shiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887, paragraph 21.

in conflict with Article 4 of legislation number 544/81 of 2 October 1981, prohibiting the exercise of particular debt-recovery measures following the introduction of a compulsory receivership order.

As Ecotrade was of the opinion that AFS's request was based on a Ministerial decree that was contrary to the EC rules on State aid, it brought the matter to Tribunale di Trieste. Tribunale di Trieste dismissed Ecotrade's claim, whereby Ecotrade appealed to Corte d'appello di Trieste. The latter body confirmed the dismissal, whereby Ecotrade appealed to Corte Suprema di Cassazione, which stayed the proceedings and in essence asked the ECJ, in accordance with Article 177 (Article 234 EC), if the application of the system introduced by legislation number 95/79, which represented a deviation from the ordinary law of bankruptcy, could be considered as granting the kind of aid that by the time was prohibited in accordance to Article 4 of the ECSC Treaty.

In paragraph 36, the Court ruled in this context that:

> Contrary to the view taken by the Commission, the possible loss of tax revenue for the State as a result of the application of the system of special administration, on account of the absolute prohibition on individual actions for enforcement and the suspension of interest on all debts owed by the undertaking in question, and the correlated reduction in creditors' profits, does not in itself justify treating that system as aid. That consequence is an *inherent feature of any statutory system* laying down a framework for relations between an insolvent undertaking and the general body of creditors, and the existence of an additional financial burden borne directly or indirectly by the public authorities as a means of granting a particular advantage to the undertakings concerned may not automatically be inferred therefrom. (emphasis added)

In this statement, the Court referred to paragraph 21 in joined Cases C-72 and 73/91, Sloman Neptun.[4] Thus the context in which it was assessed whether or not the measure was considered inherent in the system was, once again, if the measure could be considered granted through State resources and not as part of the assessment of the selectivity criterion.

5.3.3 Basic or guiding principles of the tax system

It follows from paragraph 16 of the Commission notice on tax measures, that in determining that exceptions to the system or differentiations within that system are justified "by the nature or general scheme" of the

[4] Case C-200/97 Ecotrade Srl *v* Altiforni e Ferriere di Servola SpA (AFS) [1998] ECR I-7907.

tax system, it must be established that the measures derive directly from the basic or guiding principles of the tax system in the Member State concerned. If this is not the case, then State aid is involved according to the last sentence of paragraph 16. The question is: What does basic or guiding principles of the of the tax system mean? There are no clarifications on this point in the Commission notice on tax measure. Moreover, it must be questioned why there is no reference to this provision in paragraph 26 of the notice.

However, it seems that with regard to the meaning of basic or guiding principles, a Commission Decision 2003/193/EC may be of interest. It dealt with State aid granted by Italy in the form of tax exemptions and subsidised loans to special and municipal undertakings that were being converted into joint stock companies.[5]

In this case, the transfer of assets linked to the conversion was exempt from registration tax, stamp tax, tax on the increase in the value of real estate properties, mortgage tax, and cadastral duty and other transfer taxes. Moreover, these entities were also exempt from tax on income of legal persons and from local income tax. Furthermore, joint stock companies with a public majority shareholding were granted subsidised loans. The exemption from income tax and the subsidised loans were considered to constitute State aid. The exemption from the different types of transfer tax, however, were not considered to constitute State aid, as the measure was considered to be justified by the nature or general scheme of the system.

In its decision, the Commission first noted that transfer taxes normally apply to the creation of new economic entities or to transfer of assets between different economic entities. The Commission continued to argue that, due to technicalities of the Italian legal system, it seemed that a municipal undertaking converting into a joint stock company meant the creation of a new economic entity. It follows from the decision that the Italian legal system made no provision in its general rules on conversions of the legal form of companies for conversion of municipal undertakings into joint stock companies. Therefore, the conversion technically had to take place by winding up the municipal undertaking and setting up a new joint stock company. In fact, however, the new joint stock company was the same economic entity as the municipal undertaking only under a different legal status. Consequently, the Commission considered it justifiable that the normal tax rules on transfer of assets

[5] Commission Decision 2003/193/EC of 5 June 2002 on State aid granted by Italy in the form of tax exemptions and subsidised loans to public utilities with a majority public capital holding, OJ L 77, 24.3.2003, pp. 21–40, paragraphs 76–81.

for the setting-up of a new economic entity did not apply in this case.

Moreover, the Commission concluded that the exemption was based on the principle of tax neutrality, because the conversion in itself was not an indication of an increase in income or in the capacity to produce income, and that these reasons were consistent with the function and efficiency of the tax system. It is worth noting that the Commission's decision made reference to the functioning and efficiency of the tax system, which is almost the exact wording used in paragraph 23 of the Commission's notice on tax measures. Although the expression "inherent in the tax system" was not used, the principle of neutrality surely is an example of a basic or guiding principle referred to in paragraph 16 of the Commission notice on tax measures. Moreover, if this conclusion is read together with paragraph 26 of the notice, it seems plausible that basic or guiding principles of a tax system are the type of objectives that are considered to be inherent in the tax system.

Moreover, Pinto appears to be of the opinion that objectives inherent in the tax system are tax policy objectives pursued by the measure at issue, such as the goal of redistributing income linked to the ability-to-pay principle or to the goal of avoiding international double taxation.[6] Thus it seems that the ability-to-pay and the principle of avoiding double taxation may also be the type of basic or guiding principles referred to in paragraph 16 of the Commission notice on tax measures.

Pinto's statement is based on an analysis of the Commission notice on tax measures and coincides with the statement in the first sentence in paragraph 24 of this notice. It follows from the wording of paragraph 24 that it is the redistributive purpose that justifies the progressive nature of an income tax scale. One might ask if it would not have been more accurate to refer to the ability-to-pay principle, as the progressive nature of a tax scale is usually based on this principle. The difference is that, according to the first viewpoint, it is the objectives pursued by the measure that justifies the measure. According to the second viewpoint, it is the fact that the derogation is based on the ability-to-pay principle that makes it justifiable.

5.3.4 Summary

It appears that principles like the principle of tax neutrality, the ability-to-pay principle, and the principle of avoiding double taxation may be the type of basic or guiding principles referred to in paragraph 16 of the Commission notice on tax measures. If this conclusion is read together

[6] Pinto, p. 146.

with paragraph 26, it seems plausible that these principles are also the type of objectives that would be considered inherent in a tax system and, therefore, measures based on these principles would be justified on the basis of the nature or general scheme of the system.

Furthermore, it seems that the use of the expression "inherent in the system" is not solely used in the assessment of justifications on the basis of the nature and general scheme of the system, a fact that seems to add to the blurring of an already confused picture.

5.4 Objective differences between tax payers

The last sentence of paragraph 24 of the Commission notice on tax measures states that some conditions may be justified by objective differences between taxpayers. There is no further elaboration; therefore, it is difficult to draw any conclusions about the meaning or relevance of objective differences between taxpayers. Perhaps the situations mentioned in paragraph 27 of the Commission notice on tax measures are examples that illustrate justifications based on objective differences. It states in this paragraph that specific provisions allowing tax to be determined on a fixed basis (for example, in agriculture or fishery sectors) may be justified by the nature or general scheme of the system where, for example, the provisions take account of specific accounting requirements or of the importance of land in assets which are specific to certain sectors.

There are several signs that the Commission has accepted the principle that certain business activities could require specific tax treatment. However, for this type of treatment to be justified, it has to be consistent with the rationale of the tax system concerned. In two decisions in which this view was offered, the different treatment was, however, not considered justified on the basis of the nature or general scheme of the system. The first was the Commission Decision 2002/581/EC on the tax measures for banks and banking foundations implemented by Italy[7] and the second was Commission Decision 2003/515/EC on State aid implemented by the Netherlands for international financing activities.[8]

In the first case, the Italian authorities had introduced several tax advantages for mergers in the banking sector. The Commission acknowledged

[7] Commission Decision 2002/581/EC of 11 December 2001 on the tax measures for banks and banking foundations implemented by Italy, OJ L 184, 13.7.2002, pp. 27–36.
[8] Commission Decision 2003/515/EC of 17 February 2003 on the State aid implemented by the Netherlands for international financing activities, OJ L 180, 18.7.2003, pp. 52–66.

that it was legitimate to adapt a tax system to accommodate distinctive features of an economic activity. In this particular case, however, the Commission was of the opinion that the measure at issue constituted an ad hoc aid and that the measure actually only benefitted banks involved in certain types of mergers.

In the second case, the question was whether or not Dutch rules to establish a risk reserve with the aim of preventing internationally active Dutch undertakings from sheltering their group financing activities in companies situated abroad, including in tax havens, constituted State aid. According to Dutch legislation, any undertaking of Dutch or foreign domicile that was liable to tax was entitled to set up a risk reserve. Accordingly, a risk reserve could be established by any undertaking conducting financing activities for parts of the group that were active in at least four countries or on at least two continents. An undertaking was regarded as belonging to the same group as a Dutch undertaking where the two were linked through a shareholding of over 33 % of capital.

In its assessment of the justification of the risk reserve system on the basis of the nature and general scheme of the system, the Commission first held that international transactions entail specific risks in comparison to national transactions for which the political or commercial risks are less important, or at least can be forecasted more easily. The Commission emphasised that it had observed that additions to the risk reserve must be proportional to actual risks. The Commission added that it recognised that amounts included in the risk reserve could cover real risks and that the reserve could be well justified, albeit in certain cases only, from the accounting and financial perspective. However, the Commission argued that this does not mean that limiting the reserve to certain categories is also justified. The Commission went on to state that although it is logical to set certain limits or thresholds in a tax structure to ensure that it works properly, this should not result in excessive demands being made which are not proportional to the desired aims.

Furthermore, the Commission added, objectively speaking, groups which are active in, for example, three countries or on only one continent are no less exposed to the risks associated with international financing activities than are those operating in four countries or on two continents. Thus the Commission could not endorse the argument that the sole purpose of the requirement of a minimum of four countries or two continents was to provide objective criteria which could be used to determine if the basic requirements were met. Consequently, the Commission did not consider the measures to combat erosion of the tax base or improve the lack of competitiveness, from which group financing activities in the Netherlands suffered before 1997, to justify the award of State aid to a

limited number of undertakings. Finally, the Commission concluded its comments with regard to the assessment of justification on the basis of the nature or general scheme with the statement that the aim to encourage large multinational firms to transfer their financing activities back to the Netherlands was an economic aim that was not inherent in the tax system.[9]

In Case N 482/2001, however, the Commission did approve specific tax treatment of certain financial institutes, as it approved the Danish measure allowing credit institutions to make provisions for losses the same year that the provision was made rather than the year in which the loss was a fact, reasoning that it was necessary in order to take account of the inherent credit risks.[10]

Once in 1999, moreover, in dealing with a Danish scheme, and once in 2000 in dealing with an Italian scheme, the Commission based its decisions on paragraph 27 of the notice. In both cases, agricultural land was exempted or relieved from the normal land tax and the exemption was considered to be justified by the nature and general scheme of the system with regard to the specific role of land in the agricultural production.[11]

5.5 Measures within the logic and nature of the tax system

In addition to the possibilities for justification reported in Sections 5.3 and 5.4, there seems to be another category of justifications. In at least three recent Commission decisions, the Commission has dealt with the question of whether or not a measure could be justified because it was within the logic and nature of the tax system. In Commission Decision 2002/676/EC on the dual-use exemption which the United Kingdom is planning to implement under the Climate Change Levy and the extended

[9] Commission Decision 2003/515/EC of 17 February 2003 on the State aid implemented by the Netherlands for international financing activities, OJ L 180, 18.7.2003, pp. 52–66, paragraphs 91–95.

[10] Commission Decision concerning Case N 482/2001 of 27 May 2003 regarding *Den danske ordning for den skattemæssige behandling af kreditinstitutters hensættelse til dækkning af tag på udlån*, C(2003)1649fin.

[11] Commission Decisions concerning Case N 53/99 of 22 June 1999 regarding *Loft over den kommunale grundskyldpromille*, SG(99) D/4570 and Case N 20/2000 of 12 May 2000 regarding *Vrijstelling onroerende zaakbelasting voor substraatteelt*, SG(2000) D/103619, available at http://europa.eu.int/comm/secretariat_general/sgb/state_aids

exemption for certain competing processes, it was the dual-use exemption that was assessed. The Climate change levy (CCL) was introduced to meet the United Kingdom's legally binding target to reduce greenhouse gas emissions according to the Kyoto Protocol and for moving towards domestic goals to reduce carbon dioxide emissions.

The CCL was designed to cover non-domestic use of energy products for fuel purposes. Under the CCL, energy products falling within the scope of the levy were exempted from it if they were used for purposes other than fuel. Thus the CCL did not apply to energy products used entirely as raw material (the non-fuel exemption). Furthermore, if an energy product was used principally for non-fuel purposes, the use of the product was exempt from the CCL (the dual-use exemption). A list of processes that involved the dual use of fuel was contained in the CCL. For the purposes of this dissertation, it is sufficient to note that in paragraph 40 the Commission spelled out its acceptance that it was within the logic and nature of an environmental tax system to levy the tax on energy products used for fuel, but to exempt energy products used purely for non-fuel purposes. Thus the Commission considered the non-fuel exemption with the argument that it was within the logic and nature of the tax system to exempt energy products for non-fuel purposes.[12]

In the Commission's decision regarding Case N 497/2003, it assessed the Swedish notification to prolong the 1.2 % rule of the Swedish energy tax system. Both the carbon dioxide tax and the energy tax on fossil fuels are levied on fossil fuel used as heating fuel or motor fuel. The 1.2 % rule is one of two tax relief measures applied to the most energy-intensive companies. According to the rule, industrial companies producing goods from mineral substances other than metal can enjoy a relief from the tax on fuels other than mineral oils, that is to say relief from tax on coal and gas, so that the tax actually paid does not exceed 1.2 % of the sales value of the goods produced. In its assessment, the Commission recognised that the exclusion of mineralogical processes from the scope of the tax was in the logic and nature of the system and that this view was also reflected in the Energy Tax Directive and in the discussions preceding the adoption of that Directive. This view, in turn, seems to be based on the fact that it was fuel used as heating and fuel used as motor fuel that was to be taxed according the tax system. As the use of fuel in mineralog-

[12] Commission Decision 2002/676/EC, ECSC, of the 3 April 2002 on the dual-use exemption which the United Kingdom is planning to implement under the Climate Change Levy and the extended exemption for certain competing processes, OJ L 229, 27.8.2002, pp. 15–23.

ical processes simply fell outside the scope of the tax, it was considered within the logic and nature of tax system to exempt mineralogical processes.[13]

In Commission Decision 2004/50/EC on the exemption from the Climate Change Levy which the United Kingdom is planning to implement in respect of coal mine methane, the Commission closed the Article 88(2) EC procedure that it had initiated regarding the British notification of an exemption from the CCL of supplies of electricity generated from coal mine methane (CM) from abandoned coal mines. It follows from paragraph 12 of the decision that the Commission in the preliminary phase of the examination of the measure, as opposed to the United Kingdom, did not consider the selective nature of the exemption in question to be justifiable on basis of the logic and nature of the tax system. The Commission's arguments, posed in this context, are of interest for purposes of this dissertation. Thus the Commission held that the CCL was applicable because of the harmful effect of the use of energy on climate change. Therefore, the Commission considered it to be in the nature of the tax system to exempt the use of energy, the production of which has no harmful effect.

The production of electricity from renewable sources was cited as an example of energy production with no harmful effects. However, in the case at issue the Commission concluded that the production of electricity from CM, like its production from other fossil fuel sources, has harmful effects. The Commission added that there is no difference in carbon dioxide emissions between producing electricity from CM versus natural gas. Thus the Commission concluded it would be in the nature and logic of the tax system to tax electricity produced from CM.[14]

Another example of justification based on the nature and general scheme of the system, and, more specifically, on the argument that the exemptions at issue followed from the logic and nature of the tax system, was the Commission's decision in Case NN 161/2003 regarding the renotification of the exemptions from the Swedish waste tax.[15] The over-

[13] Commission Decision concerning Case N 484/2003 of 2 February 2004 regarding *Ändringar av CO_2-skattenedsättningen för tillverkningsindustrin and Case N 497/2003 regarding Förlängning av 1,2 procentsregeln och ändring av 0,8 procentsregeln*, C(2004)316fin.

[14] Commission Decision 2004/50/EC of 17 September 2003 on the exemption from the Climate Change Levy which the United Kingdom is planning to implement in respect of coalmine methane, OJ L 10, 16.1.2004, pp. 54–59.

[15] Commission Decision concerning Case NN 161/2003 of 19 May 2004 regarding *Förlängning och ändring av stödordningen för avfallsskatt*, C(2004)1810fin.

riding purpose of the Swedish waste tax is to protect the environment. In order to reduce the amount of waste being deposited on 1 January, 2000, the Swedish Government introduced a tax on waste deposited on landfills for more than three years. The tax was levied on all material brought into the landfill and deductions were granted for all material brought out from the landfill. The tax system contained three types of tax relief.

1) A reduction in the tax base for material targeted for use in running the landfill or material necessary for construction projects, and for waste that should be composted or treated according some other method without being deposited.
2) A reduction in the tax base in the form of full deduction for certain types of waste originating from the running of the landfill or from construction projects on the landfill that are brought out from the landfill.
3) A reduction in the tax base in the form of full deduction for certain categories of waste because depositing the waste was considered the most environmentally friendly treatment available, or that depositing is preferred on the basis of the dangerous and harmful character of the material.

In its decision in Case N 284/98 on the initial notification of the Swedish waste tax, the Commission considered that the first two categories were justified on the basis of the nature or general scheme of the system.[16] The last category was, however, considered to constitute State aid but was accepted in accordance with Article 87(3) (c) EC, as the deductions in this category were considered to be in accordance with point 3.4 in the 1994 Community guideline on State aid for environmental protection.[17]

In the Commission Decision in Case NN 161/2003 regarding the renotification of the exemptions from the Swedish waste tax,[18] however, the last category of reductions were also considered justified on the basis of the nature or general scheme of the system. In its conclusion, the Commission stated that the all three categories followed from the logic and nature of the tax system.

[16] Commission Decision concerning Case N 284/98 of 24 March 1999 regarding *Stöd till vissa avfallsanläggningar inom ramen för lagen om skatt på avfall*, SG(99) D/2168.

[17] Community guidelines on State aid for environmental protection, OJ C 72, 10.3.1994, pp. 3–9.

[18] Commission Decision concerning Case NN 161/2003 of 19 May 2004 regarding *Förlängning och ändring av stödordningen för avfallsskatt* of 19 May 2004, C(2004)1810fin.

5.6 External objectives

What does the notice on tax measures reveal concerning external objectives? Unfortunately, not much. It follows from paragraph 26 that external objectives are objectives of in particularly a social or regional character. During 2002 and 2003, however, the Commission adopted several decisions dealing with the application of the State aid rules to taxes, in which external objectives appear to have been at issue.

It seems that at least six of these can be derived from two earlier Commission Decisions, one from 1999 and the other one from 2000.

5.6.1 Commission Decision 1999/718/EC

In the decision from 1999, Commission Decision 1999/718/EC concerning State aid granted by Spain to Daewoo, the Commission received a complaint from Asociacíon Nacional de Fabricantes de Electrodomésticos de Línea Blanca (the Spanish federation of manufacturers of household appliances) stating that Spain had granted aid to Daewoo Electronics Manufacturing España, SA (Demesa), an undertaking established at Vitoria-Gasteiz in the Autonomous Community of the Basque Country.[19] According to the complaint, the aid consisted of grants and tax exemptions. The possibility of justification on the basis of the nature or general scheme was not raised in this decision but appeared in the Court judgment following the appeal of the decision.

In the Court's judgment in joined Cases T-127/99, T-129/99, and T-148/99, Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission, the applicants argued that the tax measures were justified by the nature or overall structure of the tax system, as it met uniformly applicable objective criteria and was used to attain the objective of the tax provision that introduced it. In this context, the CFI pointed out that even if the tax measure in question determines its scope on the basis of objective criteria, the fact remains that it is selective in nature. The CFI maintained that justifications based on the nature and general scheme of the system reflect the consistency of a specific tax measure with the internal logic of the tax system in general. The CFI added that a specific tax measure which is justified by the internal logic of the tax system, such as the progressiveness of the tax which is justified by the tax

[19] Commission Decision 1999/718/EC of 24 February 1999 concerning State aid granted by Spain to Daewoo Electronics Manufacturing España SA, OJ L 292, 13.11.1999, pp. 1–22.

system's aim of redistribution, will avoid application of Article 92(1) of the Treaty (Article 87(1) EC).

The applicants argued that the tax measure at issue had some of the characteristics of the nature and overall structure of the Spanish tax system. They argued that the tax credit was inspired by the principles of progressiveness and efficiency in tax collection. Moreover, the applicants asserted that the aim of the tax credit was to prompt economic development in the Basque Country. The Court did not accept these arguments, and held that by fixing the minimum amount of investment at a certain level, the tax credit at issue only favoured undertakings with significant financial resources and, therefore, breached the principle of progressiveness and redistribution which form an integral part of the Spanish tax system. Nor had the applicants shown how the tax credit could contribute to the efficiency in tax collection. With regard to the argument of promoting economic development of the Basque Country, the CFI added that this type of objective is unrelated to the tax system concerned.[20]

Thus it follows from this judgment that the progressive nature of a tax system is considered inherent in the logic of the tax system. Moreover, the statement that the applicants could not show how the tax credit could contribute to the efficiency in tax collection suggests that it perhaps could have been possible to argue that the measure would have been justified if it had been proved that the measure contributed to the efficiency in tax collection.

The Commission Decision 1999/718/EC concerning aid granted by Spain to Daewoo Electronics, as well as the initiated court procedure in Case T-127/99, T-129/99, and T-148/99, Territorio Histórico de Álava – Deputación Foral de Álava and Others *v* Commission, probably triggered the Commission to adopt three decisions concerning aid in the form of a tax credit amounting to 45 % of certain investments available in the Spanish provinces of Álava, Vizcaya and Guipúzcoa. In each of these decisions the Commission made the similar statement with regard to the invoking of the possibility of justifying the 45 % tax credit. Thus the Commission held that the important factor in the assessment of the possibility of justifying an aid measure on the basis of the nature and the general scheme of the system is to determine if the tax measure involved meets the objectives inherent in the tax system itself, or if, on the contrary, the tax measure pursues other, possibly legitimate, objectives outside the tax system.

[20] Joined Cases T-127/99, T-129/99, and T-148/99 Territorio Historíco de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1275, paragraphs 162–167.

In the three decisions at issue, the Commission argued that the 45 % tax credit in question did not fulfil the internal objectives of the Spanish tax system, which, apart from the principal objective inherent in any tax system of collecting revenue for financing public expenditures, is founded on the principles of equality and progressiveness. The Commission held that in this regard the 45 % tax credit could be discriminatory in favour of large economic units at the expense of other smaller and less powerful units without this discrimination being justified by the internal logic of the tax system. Additionally, the Commission emphasised that the fact that the tax credit was introduced by the regional authorities empowered with the authority to tax did not demonstrate that it is consistent with the nature of the tax system. Moreover, with regard to the Spanish authorities' claim that the aim of the 45 % tax credit was to promote economic activities and that the tax credit, therefore, fulfilled industrial policy objectives pursued by the Basque Government, the Commission held that the industrial policy objectives are not inherent in the tax system. Thus the Commission found that the 45 % tax credit could not be justified on the basis of the nature and general scheme of the system.[21]

5.6.2 Commission Decision 2000/795/EC

Not long after the Commission had adopted Commission Decision 1999/718/EC concerning State aid granted by Spain to Daewoo Electronics, it adopted another decision in 2000 that would result in Court judgments as well as subsequent Commission decisions. In the 2000 decision, Commission Decision 2000/795/EC on the State aid implemented by Spain for Ramondín and Others, the Commission had to deal with the fact that Ramondín, a manufacturer of metal capsules for wine bottles, had decided to move its industrial facilities from Logrono (Rioja) to Laguardia (Álava, Basque Country), five kilometers from its existing site. The President of the Autonomous Community of Rioja

[21] Commission Decision 2002/820/EC of 11 July 2001 on the State aid scheme implemented by Spain for firms in Álava in the form of a tax credit amounting to 45 % of investments, OJ L 296, 30.10.2002, pp. 1–19, paragraphs 66–68; Commission Decision 2002/894/EC of 11 July 2001 on the State aid scheme implemented by Spain for firms in Guipúzcoa in the form of a tax credit amounting to 45 % of investments, OJ L 314, 18.11.2002, pp. 26–44, paragraphs 73–75; Commission Decision 2003/27/EC of 11 July 2001 on the State aid scheme implemented by Spain for firms in Vizcaya in the form of a tax credit amounting to 45 % of investments, OJ L 17, 22.1.2003, pp. 1–19, paragraphs 73–75.

complained to the Commission and alleged that Ramondín's decision to relocate its activities to Álava was motivated by tax incentives and public aid for investment offered by the Álava Provincial Council and the Autonomous Community of the Basque Country respectively.[22]

What had been offered to and accepted by Ramondín was

1) an ESP 150 million grant awarded by the Basque Regional Government within the framework of the Ekimen (a regional aid scheme that had already been approved by the Commission),
2) a tax credit equivalent to 45 % of the total amount of the investment made by Ramondín, granted by the Álava Provincial Council, and
3) a reduction of 99 %, 75 %, 50 %, and 25 % in the basis of assessment of corporation tax, applicable, respectively, for four consecutive years running from the first year in which the basis of assessment was positive.

These reductions were available to newly established undertakings under the condition that they invested a minimum of ESP 80 million and created a minimum of ten jobs. Furthermore, Ramondín and Álava Agencia de Desarrollo SA, a development agency controlled by the Álava provincial authorities, agreed on the sale of a plot of land in the estate of Laguardia (Álava) to Ramondín at a price of ESP 2500 per square meter.

With regard to the award granted within the Ekimen aid scheme, the Commission concluded that it had been awarded in accordance with the conditions governing the Ekimen aid scheme. Regarding the sale of land, the Commission found that the price paid by Ramondín was within the range determined by experts on valuation of land. Consequently, neither measure was considered to constitute State aid. Regarding the tax credit and the reduction of the tax base, however, the Commission came to another conclusion. As part of the assessment of the selectivity criterion, the Commission discussed the possibility of justifying the tax credit on the basis of the nature or general scheme of the system.

In paragraph 90, the Commission emphasised that not all differences in treatment between groups of economic operators constitute State aid and that it is necessary to make a distinction between:

– differentiated treatment that does not constitute an exception (32) to the ordinary rules but results rather from the application, to specific situations, of the same principles as those underlying the ordinary rules, and

[22] Commission Decision 2000/795/EC of 22 December 1999 on the State aid implemented by Spain for Ramondín SA and Ramondín Cápsulas SA, OJ L 318, 16.12.2000, pp. 36–61.

– differentiated treatment which, favouring certain undertakings, departs from the internal logic of the ordinary rules.

With reference to the argument articulated by the ECJ in its judgment in Case 173/73, Italy *v* Commission, the Commission held in paragraph 93 that:

> ... the "nature or general scheme of the system" cannot merely consist of the attainment of an objective which the authority wishes to achieve through the differentiated treatment of a group of economic operators, since in that case it would be sufficient to refer to a particular economic policy objective in order to evade the rules of Articles 87, 88 and 89 of the Treaty. In other words, the justification for differentiated treatment on the basis of the nature or general scheme of the system cannot be provided by referring to external objectives, but must be established by demonstrating the consistency of the measures in question with the internal logic of the system.

In paragraph 94 of the decision, a statement made by AG Ruiz-Jarabo Colomer in his opinion in Case C-6/97, Italy *v* Commission,[23] was cited. Accordingly,

> ... it can sometimes prove very difficult to draw the dividing line between measures that may constitute public subsidies, on the one hand, and those which belong to the general scheme of a State's tax system, on the other. Any tax system of tax relief has the effect of exempting a sector or group of taxpayers from the generally applicable tax rules. Such exemptions (18) are often geared to objectives that differ from what can be described as the primary taxation requirement (19); they pursue social, industrial or regional development or other similar objectives. From the standpoint of their function, they resemble in that respect direct aid measures granted by States and should normally be treated as such for the purpose of Article 92 of the Treaty (Article 87 EC). In that case, it will be for the State establishing them to demonstrate, on the contrary, that they constitute what is frequently referred to as 'measures of a general nature' and that, as such, they fall outside the scope of Article 92 (Article 87 EC). To that end, the State in question must specify which internal logic of the system the measures follow, something which should of course rule out any intention of improving conditions for a particular sector in comparison with its foreign competitors ...[24]

[23] Case C-6/97 Italian Republic *v* Commission [1999] ECR I-2981.

[24] Although the overall message is more or less the same the citation made does not correspond to the statement made by AG Ruiz-Jarabo Colomer in paragraph 27 of the opinion in Case C-6/97 Italy v Commission [1999] ECR I-2981.

In paragraph 95 of the same decision, the Commission cited a statement of AG La Pergola. He concluded in his opinion in Case C-75/97, Maribel bis/ter,[25] described in Section 2.5.3.1.1, that:

> ... In other words, can the derogations or amendments introduced by the disputed measures into the general social security system, which they leave in place, be said to be objectively justified by the economy and the nature of such an arrangement under the ordinary law, having regard to its internal logic, or do they serve the sole purpose of arbitrarily benefiting certain undertakings or specific sector (9)? It should be held, in my opinion, that a measure is general when it is aimed at achieving equality between businesses. The general principle of equality of treatment is recalled in the provision in Article 92(1) of the Treaty specifically prohibiting measures whereby the State favours certain undertakings or the production of certain goods at the expense of others within the same category of undertaking, to which the provisions adopted should be capable of being applied. Such measures remain subject to the rules on aid because, by operating discrimination that is unjustified and hence expressly prohibited by the Treaty, they do not comply with but contradict the criterion of general measures, which the applicant asks us to take into account.[26]

On the basis of these statements, the Commission concluded that the minimum investment requirement aimed at attracting large undertakings pursued an objective that was foreign to the internal logic of the tax system and, therefore, could not be justified on the basis of the nature and general scheme of the system. Furthermore, the Commission added that the temporary nature of the measure in question ruled out, from the start, the possibility of considering that it was compatible with the nature or general scheme of the tax system.

With regard to the reduction in the tax base, the Commission concluded that the stated objective of stimulating the creation of new business initiatives was not considered to be an objective that could justify the reduction of the tax base on the nature or general scheme of the system. Consequently, the two measures were found to constitute State aid. These statements suggest that the Commission was of the opinion that a measure that pursues external objectives cannot be justified on the basis of the nature or general scheme of the system.

This decision was appealed to the CFI, on the one hand by three provinces in Spain, the provinces of Álava, Giupúzcoa, and Vizcaya, in

[25] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

[26] In this case the citation corresponds to AG La Pergola's statement in paragraph 8 of the opinion in Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671, only (9) should be (8).

the joined Cases T-346/99, T-347/99 and T-348/99, Diputación Foral de Álava and Others *v* Commission, and, on the other hand, by the Spanish Province of Álava together with Ramondín SA and Ramondín Cápsulas SA in joined Cases T-92/00 and T-103/00.

In the judgment in joined Cases T-346/99, T-347/99, and T-348/99, Diputación Foral de Álava and Others *v* Commission, the CFI referred to the joined Cases T-127/99, T-129/99 and T-148/99, Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission, described above, and held that justifications based on the nature or overall structure of the tax system reflects the consistency of a specific tax measure with the internal logic of the tax system of which it forms part. The applicants argued that the tax measures were operated according to objective criteria, that the Basque authorities were granted certain powers of taxation, and that the measures were justified by reference to economic policy objectives external to the Basque tax system. The CFI did not consider that any of the arguments articulated by the applicants showed that tax measures available to the restricted group of beneficiaries could be justified by the internal logic of the Basque tax system.[27]

In the judgment of joined Cases T-92/00 and T-103/00, Territorio Histórico Álava – Diputación Foral de Álava and Others *v* Commission, the CFI once again held that justifications based on the nature or overall structure of the tax system reflects the consistency of a specific tax measure with the internal logic of the tax system of which it forms part. In addition, the CFI repeated an opinion it had expressed previously in joined Cases T-127/99, T-129/99, and T-148/99, Territorio Histórico de Álava – Deputación Foral de Álava and Others *v* Commission and elsewhere, that a specific measure, which can be justified on the basis of the internal logic of the tax system – such as a progressive tax scale can be justified on the basis of the redistributive purpose of the tax – will fall outside the scope of Article 87(1) EC.

In the case at issue, the applicants had argued that the aim of the tax measures was to promote investment and thus attract new undertakings in order to secure future tax revenues. The CFI responded to this claim by holding that '... the applicants adduce no evidence in support of their argument that the real objective of the fiscal measures at issue is to increase tax revenue. That explanation is, moreover, hard to reconcile with the granting of tax reductions. Even if that were the intended objective – which is not established –, it could also have been attained by general fiscal measures. In those circumstances, the specific fiscal measures in

[27] Joined Cases T-346/99, T-347/99 and T-348/99 Diputación Foral de Álava and Others *v* Commission [2002] ECR II-4259.

question cannot be regarded as justified by the nature or overall structure of the tax system.'[28]

This statement raises at least two interesting questions. The CFI appears to be of the opinion that it is difficult to reconcile the exemptions with the aim of increasing tax revenues. Is this statement of general application? The most reasonable answer ought to be no. It is possible to imagine cases in which a reduction actually would increase, if not tax revenue, the budget as a whole. Imagine that, for example, undertakings with fewer than ten employees were granted a reduced tax rate from a minor tax for administrative reasons, that is to say, the cost of the administrative resources would exceed the amount of revenue collected. In this example, the tax exemption would result in a gain for the State. Another question is: Would it have been justifiable if it would have been established that the aim of the tax reduction was to secure future tax revenue and this could not be achieved by general fiscal measures? At least the Commission appears to have answered this question negatively in three Commission decisions following these two judgments.

In these three Commission decisions, the Commission had to deal with an aid scheme addressed to certain newly established firms in the provinces of Álava, Guipùzcoa, and Vizcaya in Spain. According to the relevant aid scheme, undertakings starting their business in any of the three provinces would obtain a reduction from corporation tax in the sense that the tax base was reduced over four consecutive tax periods, starting from the first year in which, within four years from start-up, they obtain positive tax bases. In each of these three decisions the Commission initiated the assessment of the possibility of justifying the reduction of the tax base with the same opening phrase as it used in the three Commission decisions mentioned above. Thus what matters is determining whether the tax measures involved meet the objectives inherent in the tax system itself, or if, on the contrary, they pursue other, possibly legitimate, objectives outside the tax system. Moreover, the Commission added that it is up to the Member State concerned to establish that the tax measure in question follows the internal logic of the tax system.

The Commission further emphasised that the fact that the Spanish authorities had argued that the measures were objective and cross-sector in character and, therefore, were consistent with the internal logic of the tax system, did not demonstrate that it followed from the internal logic of the tax system. The Commission added that it was not sufficient evidence that the measure in question fulfilled the principal objective inherent in

[28] Joined Cases T-92/00 and T-103/00 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1385, paragraph 62.

any tax system, which is to gather revenue for financing the expenditure of the State, or that it satisfies the principles of equality and progressiveness inherent in the Spanish tax system. Thus it seems that at least the Commission is of the opinion that the pure aim to secure future tax revenue is not a sufficient foundation for a measure to be justified on the basis of the nature or general scheme of the system.

Furthermore, the Spanish authorities had argued that the reduction of the tax base satisfied the objectives of promoting investments and therefore helped to achieve the industrial policy objectives pursued by the Government. The Commission responded to this argument in a manner similar to that expressed in its three decisions mentioned above – that is to say, it indicated that the industrial policy objectives were not inherent in the Spanish tax system. Consequently, the Commission did not find that the reduction of the tax base for newly established firms in the three provinces was justified on the basis of the nature or general scheme of the system.[29]

5.6.3 Case C-75/97, Maribel bis/ter

The ECJ's judgment in Case C-75/97, Maribel bis/ter, provides another example in which the ECJ assessed the possibility of justifying a certain measure on the basis of the nature or general scheme of the system.[30] The case is described in Section 2.5.3.1.1 but is briefly mentioned again in this context. Belgium had introduced increased reduction of social security contributions to undertakings belonging to certain sectors of the processing industry. In assessing the possibility of justification, the Court confirmed that, as Community law stands, the Member States retain their power to organise their social security system. Thus the Member States may pursue objectives of employment policy such as those relied on by Belgium, amongst which are, in particular, the maintenance of a high level of employment among manual workers and the maintenance of an industrial sector in order to balance the economy of Belgium.

[29] Commission Decision 2002/892/EC of 11 July 2001 on the State aid scheme applied by Spain to certain newly established firms in Álava, OJ L 314, 18.11.2002, pp. 1–16, paragraphs 70–72; Commission Decision 2002/540/EC of 11 July 2001 on the State aid scheme applied by Spain to certain newly established firms in Guipúzcoa, OJ L 174, 4.7.2002, pp. 31–45, paragraphs 70–72; Commission Decision 2002/806/EC of 11 July 2001 on the State aid scheme applied by Spain to certain newly established firms in Vizcaya, OJ L 279, 17.10.2002, pp. 35–49, paragraphs 70–72.

[30] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

However, the Court maintained that the increased reduction introduced in order to attain that objective had 'the sole direct effect of according an economic advantage to the recipient undertakings alone, relieving them from part of the social costs which they would normally have to bear.' In the same paragraph the Court emphasised that '[t]his is even more true for the horticulture and forestry sectors in relation to which the Maribel *bis /ter* scheme can under no circumstances be justified by the objectives of employment policy, ...'.[31] Thus the Court seems to indicate that Member States may introduce measures in pursuit of different objectives like employment policy, but that they do not have the right to introduce selective measures. Consequently, the Court did not find the Maribel bis/ter scheme to be justified.

5.6.4 Commission Decision 2002/778/EC

The judgment in Case C-75/97, Maribel bis/ter, was of interest in Commission Decision 2002/778/EC on the aid schemes C 74/2001 (ex NN 76/2001) implemented by Belgium and which Belgium is planning to implement for the diamond industry.[32] In this case, the Commission made an assessment of the possibility of justifying an aid measure that the Belgium Government planned to implement for the diamond industry. The objective of the scheme was to promote Antwerp's diamond industry and to prevent it from relocating to countries outside the Community. The idea was to make certain payments to employers in the diamond industry, intended to partly compensate them for their social security contributions. On the matter of whether or not the Commission found this measure justifiable on the nature and general scheme of the system, the Commission held that the measure in question created a selective exception, outside the general system, for employers in the diamond industry, thus competition would be distorted.

The Commission emphasised that Belgium itself regarded the scheme as a specific adjustment for the diamond industry and thereafter concluded that this confirmed that the measure could not be justified on the nature and general scheme of the Belgium social security system. It was in this context that the Commission referred to the Court's findings in

[31] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671, paragraph 38.

[32] Commission Decision 2002/778/EC of 9 April 2002 on the aid schemes C 74/2001 (ex NN 76/2001) implemented by Belgium and which Belgium is planning to implement for the diamond industry, OJ L 272, 10.10.2002, pp. 25–34.

Case C-75/97, Maribel bis/ter,[33] and the ECJ's statement that a scheme that pursues an employment policy by means of affording a direct advantage only in relation to the competitive situation of the undertakings concerned, which belong to certain sectors of economic activity, is not justified by the nature and general scheme of the social security scheme in force in Belgium. In the discussions preceding the adoption of the decision, Belgium had argued that the Commission had accepted other sector-specific social security systems, for example the one for seamen. The Commission responded to this argument and held that the characteristics of the sector of seamen were highly specific and that the concept of State aid applicable in this sector had been clarified in particular Community Guidelines on State aid to maritime transport.

5.6.5 Summary

In summary, industrial and economic policy objectives as well as employment policy objectives seem to be additional examples of external objectives to be added to the objectives of social and regional character mentioned in paragraph 26 of the Commission notice on tax measures. Moreover, the Commission, as well as the ECJ and the CFI, appear to agree that differentiated treatment cannot be justified by reference to external objectives but must be established by demonstrating that the measures in question are in some way based on objectives inherent in the system.

5.7 A parallel to the assessment of the principle of equal treatment

In the context of analysing the possibility of justifying the selective nature of a measure on the basis of the nature of general scheme of the system, it is interesting to note that in an article on the application of the principle of equality to Community measures, Tridimas has discussed justifications of discriminatory treatment in a way that may contribute to the understanding of justifications on the basis of the nature or general scheme of the system that are provided for in paragraphs 23–27 of the Commission notice on tax measures, especially with regard to the content of objective differences between tax payers.

[33] Case C-75/97 Kingdom of Belgium *v* Commission [1999] ECR I-3671.

According to Tridimas, difference in treatment between comparable situations is not prohibited where it is objectively justified. He advocates that the notion of objective justification is not easy to define in the abstract but is dependent on the particular circumstances of each case, taking into account the objectives of the measure at issue. Tridimas cites Toth who, on the basis of case law, has listed different cases where the treatment of comparable products or undertakings is justified. Accordingly, Tridimas believes that the difference in treatment of comparable products or undertakings is justified:

1) where it is justified by the aims which Community institutions lawfully pursue as part of Community policy;
2) where its purpose is to obviate special difficulties in one sector of industry,
3) where it is not arbitrary in the sense that it does not exceed the broad discretion of the Community institutions, and
4) where it is based on objective differences arising from the economic circumstances underlying the common organization of the market in the relevant products.[34]

Thus Tridimas concludes that the guiding principle seems to be that the difference in treatment must not be arbitrary, but must be based on rational considerations.

Examining the fourth ground for justification, Tridmas mentions an example, Case 59/83 Biovilac *v* EEC [1984] ECR 4057, at paragraph 19, in which it was argued that by subsidising skimmed-milk powder the Commission discriminated against competing products made from whey, which was not justifiable. In its judgment, the ECJ held that the granting of subsidies to skimmed-milk powder was justified owing to the nature of the product and the market-supporting role it played in the common organisation of the market in milk products. Products made from whey, however, were not considered to present similar characteristics, as whey is a waste product obtained in the production of cheese.[35]

In the general context of applying the derogation method and the selectivity criterion of Article 87(1) EC to taxes, the reference of economic circumstances underlying the common organisation of the market in the relevant products may not be the most relevant reference. But the principle of analysing the economic circumstances of the market of the relevant product in order to assess whether or not the differences in treatment of comparable products or undertakings could be justified,

[34] Tridimas p. 225 citing Toth, The Oxford Encyclopedia of European Community Law (1990), Vol. I, p. 193.

[35] Ibid, pp. 225–226 and 234.

appears to clarify the meaning of the possibility of justifying the selective nature of a measure on the basis of objective differences.

Moreover, the conclusion that the guiding principle seems to be that the difference in treatment must not be arbitrary, but must be based on rational considerations, also seems to contribute to the understanding of the statement in paragraph 23 of the Commission notice on tax measures. As mentioned, paragraph 23 states that '[t]he differential nature of some measures does not necessarily mean that they must be considered to be State aid. This is the case with measures whose economic rationale makes them necessary to the functioning and effectiveness of the tax system.'

Accordingly, it seems plausible that what the Commission means to say in paragraph 23 is that justifications must be objective and based on rational considerations. What makes justifications objective and based on rational considerations, however, seems to remain an assessment that must be judged on a case-by-case basis.

5.8 Might the selective effect of a measure due to the discretionary powers of an authority be justified?

It is mentioned in Section 4.5.3 that in Decision 2002/937/EC on the aid scheme implemented by Finland for Åland Islands' captive insurance companies, the Commission argued that a measure could be selective because it is granted either as an exception to a general tax arrangement established by law, regulation, or administrative practice, or at the discretion of the tax administration.[36]

The fact that a measure can be considered to be selective as a result of discretionary practice of the tax administration also follows from paragraph 21 of the Commission notice on tax measures. However, because potential distortion of competition is also prohibited according to Article 87(1) EC, it is, in general, considered that assigning discretionary aid granting powers to the authority responsible for granting the aid constitutes State aid.

Moreover, it follows from paragraph 21 of the Commission notice on tax measures that the individual application of a general measure may

[36] Commission Decision 2002/937/EC of 10 July 2002 on the aid scheme implemented by Finland for Åland Islands' captive insurance companies, OJ L 329, 5.12.2002, pp. 22–29.

also turn out to be selective in cases that treat general economic agents on a discretionary basis. Furthermore, it follows that the individual application of a general measure may take the feature of a selective measure, in particular when the exercise of the discretionary powers goes beyond the simple management of tax revenue by reference to objective criteria. The source of most of these conclusions is the Court's judgment in Case C-241/94, Kimberly Clark Sopalin, as well as AG Jacob's opinion in that case.

Kimberly Clark Sopalin was an undertaking that employed 465 people; its primary business had been the manufacturing and processing of cellulose wadding. As a result of a restructuring operation, Kimberly Clark decided to concentrate solely on the manufacture of paper handkerchiefs. At the same time it decided to modernise its industrial equipment, reorganise its production system, adopt new working methods, and reduce its workforce by 207. At the time, the French rules provided that, in the event of redundancies on economic grounds, the employer had certain duties, such as, to pay compensation to the laid-off employees and grant the employees concerned 're-recruitment priority' for one year. Over and above these minimum requirements, the French legislation provided for a social plan, which had to be drawn up and implemented in undertakings with 50 or more employees and where the number of redundancies envisaged was 10 or more within a period of 30 days. In accordance with these rules, Kimberly Clark drew up a social plan containing a number of measures, some of which where jointly financed by the State and the National Employment Fund (FNE).

In its decision, the Commission considered that the financial participation of the FNE constituted State aid according to Article 92(1) of the Treaty (Article 87(1) EC). This Commission decision was brought to the ECJ in Case C-241/94, Kimberly Clark Sopalin. In its judgment, the Court agreed with the Commission that the FNE enjoyed a sufficient degree of latitude that it was liable to place certain undertakings in a more favourable situation than others and therefore met the conditions for classification as aid within the meaning of Article 92(1) of the Treaty (Article 87(1) EC). The powers that had been granted to the FNE enabled it to adjust its financial assistance with regard to a number of considerations, in particular, the choice of beneficiaries, the amount of the financial assistance, and the conditions under which financial assistance was to be provided.[37] This conclusion has been repeated in Case

[37] Case C-241/94 French Republic *v* Commission [1996] ECR I-4551, paragraphs 23 and 24, and AG Jacobs opinion in the same case, I-4561, paragraph 38.

C-200/97, Ecotrade and Case C-295/97, Piaggio.[38] In these two cases, it was held that it was the discretionary power of the authority, taken together with the class of undertakings covered by the legislation, that made the legislation selective.

In paragraph 22 of the Commission notice on tax measures, it is emphasised that if tax rules need to be interpreted in daily practice, they cannot leave room for discretionary treatment of undertakings. It is stated that every decision of the administration that departs from the general tax rules to the benefit of individual undertakings, leads, in principle, to a presumption of State aid and must be analysed in detail. In addition, in so far as administrative rulings merely contain an interpretation of general rules, they do not give rise to a presumption of aid. According to the paragraph, however, the opacity of the decisions taken by the authorities and the manoeuvering room that the authorities sometimes enjoy support the presumption that, in some instances, the authorities' actions may lead to a presumption of State aid.

It follows that a measure may be considered selective as a result of discretionary practices of the tax administration. Moreover, it follows from paragraph 12 of the Commission notice on tax measures that the selective nature of a measure may be justified by the nature or general scheme of the system. Against this background, it may seem reasonable to assume also that the selective nature of a measure based on the discretionary practice of a tax administration may be justifiable on the basis of the nature or general scheme of the system.

However, this does not seem possible in light of paragraph 27 of the Commission notice on tax measures in which it is stated that '[s]pecific provisions *that do not contain discretionary elements*, ... , may be justified by the nature and general scheme of the system where, ...' (emphasis added). On the face of it, this statement may appear contradictory but on closer examination it actually seems to make sense. It appears to follow from the above discussion of justifications that the possibility of justifying a measure on the basis of the nature or general scheme of the system is aimed at justifying the applicability of certain kinds of exceptions from the tax system. If the selective nature of a measure based on the discretionary practice of a tax administration could be justified, it would be the discretionary powers of the tax administration that would have to be jus-

[38] Case C-200/97 Ecotrade Srl *v* Altiforni e Ferriere di Servola SpA (AFS) [1998] ECR I-7907, paragraphs 38–40 and Case C-295/97 Industrie Aeronautische Meccaniche Rinaldo Piaggio SpA *v* International Factors Italia SpA (Ifitalia) and Others [1999] ECR I-3735, paragraphs 37–39.

tified. It is difficult to imagine that the discretionary powers of a tax administration could be justifiable.

The point may be questioned, however, if not, the understanding of the application of Article 87(1) EC would be improved if paragraph 12 or any other paragraph of the Commission notice on tax measures were clarified on this specific point: that although the situations in which an authority has been empowered to take discretionary measures about when and to whom to grant aid is presumed to fulfil the selectivity criterion, this type of selective character cannot be justified on the basis of the nature or general scheme of the system.

5.9 Justifications and the Commission's authority

5.9.1 Introduction

The ECJ and the CFI have consistently held that Article 92(1) of the Treaty (Article 87(1) EC) does not distinguish between State interventions by reference to their causes or aims but defines them in relation to their effects. Accordingly, the CFI in paragraph 52 of Case T-67/94 held that '... [i]t follows that the concept of aid is objective, the test being whether a State measure confers an advantage on one or more particular undertakings'.[39] In addition, the CFI argued that '... [t]he characterisation of a measure as State aid, which, according to the Treaty, is the responsibility of both the Commission and the national courts, cannot in principle justify the attribution of a broad discretion to the Commission, save for particular circumstances owing to the complex nature of the State intervention in question'.

These statements trigger three interesting questions. Is the assessment of the selectivity criterion to taxes an objective assessment? Does the Commission trespasses its authority when it assesses the possibilities of justification? Or is the assessment of justification perhaps embraced by the statement: "save for particular circumstances owing to the complex nature of the State intervention in question" mentioned by the CFI in paragraph 52 of Case T-67/94, Ladbroke Racing?

[39] Case T-67/94 Ladbroke Racing Ltd *v* Commission [1998] ECR II-1, paragraph 52.

5.9.2 The assessment of the selectivity criterion to taxes – an objective assessment?

According to Pinto, the assessment of the selectivity criterion, presupposing that this assessment contains the derogation method and may sometimes be supplemented with an assessment of whether or not the derogation may be considered a general measure, is an objective assessment. But he regards the assessment of justification to be a subjective assessment.[40] Having analysed the various possibilities of justifying the selective nature of a measure, Pinto's description appears to be valid.

If this assumption is correct, it leads to further questions. Does the Commission trespass its authority in its assessment of Article 87(1) EC when it assesses whether or not a derogation can be justified on the nature or general scheme of the system? Or may the assessment of justification perhaps be embraced by the statement "save for particular circumstances owing to the complex nature of the State intervention in question" mentioned by the CFI in paragraph 52 of Case T-67/94, Ladbroke Racing? It is relevant at this point to consider what is meant by "save for particular circumstances owing to the complex nature of the State intervention in question".

5.9.3 The meaning of "particular circumstances owing to the complex nature of the State intervention in question"

In response to the statement that the Commission, in principle, has no discretionary powers in the application of the criteria of Article 87(1) EC, save in particular circumstances owing to the complex nature of the State intervention in question, the CFI referred to two judgments, the judgment in Case C-56/93, Belgium *v* Commission[41] and the judgment in Case T-358/94, Air France *v* Commission.[42]

In Case C-56/93, Belgium *v* Commission, the Kingdom of Belgium had brought an action for the annulment of a Commission decision. It involved Gasunie, an undertaking governed by private law even though 50 % of the share capital was directly or indirectly owned by the Netherlands State. Gasunie had applied a tariff system in the Netherlands for

[40] Pinto, pp. 145–146.

[41] Case C-56/93 Kingdom of Belgium *v* Commission [1996] ECR I-723, paragraphs 10–11.

[42] Case T-358/94 Compagnie Nationale Air France *v* Commission [1996] ECR II-2109, paragraph 71.

supplies of natural gas. Eventually, Gasunie made changes in the tariff structure, one of which was the introduction of a new tariff, Tariff F. In practice, Tariff F was intended especially for Dutch producers of ammonia that was to be used for the manufacture of nitrate fertilizer. First the Commission decided to initiate the procedure provided for in Article 93(2) of the Treaty (Article 88(2) EC). Then it decided to terminate the Article 93(2) procedure (Article 88(2) EC procedure).

Following the proceedings brought by French ammonia producers, the Court annulled the Commission's decision to terminate the Article 93(2) procedure (Article 88(2) procedure). Therefore, the Commission had to re-examine the case. This time the Commission concluded that Tariff F was justified on commercial grounds and that it did not favour Dutch ammonia producers in relation to those in other Member States, and that the Netherlands State had not influenced the fixing of the tariffs to a greater extent than any normal shareholder. It was this decision that was appealed in Case C-56/93, Belgium *v* Commission. In its judgment, the ECJ held that a complex economic appraisal was involved in the Commission's consideration of the question of whether or not a particular measure may be regarded as aid within the meaning of Article 92(1) of the Treaty (Article 87(1) EC) where the State had allegedly not acted 'as an ordinary economic agent'.

In Case T-358/94, Air France *v* Commission, the Commission's decision was brought to the CFI by Air France. The decision of the Commission had been that one of the many injections of capital into Air France was considered as operating aid that was incompatible with the common market. Its rationale was that a rational private investor would not have injected the amount at issue into Air France in view of its recent poor financial and operating performance, its failure to carry out the restructuring programme put in place in an earlier stage, and the manifest insufficiency of the newer restructuring programme to address the situation. In its judgment the CFI considered the Commission's application of the test of a prudent private investor's normal conduct to involve a complex economic appraisal similar to that mentioned in Case C-56/93, Belgium *v* Commission.

In both judgments, the ECJ and the CFI, respectively, held that it is confirmed by case law that the Commission has a discretion when adopting a measure involving this type of appraisals. It further argued that the judicial review must be restricted to determining if the Commission complied with the rules governing procedure and the statement of reasons, if the facts on which the contested findings were based were accurate and if there were any manifest error of assessment or misuse of powers. In Case C-56/93, Belgium *v* Commission, reference is made to several

court cases, such as Case 138/79 Roquette Frères *v* Council of the European Communities[43] and Case C-225/91, Matra *v* Commission.[44]

Thus on the one hand, it seems to follow from Case T-67/94, Ladbroke Racing, that the main rule is that the Commission does not have discretionary powers with regard to its assessment of Article 87(1) EC. It also seems to follow, however, that this main rule ceases to apply in exceptional cases. On the other hand, the examination of Case C-56/93, Belgium *v* Commission, and Case T-358/94, Air France *v* Commission, provides a totally different impression. If the examinations made in the two cases are typical examples of complex economic appraisals, it is almost impossible to imagine any assessment of Article 87(1) EC that would not be a complex economic appraisal as most aid matters are of a sophisticated and of complex economic character.

It should be emphasised that what the Court said in Case T-67/94, Ladbroke Racing, was '... cannot *in principle* justify the attribution of a broad discretion to the Commission, save for particular circumstances ...' (emphasis added). The meaning of the words "in principle" is not developed further by the Court. Perhaps the Court used this expression intentionally against the background of the Court's statements in Case C-56/93, Belgium *v* Commission, as well as in Case T-358/94, Air France *v* Commission. Thus it seems that although the Commission, according to the statement of the CFI in paragraph 52 of Case T-67/94, Ladbroke Racing, is not supposed to have any discretionary powers with regard to the application of Article 87(1) EC, this statement does not have any meaning in practical terms. This conclusion, in turn, suggests that the Commission is not overstepping its authority when it is assessing the possibility of justifying the selective nature of a measure on the basis of the nature or general scheme of the system.

5.10 The obligation to give prior notification of a measure that may be justifiable

As follows from Section 3.2.2, the scope of the obligation to provide prior notification according to the first sentence of Article 88(3) EC, coincides with the scope of Article 87(1) EC. Thus the Member States are obliged to submit notification for measures that fulfil the criteria of

[43] Case 138/79 Roquette Frères *v* Council of the European Communities [1980] ECR 3333.

[44] Case C-225/91 Matra SA *v* Commission [1993] ECR I-3203, paragraph 25.

Article 87(1) EC. Although the Member States' dilemma, discussed in Section 3.2.4, will always remain, it is interesting to question whether the Member States are obliged to give prior notification for tax measures that they consider justifiable on the basis of the nature or general scheme of the system. If paragraph 23 of the Commission notice on tax measures is scrutinised once again from this angle, the first and last sentences, read: 'The differential nature of some measures does not necessarily mean that they must be considered to be State aid ...'; and '... [h]owever, it is up to the Member State to provide such justification', and taken together they appear to indicate that there is a presumption that a differentiation fulfils the selectivity criterion and that it is the Member State that has the burden of proof that the selectivity criterion is not fulfilled. Against this background, it seems reasonable to assume that the Member States, at least according to the present view of the Commission, are obliged to give prior notification to the Commission also for measures that they consider justifiable on the basis of the nature or general scheme of the system.

5.11 Concluding remarks

It follows from paragraph 12 of the Commission notice on tax measures that the selective nature of a measure may be justified on the basis of the nature or general scheme of the system. With regard to this assessment, paragraph 26 of the Commission notice on tax measures provides that a distinction must be made between, on the one hand, the external objectives assigned to a particular tax scheme and, on the other hand, the objectives which are inherent in the tax system itself. It follows from paragraph 16 of the notice that exception to the tax system or differentiations within that system are justified by the nature or general scheme of the tax system if they derive directly from the basic or guiding principles of the tax system in the Member State concerned. Moreover, according to paragraph 24 of the Commission notice on tax measures, it appears to be possible to justify measures that are based on objective differences between taxpayers. However, the notice does not clarify the relationship between paragraph 26 and paragraphs 16 and 24, respectively, nor does it provide a clarification on the concepts of "external objectives" and "objectives inherent in the tax system", or provide any information with regard to the effects of the classification of measures as being based on external objectives or objectives inherent in the tax system, respectively.

Fortunately, the case practice of the Commission, as well as the case law of the ECJ and the CFI, contributes to clarifying these concepts and

the conditions for their application. Thus it follows from, among others, Commission Decision 2000/795/EC on the State aid implemented by Spain for Ramondín and Others, that only measures that are based on objectives inherent in the system may be justified.

It seems that industrial and economic policy objectives as well as employment policy objectives are examples of external objectives that could be added to objectives of social and regional character mentioned in paragraph 26 of the Commission notice on tax measures. Objectives inherent in the system appear more difficult to describe. It follows from the three Commission decisions[45] following the judgment in joined Cases T-346/99, T-347/99, and T-348/99, Diputación Foral de Álava and Others *v* Commission,[46] and joined Cases T-92/00 and T-103/00, Territorio Histórico Álava – Diputación Foral de Álava and Others *v* Commission,[47] that the Commission considers the principal objectives inherent in any tax system to be the gathering of revenue for financing the expenditures of the State as well as for satisfying the principles of equality and progressiveness. As the principal objective in any tax system is considered to be the gathering of revenue for financing the expenditures of the State, it is reasonable to assume that measures contributing to increasing the efficiency of tax collection, which was at issue in joined Cases T-127/99, T-129/99, and T-148/99, Territorio Histórico de Álava – Deputación Foral de Álava and Others *v* Commission,[48] may be an example of measures that could be considered to be based on objectives inherent in the tax system.

Moreover, it seems to follow that basic or guiding principles, such as the principle of tax neutrality and the principle of progressiveness (or perhaps the ability-to-pay principle), are considered as objectives inherent in the system. Thus measures based on the principle of tax neutrality and the principle of progressiveness (or perhaps the ability-to-pay principle)

[45] Commission Decision 2002/892/EC of 11 July 2001 on the State aid scheme applied by Spain to certain newly established firms in Álava, OJ L 314, 18.11.2002, pp. 1–16, paragraphs 70–72; Commission Decision 2002/540/EC of 11 July 2001 on the State aid scheme applied by Spain to certain newly established firms in Guipúzcoa, OJ L 174, 4.7.2002, pp. 31–45, paragraphs 70–72; Commission Decision 2002/806/EC of 11 July 2001 on the State aid scheme applied by Spain to certain newly established firms in Vizcaya, OJ L 279, 17.10.2002, pp. 35–49, paragraphs 70–72.

[46] Joined Cases T-346/99, T-347/99 and T-348/99 Diputación Foral de Álava and Others *v* Commission [2002] ECR II-4259.

[47] Joined Cases T-92/00 and T-103/00 Territorio Histórico de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1385.

[48] Joined Cases T-127/99, T-129/99 and T-148/99, Territorio Historíco de Álava – Diputación Foral de Álava and Others *v* Commission [2002] ECR II-1275.

could be justified on the basis of the nature or general scheme of the system. In this context the meaning of the Commission's statements made in Commission Decisions 2002/892/EC on the State aid scheme applied by Spain to certain newly established firms in Álava, 2002/540/EC on the State aid scheme applied by Spain to certain newly established firms in Guipúzcoa and 2002/806/EC on the State aid scheme applied by Spain to certain newly established firms in Vizcaya, must be questioned. In these decisions (see Section 5.6.2) the Commission held that it was not sufficient evidence that the measure in question fulfilled the principal objectives inherent in any tax system, which is to gather revenue for financing the expenditure of the State, or that it satisfies the principles of equality and progressiveness. This statement seems to conflict with the Commission's statement in paragraph 24 of the Commission notice on tax measures which states that the progressive nature of an income tax scale is justified by the redistributive purpose of the tax.

Thus although it seems to follow that the principle of progressiveness is an example of the type of objectives that would be considered as an "objective inherent in the system" and although it follows from for example Commission Decision 2000/795/EC on the State aid implemented by Spain for Ramondín and Others, that only measures that are based on objectives inherent in the system can be justified, the Commission in its statements in decisions 2002/892/EC, 2002/540/, 2002/806/EC mentioned above appears to imply that the fact that a measure is based on for example the principle of progressiveness does not suffices for it to be justified on the basis of the nature or general scheme of the system.

Irrespective of how the Commission's statement in Commission Decisions 2002/892/EC, 2002/540/, 2002/806/EC should be interpreted, it must be questioned if it is always the purpose of all types of taxes to gather revenue to finance State expenditures. The most probable answer seems to be no. The strength of the desire to gather revenue varies, at least with regard to excise duties. There are, for example, environmental taxes the sole aim of which sometimes appears to be the creation of incentives to protect the environment.

Furthermore, the reference to the principle of tax neutrality does raise several questions. The first is: What does the principle of tax neutrality mean? To begin, there is not only one principle of neutrality but several. According to Terra, there are internal neutralities consisting of legal neutrality, competition neutrality, and economic neutrality, and external neutralities which are characterised by international aspects of neutrality.[49] Moreover, although most types of taxes are expected to rest on the

[49] Terra, pp. 15–19.

principles of neutrality, the characteristics of specific consumption taxes (for example, several excise duties), besides having a fiscal motive, usually have an aim of creating incentives to, or prohibitions of, a certain behaviour. Thus the tax is not based on the principle of tax neutrality.

According to Surrey, a tax on alcohol and cigarettes is an example of a tax, the aim of which is to target a special form of consumption and to place a higher burden on a particular type of commodity. He claims that the purpose of tax on alcohol or cigarettes is, generally, to raise revenue and that the disincentive effects of this type of tax are either tolerated or seen as sufficiently proper. But a tax may be designed only for its disincentive effect. In these cases, the contours of the tax, in Surrey's view, presumably mark its purpose and tax expenditures are not involved. In this context, Surrey stated an example of an interest equalisation tax that applies only to foreign bonds and not to foreign stocks. This does not represent a subsidy for stocks, but simply constitutes a disincentive to the purchase of foreign bonds. Surrey adds that this probably is true also if an alcohol tax excluded beer or wine.[50] Thus because excise duties are regarded as specific consumption taxes, it ought not to be possible to justify them on the basis of the principle of neutrality.

Moreover, with regard to the reference to the ability-to-pay principle, it should first be remembered that the Commission has said in several decisions that one of the principal objectives inherent in the tax system is to satisfy the principle of progressiveness. Furthermore, it follows from paragraph 24 of the Commission notice on tax measures, that the progressive nature of an income tax scale or profit tax scale is justified by the redistributive purpose of the tax. It is unclear if the real aim of the Commission was to refer to the ability-to-pay principle and that, by referring to this principle, the Commission considered this type of objectives to be inherent in the tax system and that measures that were based on the ability-to-pay principle, therefore, could be justified.

However, if all these assumptions are correct, it is interesting to note that the ability-to-pay principle has been a important principle in the area of individual income tax, but a principle of lesser or no importance with regard to corporate income tax and excise duties. As Article 87(1) EC applies to taxes in general and only to benefits received by economic operators, it seem that the possibility of justifying a measure on the basis of the ability-to-pay principle is limited. Thus the ability-to-pay principle does not really appear to be of relevance in a State aid context as the measure, in order to constitute State aid, must benefit an economic operator,

[50] Surrey, pp. 27–28.

whereas aid to individuals, as a rule, falls outside the scope of Article 87(1) EC.

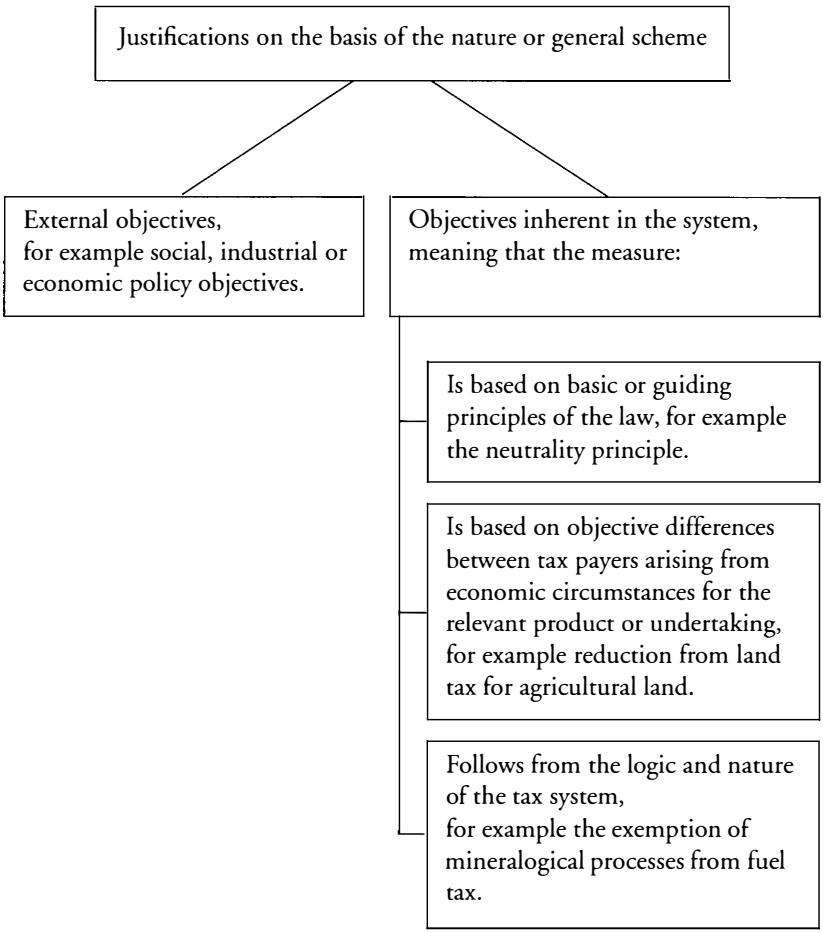
Moreover, it follows from paragraphs 24 and 27 of the Commission notice on tax measures that measures based on objective differences between tax payers may be justified. As mentioned, the relationship between paragraph 24 and 26 of the notice is not clarified in the notice itself. But as paragraph 26 of the notice states that a distinction must be made between external objectives on the one hand and objectives inherent in the tax system on the other hand, and as it follows from Commission case practice that it is only measures based on objectives inherent in the tax system that may be justified; it also appears that objective differences are considered as objectives that are inherent in the system and thus a possible ground for justification on the basis of the nature or general scheme of the system. Examples of measures that have been considered justified with reference to objective differences between taxpayers are when agricultural land was exempted from land tax and was justified with regard to the specific role of land in agricultural production.

Furthermore, a glance at the discussion regarding the principle of equal treatment seems to provide a clarification with regard to the understanding of justifications based on objective differences. Accordingly, the justification of a measure on the basis of objective differences could mean that the economic circumstances of the market of the relevant product must be assessed for the purpose of assessing whether the difference of treatment of comparable products or undertakings could be justified.

Moreover, there seems to be yet another possibility for justifying measures in the case of an exemption that follows from the logic or the nature of the system. As it is only measures based on objectives inherent in the tax system that may be justified, it follows that references to the logic and nature of the tax system are also objectives considered inherent in the tax system.

Consequently, it seems that the assessment of justification of the selective nature of a measure on the basis of the nature or general scheme of the system contains one assessment according to which it must be established whether the exemption is based on external objectives or objectives inherent in the tax system. The possibility of justifying measures on the basis of objectives inherent in the system, in turn, appears to contain three different possibilities of justification: 1) if the measure is based on basic or guiding principles of the tax system, 2) if the measure is based on objective differences between tax payers, and 3) if the exemption follows from the logic or nature of the system. It follows from Commission case practice that only measures based on objectives inherent in the system may be justified, however, with reservation for the meaning of the

Commissions statement in Commission Decisions 2002/892/EC on the State aid scheme applied by Spain to certain newly established firms in Álava, 2002/540/EC on the State aid scheme applied by Spain to certain newly established firms in Guipúzcoa and 2002/806/EC on the State aid scheme applied by Spain to certain newly established firms in Vizcaya, dealt with under Section 5.6.2. The following sketch may illuminate the structure according to the interpretations made.



Measures, the selective nature of which is a result of discretionary powers entrusted with the authority responsible for the aid scheme, may not be justified.

The possibility of justifying a measure on the basis of the nature or general scheme of the system is also interesting in another respect. It follows from Section 5.9.1 that, in principle, the Commission is not considered to have discretionary powers with regard to the assessment of Article 87(1) EC but only with regard to the assessment of Article 87(3) EC. However, as the assessment of justifications is part of the selectivity criterion and, thus, is part of the assessment of Article 87(1) EC, and no doubt constitutes a subjective assessment, it is an interesting task to examine in more depth the authority of the Commission with respect to the assessment of Article 87(1) EC. With regard to the wording of the CFI's judgment in Case T-67/94, Ladbroke Racing,[51] and to its rulings in Case C-56/93, Belgium *v* Commission[52] and Case T-358/94, Air France *v* Commission,[53] it would appear that the Commission's assessment of justifications is a complex economic appraisal, which would justify discretionary assessments by the Commission in regard to the application of Article 87(1) EC.

Furthermore, the understanding of paragraph 23 of the Commission notice on tax measures appears to be improved by noting that Tridimas, in assessing whether or not different treatment of comparable products or undertakings is justifiable in accordance with the principle of equal treatment, concluded that the difference in treatment must not be arbitrary, but must be based on rational considerations. Thus the Commission appears to mean that justifications must be objective and based on rational considerations. What makes justifications objective and based on rational considerations, however, seems to remain an assessment to be pursued on a case-by-case basis.

A final question discussed in this chapter was whether the obligation to notify the Commission in advance also covered measures that the Member States considered justifiable. It appears that this is the case.

[51] Case T-67/94 Ladbroke Racing Ltd *v* Commission [1998] ECR II-1.

[52] Case C-56/93 Kingdom of Belgium *v* Commission [1996] ECR I-723.

[53] Case T-358/94 Compagnie Nationale Air France *v* Commission [1996] ECR II-2109.

6 The selectivity criterion from a norm perspective

6.1 Introduction

It follows from the information and arguments presented in the first five chapters that the selectivity criterion appears to contain two parts: 1) the application of the derogation method, sometimes supplemented with an assessment establishing if the measure is general or selective, and 2) the assessment of justification described in Chapter 5. Chapter 6 presents an analysis of the selectivity criterion applied to taxes as defined in the previous sentence, from a norm perspective. As was clarified in Section 4.4.2, several scholars have criticised the application of the derogation method. Bacon criticises the fact that neither the Commission nor the Court has defined what constitutes the "norm" or a "general system".[1] Moreover, Schön has emphasised the difficulty of determining the "normal" tax rate in order to identify whether or not a certain tax rate reduction deviates from a tax burden "normally borne".[2]

It is obviously a delicate problem connected to the application of the derogation method, to establish the point of departure or the benchmark against which the exemption is to be assessed. Is it some type of norm? The first part of this chapter is dedicated to this issue. As the method of identifying tax expenditures is similar to the application of the derogation method, reference will once again be made to the tax expenditure debate held in the 1970s and 1980s.

According to Kube, the two assessments at issue – that is to say the application of the derogation method and the assessment of justifications – are incoherent.[3] In what way are they incoherent?

The clarification of what is currently considered to be the point of departure in the application of the derogation method is followed in this chapter by a discussion of the logic of the current application of the selectivity criterion to taxes, as defined at the beginning of this section.

[1] Bacon, p. 298.
[2] Schön, p. 930.
[3] Kube, p. 18.

6.2 What is the benchmark of the derogation method?

6.2.1 Introduction

In order to elaborate on the involvement of some type of norm in the application of the derogation method, the concept of "norm" needs to be examined more closely, as it is a word with several meanings. In the context of taxes, the meaning of norm was one of the most hotly discussed issues during the 1970s and 1980s within the tax expenditure debate mentioned in Sections 1.4.4 and 4.3.

6.2.2 The norm definition in the early tax expenditure debate

It follows from Section 4.3.2 that one of the great difficulties in establishing tax expenditures is to determine the "normative structure" of a tax. The idea of departing from a normative tax structure to identify tax expenditures originates from Surrey. According to Surrey, the tax expenditure analysis and the Tax Expenditure Budget for income tax involved a basic definitional question: Which income tax rules are special provisions representing Government expenditures made through the income tax system to achieve various social and economic objectives and which income tax rules are just tax rules, that is, constitute the basic structure of an income tax system and thus are integral to having an income tax at all?[4]

In Surrey's view, the building of an income tax system requires two types of provisions that together perform two functions, the first function being that the provisions must answer the questions:

- what receipts should be included and what expenses allowed to obtain the proper measure of net income for an income tax – "proper" in the sense that it is an *income tax* for which the measure is being sought;
- in what time periods should includable receipts be included and allowable expenditures be taken (e.g., cash and accrual accounting, expensing or capitalization of expenditures, and if the latter, how written off – the method of depreciation, for example);
- over what interval of time should the measurement itself be made (e.g., averaging and net operating loss questions);
- what is the unit whose income is being measured (e.g., is the family to be taxed as a unit or the members separately taxed);
- how should the income of organizations of individuals be treated (e.g., the relationship of corporate income and the corporate tax to the tax treatment of the shareholders).

[4] Surrey, p. 15.

Moreover, Surrey suggests, 'questions that would essentially be treated in much the same way by any group of tax experts building the structure of an income tax and being governed in that task by all the requirements implicit in such a tax because it is an *income tax*'. According to Surrey, these answers become the structural provisions which shape a normative income tax.

Surrey's second function is that the provisions answer questions that are necessary for building an income tax system, but that could, in the view of Surrey's group of tax experts, be treated differently from country to country depending on the opinions and policies shaped by other goals, rather than by factors unique to an income tax. According to Surrey, these answers were not to be considered as part of the normative structure but were essential to the operation of the tax. Once they have been determined, however, these answers are to be considered as structural parts of the income tax and were not considered to constitute tax expenditures.[5]

Surrey used examples to illuminate the first category of matters relating to the measurement of net income and the periods for inclusion of that income. Perhaps double taxation relief based on the grounds that a person drawing income from abroad which is liable to foreign tax has less ability to pay than a person drawing the same amount of income from one single country, which according to Willis and Hardwick appeared to be a generally accepted as an essential element in the structure of a modern income tax could constitute another example of the first category.[6]

Examples used to illustrate the second category were the levels of personal exemptions and tax rates and the degree of rate progressivity based on the ability-to-pay principle as well as on the treatment of corporations as a separate entity.[7] The latter must be read in the context that it was the Haig-Simons definition that was the basis for Surrey's identification of income tax expenditures. If this definition, which stresses that taxes should be based on consumption plus the change in net wealth is accepted, it would be inconsistent to argue that corporate income tax is a normal part of the income tax structure, because the corporate tax is not based on the income of individuals.[8]

In order to illuminate Surrey's view further, an article by Surrey and McDaniel from 1979 may be useful. They explain the method according to which tax expenditures are to be identified. According to these authors,

[5] Surrey, pp. 16–17.
[6] Willis and Hardwick, pp. 3–4.
[7] Surrey, p. 17; Hellmuth and Oldman, p. 593.
[8] Smith, p. 35.

the tax expenditure analysis is based on the concept of a normal or normative tax. They explain that in the United States' analysis of tax expenditures, the normative concept of the net income was the general economic definition of income under the Haig-Simons approach – that is to say an increase in net economic wealth between two points in time plus consumption during that period. In order to illuminate how the analysis was pursued, it may be of interest to discuss Surrey's and McDaniel's conclusions. They held that 'consumption' is broadly applied and, in essence, covers all expenditures except those incurred as a cost in the earning or production of income, and hence are proper offsets to gross income to arrive at taxable net income. In addition, they believed that because the Haig-Simons approach does not identify appropriate accounting techniques, it is necessary to resort to widely accepted 'standards of business accounting' used to determine income for financial reports.

The application of these economic and accounting norms is then tempered by a reference to the 'generally accepted structure of an income tax'. This reference excluded as normative the inclusion of, for example, unrealised appreciation in assets values, because in the United States as in most other developed countries, these items are not commonly regarded as income for tax purposes even though they fall within the economic definition of income. Moreover, Surrey and McDaniel argued, neither the tax unit nor the tax rate schedule are defined by the Haig-Simons definition, but are the result of choice based on policy issues. Thus Surrey and McDaniel concluded that whereas factors such as the taxable unit or a rate schedule are necessary components of the structure of an income tax, their particular determinations are not part of the normative concept of the income tax, contrary to, for example, the determination of the tax base and the accounting techniques to identify the net income of a given period. However, once a general rate schedule is decided upon as a matter of fiscal policy, a special variation in that rate intended to confer as special tax benefit becomes a departure from the normal structure.[9]

Mattsson, who by and large seems to agree with the views of Surrey and McDaniel, has added that there is a need to establish a method for tax expenditures to be identified when the tax experts disagree about a particular tax measure. Mattsson suggests that in these cases it is the aim of the relevant provision that should be decisive. Thus if the tax provision is of the type that might as well have been formulated as a direct subsidy, then the measure should be identified as a tax expenditure.[10]

[9] Surrey and McDaniel, p. 229.

[10] Mattsson, p. 140.

Surrey emphasised that each nation must make its own choices about the type of personal taxes it desires, depending on what aspects of 'ability to pay' it seeks to stress: the individual's income, consumption, or wealth. Each tax has its own appropriate structure, advantages, and disadvantages. The important thing, according to Surrey, is that the scope of application of each tax must be tested by *its* concepts – the concepts that led to its choice in the first place. Thus in order to determine tax expenditures in an income tax system, a normative definition of income must be the point of departure, and a normative definition of consumption must be established when it is consumption tax expenditures that are to be established.[11]

The criteria that Surrey suggests for establishing tax expenditures that has been described in this section were adopted by the International Fiscal Association for its 1976 Congress. The guidelines laid down by the Association in the field of individual taxation were:

(i) the economists' definition of income as the market value of the individual's consumption, plus or minus the increase or decrease in his wealth over the year (the Haig-Simons definition); and
(ii) "the generally accepted structure of an income tax that would exist in the absence of the use of tax incentives or tax reliefs".[12]

In summery it seems that Surrey's normative model contained two functions, of which the first comprised two stages. Thus the first function was to establish the economists' definition (the first stage) and the generally accepted structure of an income tax (the second stage), whereas the second function meant that the result of the first function should be applied in different countries. The aim of the second function is to enable country specific circumstances to be taken into account. In this context, it should be mentioned that, in a similar sense, the McDaniel and Surrey study from 1985 established a normative structure also for VAT and wealth tax.[13]

6.2.2.1 Critical voices

The criteria established by Surrey to single out income tax expenditures have been criticised by several authors, of which Bittker and McIntyre are discussed here.

As mentioned in Section 1.4.4 Surrey's goal of developing a description and analysis of tax expenditures was reached in the 1968 Annual

[11] Surrey, p. 21.
[12] Willis and Hardwick, pp. 1–2.
[13] McDaniel and Surrey, pp. 63–114.

Report of the Secretary of the United States Treasury. This project was, however, criticised by Bittker in the article 'Accounting for Federal "Tax Subsidies" in the National Budget'.[14] The idea of creating a list of tax expenditures had, however, already been criticised by Bittker as early as 1967 in the article 'A "Comprehensive Tax Base" as a Goal of Income Tax Reform'.[15]

The main reason for illuminating tax expenditures had been to expose public spending that was not visible in the budget. Furthermore, for several reasons, more than one author in addition to Surrey considered that direct subsidies would be better suited for reaching the intended goals of the subsidies. Surrey provided a clear example of this reasoning in his book *Pathway to Tax Reform*, in which the effect of a medical expense deduction in two different families was compared. One family was in the 70 % tax bracket and the other one was in the 14 % tax bracket. For the 70 % bracket family, the tax deduction – the yielding of the tax claim – meant that the Government was, in effect, paying 70 % of the medical expenses. For the 14% bracket family, the Government, through the deduction, was paying only 14 % of the medical expenses. This unfair effect is the inevitable result of a deduction under a progressive income tax.[16] Moreover, it was considered that tax expenditures erode the tax base. Thus Surrey and others suggested a reformed Internal Revenue Code with a "correct" tax base.

In his 1967 article, Bittker contended that Surrey's proposal had much in common with the call for a comprehensive income tax base, which presupposes an ideal tax structure. According to Bittker, there is no ideal tax structure and no such thing as a correct tax base because the income tax structure cannot be discovered, but must be constructed. Bittker contends that we do not begin with a consensus on the meaning of income, but with myriad arguments about what should be taxed, when, and to whom. An 'exception' would be possible to identify only if we were dealing, not with income tax, but with a tax label that described its reach with greater precision.[17] Furthermore, in his article from 1971, Bittker added that what is needed is not an ad hoc list of tax provisions but a generally acceptable model or a set of principles, enabling us to decide with reasonable assurance which income provisions are departures from the model and whose costs are to be reported as tax expenditures.[18] Thus

[14] Bittker, (1969) I, pp. 244–261.
[15] Bittker, (1967), p. 927.
[16] Surrey, p. 22.
[17] Bittker, (1967), p. 985.
[18] Bittker, (1969) I, p. 247.

Bittker concluded that an income tax is what the theoreticians say it should be and a 'departure' or 'concession' is the Congressional failure to follow the theoreticians' advice.[19]

Surrey and Hellmuth explained their point of departure in a reply to Bittker's article.[20] They pointed out that they strived for a larger measure of guidance than the economists' reference to the 'comprehensive tax base', according to which a change in the net economic power of an individual is measured between two points in time. Therefore, they used 'widely accepted definitions of income' and the 'generally accepted structure of an income tax' as the governing guidelines. They held that whereas economists may believe that some things must be treated as part of the proper structure of an income tax, this treatment may not coincide with the general understanding of the income tax structure. They added that such a standard of general acceptance, of course, results in changes over time as the economist's norm at a particular moment becomes more and more accepted.

As Surrey and Hellmuth saw it, the development of boundaries for the income structure was a two-stage process. The first would be the stage at which most people simply could not accept a proposed change, based on the economist's evaluation, in the existing treatment of an item as being necessary to the determination of a proper income tax base. The second step would then be the acceptance of the economist's approach and a perception of the change as being the proper one for the income tax base. The question is: Accepted by whom? Bittker's view is understandable, as articulated in his reply to Surrey and Hellmuth, in which he argued that 'it is difficult to see what difference it makes whether some people, most people, or all people regard a specific provision as a "proper" part of the income tax structure'.[21] Surrey and Hellmuth's explanation of their first stage seems to refer to "people" and "the public" as synonymous. However, it appears that the second stage implicitly refers to the acceptance of the legislator; it might well refer to the public as well.

McIntyre, who had followed the intensive debate on tax expenditures, proposed a solution to the problem of defining tax expenditures. McIntyre believed that if this solution were chosen, it was held that it would not be necessary to identify an ideal tax structure. He used a horticulture metaphor to explain his potential solution according to which a man had bought an old estate that contained a once-fine flower garden that was now engulfed in weeds. The man hired a gardener to cultivate the garden

[19] Bittker, (1969) I, p. 259.
[20] Surrey and Hellmuth, p. 532.
[21] Bittker, (1969) II, p. 539.

and remove the weeds. Before undertaking his work, the gardener wanted the man to define weed.

"A weed" said the man "is a plant that has no place in a flower garden". The gardener did not feel fully enlightened by this statement, but nevertheless went to work. After a few days, the man visited the estate and was content with the improvement. The gardener then took the opportunity to ask the man about several types of flowers that he found appealing but which he suspected might be weeds. They agreed that the gardener should take samples of the plants to experts at a nearby botanical garden for an opinion. The gardener was informed that the experts considered all the plants in question to be weeds, and the gardener started to dig them out of the garden.

Upon seeing the gardener digging up a very nice flower, the man exclaimed: "What are you doing?"

The gardener explained that all the experts consulted had concluded that the plants he had shown them had no proper place in a flower garden. The man replied that the experts' opinions were of no importance and that the flowers at issue did have a place in his flower garden.

McIntyre believes that the problem of defining of a weed as 'a plant that has no proper place in a flower garden' has some similarities with the problem of defining tax expenditures. He holds that one of the difficulties in defining a weed is its relationship with things external to it and suggests that almost any plant would be considered a weed under some circumstances. Moreover, in defining a weed and in defining tax expenditures, there is an unavoidable incorporation of subjective value judgments. Finally, weeds and tax expenditures cannot be identified precisely without changing the core meaning of the term.

How then was the gardener able to weed the garden to the man's satisfaction? According to McIntyre, the answer is that the gardener understood that the purpose was to enhance the beauty of the man's garden, and that this goal became the touchstone for resolving all sorts of issues.

And this is the solution that McIntyre proposes for identifying tax expenditures. He contends that if the purpose of the tax expenditure list is to provide Congress with reliable estimates of the costs, in foregone revenue, of tax provisions that are functionally equivalent to spending programs, there are many more ways to go about it than to divide tax provisions into normal and special provisions, where special provisions would constitute tax expenditures.[22]

In my view, an obvious problem with McIntyre's suggestion seems to be that it is up to the beholder to judge what enhances the beauty of a garden.

[22] McIntyre, pp. 83–89.

6.2.2.2 Accounting issues

It follows from Section 6.2.2 that Surrey and McDaniel considered the determination of the tax base and the determination of accounting techniques to identify the net income of a given period to be part of the normative concept of the income tax. Thus for corporations, the determination of accounting methods is essential for deciding if a certain measure constitutes a tax expenditure. Surrey and McDaniel also held that the Haig-Simons approach does not identify appropriate accounting techniques and that it is, therefore, necessary to resort to widely accepted 'standards of business accounting' used to determine income for financial reports. Furthermore, they suggest that these economic and accounting norms should be tempered by referring to the 'generally accepted structure of an income tax'.

According to Mattsson, the rules for calculating asset depreciation vary from country to country.[23] Moreover, it follows from Gjems-Onstad's dissertation, *Avskrivninger,* that there are several ways or methods for calculating assets depreciation. Some countries accept free depreciation, by which it is up to the tax subject to determine how much the value depreciates from year to year over the length of life of the object at issue. Other countries apply systematic depreciation, which in turn may be divided in different methods based on time or production units. Systematic depreciation methods may be 1) straight line, in which a certain monetary amount is depreciated annually for a certain number of years; 2) degressive, in which the monetary amount depreciated decreases from year to year; or 3) a system according to which the annual depreciation corresponds to a fixed percentage of the declining balance value of the asset. A systematic depreciation method based on production units means that depreciation is based on the number of hours that a machine has been used, the number of kilometers a vehicle has been driven, or the number of products transported or used.[24] The forgoing provides illustrative examples only and may very well exist in different combinations.

A common feature of the different types of systematic depreciation methods is their provision for a proxy for the consumption of the asset. Only in rare cases would it be possible to imagine a corresponding actual consumption. One of the arguments for upholding the proxy character of the depreciation rules is to avoid the difficult issue of determining a certain value of the asset each year.

Moreover, Gjems-Onstad emphasised that it is a commonly held view that the depreciation rules should be neutral. In order to determine if

[23] Mattson, pp. 255–256.

[24] Gjems-Onstad, pp. 101–109.

this is so, it is necessary to examine the fiscal treatment of interest expenses. The treatment of interest expenses is, in turn, of importance for the depreciation rules.[25]

Against this background, it appears to be a difficult task to theoretically determine a normative structure for rules of depreciation, a conclusion which was also reached by Gjems-Onstad.[26] In general, however, the rules relating to the calculation of asset depreciation are, according to Mattsson, based upon widely accepted standard business accounting practices and deviations from this standard would therefore be considered to be a derogation from a normative tax system.[27]

In summary the concept of 'norm' as discussed in the 1970s and 1980s tax expenditure debates is vague and difficult to apply. It is based on technical definitions, which in themselves may be difficult to understand and apply; on tax principles, and the general acceptance of officials and the public.

6.2.3 Objectives inherent in the tax system – a correspondence with the second function of Surrey's method to determine a normative model?

Although Surrey's method may not be altogether clear it appears that the assessment of justifications presented in Chapter 5 resembles, to some extent, the second function of Surrey's methodology for determining a normative model that is discussed in Section 6.2.2. The second function of Surrey's normative model is the stage at which the norm (according to the economist' definition supplemented with the generally accepted structure of an income tax) is supplemented by, or perhaps, rectified by tax experts' views of what must be considered to be structural parts of the tax system based on country specific considerations.[28] In both cases, it is a question of a subjective assessment of measures considered as derogations from a tax system. It appears that the Commission, at least in its notice on tax measures, has been influenced by the tax expenditure debate, as evidenced by its view on progressivity.

Paragraph 24 of the notice is placed under the heading '[j]ustification of a derogation by "the nature or general scheme of the system"' and it follows from this placement that the progressive nature of an income tax scale is considered to be a derogation from the common, applicable sys-

[25] For further reading, see Gjems-Onstad, pp. 109–118.
[26] Gjems-Onstad, pp. 146–157.
[27] Mattsson, pp. 255–256.
[28] Willis and Hardwick, pp. 1–2.

tem, but that it is justified by the redistributive purpose of the tax. According to Surrey, the degree of rate progressivity is an example that falls within the second function of his normative model.[29] Thus; Surrey viewed the degree of rate progressivity as a structural parts of the tax and not a as tax expenditure. According to paragraph 24 of the Commission notice on tax measures, such a measure would be considered to be a justifiable derogation.

Although the resemblance between the second function of Surrey's normative model and the Commission's view on what constitutes the point of departure in the application of the derogation method may be limited, it triggers the question: Is there a resemblance between the first function of Surrey's normative model and the Commission's view on what constitutes the point of departure in the application of the derogation method?

6.2.4 The benchmark – a norm?

As mentioned in Section 4.2.1, in his opinion in joined Cases C-72 and 73/91, Sloman Neptun, AG Darmon referred to three Court cases in support of his conclusion that the Court applied a derogation method.[30] These were the Court's judgments in joined Cases 6 and 11/69, Commission *v* France,[31] the judgment in Case 203/82, Commission *v* Italy,[32] and the judgment in Case 173/73, Italy *v* Commission.[33]

In joined Cases 6 and 11/69, Commission *v* France, described in Section 2.5.3.1.1, AG Darmon held that the derogation must be considered to lie in the existence of a special rate for export claims, a rate lower than that generally applied for domestic claims. In Case 203/82, Commission *v* Italy, described in Section 2.5.3.2.6, the Commission identified the aid as consisting of the larger reduction in employers' contributions to a sickness insurance scheme for female workers than for male workers. In Case 173/73, Italy *v* Commission, reported in Section 1.1, the derogation consisted of the partial exemption of undertakings of a particular industrial sector from the financial charges arising from the normal application of the general social security system.

In joined Cases 6 and 11/69, Commission *v* France, it apparently was the general rediscount rate system that was used as the benchmark from

[29] Surrey, p. 17.

[30] Joined Cases C-72 and 73/91 Sloman Neptun Shiffahrts AG *v* Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG [1993] ECR I-887.

[31] Joined Cases 6 and 11/69 Commission *v* French Republic [1969] ECR 523.

[32] Case 203/82 Commission *v* Italian Republic [1983] ECR 2525.

[33] Case 173/73 Italian Government *v* Commission [1974] ECR 709.

which derogation was made for exports. In Case 203/82, Commission *v* Italy, the general system must have been considered to be the social security system, which was also the case in Case 173/73, Italy *v* Commission. It follows from the cases referred to that it is the scheme of the system in which the derogation is set that is considered to be the benchmark.

Against this background, the wording of paragraph 16 of the Commission notice on tax measures, in referring to "the common system applicable", may be considered to be clarified to some extent. Thus it seems that it is the existing system or the tax system to be applied in a particular Member State that constitutes the benchmark, rather than a norm in the way it was defined by Surrey corresponding to the first function of his normative tax model. Consequently, the benchmark will vary from situation to situation and from Member State to Member State. It is interesting to note that viewed in the context of the Nordic Council of Ministers' report mentioned in Section 4.3.2.4, this interpretation of a norm was considered as one out of two extremes.

The conclusion that the common system applicable means a particular Member State's existing tax system or the tax system to be applied as the benchmark may, perhaps, explain the Commission's stand in the process of the initial notification of the Swedish waste tax.[34] According to the initial draft, a tax was to be introduced on waste deposited on landfills. The proposed rate was to be set at SEK 250 per tonne of waste, without any differentiation between types: household waste versus industrial waste, for example. In the draft, however, it was held that some types of landfills should not be covered by the tax if they exclusively deposited either:

1. one or several of the following types of waste, namely,
   a.) earth, stone, clay, shale, limestone dust, limestone, or other stones,
   b.) dead rock from manufacturing processes in industrial quarrying operations, and
   c.) waste sand from manufacturing processes in industrial quarrying operations, and certain types of waste water, or,
2. radioactive waste.

Furthermore, various tax relief measures were proposed. And because, at the time of the initial draft, it was unclear if also the exclusion of certain tax subjects from the system would be considered to constitute a deroga-

[34] As an official at the State aid unit at the Ministry of Industry and Trade responsible for State aid matters I was one of the persons responsible for negotiating the Swedish waste tax with the Commission.

tion classified as State aid, the Commission was also notified about the exclusion of these subjects.

During negotiations with Commission officials, it became apparent that some of them held the opinion that also tax subjects left out of the system were considered as derogation and consequently constituted State aid, whereas other officials were of the opinion that they did not. In the subsequent Commission Decision, however, the tax subjects left outside the tax system were mentioned only *obiter dictum*, whereas the various relief measures were thoroughly analysed and accepted against the background of the guidelines for environmental protection. Thus, it seems that it is up to the Member State to determine the scope and content of the tax system and that it is only derogations from that system that may constitute State aid. A consequence of this reasoning seems to be that a derogation must be articulated in order for it to constitute State aid according to Article 87(1) EC.

6.2.5 Kube's incoherence

As mentioned in Section 6.1, Kube is of the opinion that the application of the derogation method and the assessment of justification are incoherent. The most reasonable explanation for this conclusion is that the benchmark in the application of the derogation method is the existing tax system or the tax system to be applied, according to which all articulated derogations from the existing system, or the system to be applied, would objectively be considered to be derogations. As follows from the discussion in Chapter 5, however, the assessment of justifications is a subjective assessment, according to which it should be established if the derogating measure could be justified on the basis of any of the principles on which the tax system is based, on the basis of the objective difference of the derogating measure, or on the basis of the logic and nature of the tax system. Thus in this sense, it seems that the two assessments are incoherent.

6.2.6 Other possible options?

It follows from the above that Surrey's model of a normative tax structure can and has been criticised on several grounds and that the guidelines for establishing tax expenditures for personal taxation (in which the International Fiscal Association referred to the economist's definition of income as the Haig-Simons definition and the generally accepted structure of an income tax) raise theoretical problems.[35]

[35] Willis and Hardwick, pp. 1–2.

The Commission, the ECJ, and the CFI all seem to have avoided these theoretical difficulties by using the existing tax system as the benchmark in the application of the derogation method rather than relying on a norm resembling the first function of Surrey's method to determine a normative model – that is to say a norm in accordance to the economist's definition and the generally acceptable structure of an income tax. This may have been a conscious choice to avoid the theoretical difficulties connected to the definition of a norm according to Surrey's normative model or to accommodate a political need for a pragmatic system based on the fact that the Community has always had several members. Today, there are 25 members of the EU, and one might question if any other view would have been possible other than to regard the existing system as the benchmark in the application of the derogation method. In theory, it would be possible to establish different norms for different types of taxes in all 25 Member States. In practice, however, this does not appear plausible.

6.3 Derogations or consequences of the application of the system

All the decisions dealt with in Section 5.5 regarding measures following from the logic and nature of the tax system seem to be logical with regard to the Commission's statement in paragraph 25 of its notice on tax measures, which states that: 'Obviously, profit tax cannot be levied if no profit is earned. It may thus be justified by the nature of the tax system that non-profit-making undertakings, such as foundations or associations, are specifically exempt from the taxes on profits if they cannot actually earn any profits ...' It follows from the wording of paragraph 25 and from the fact that paragraph 25 is placed under the heading '[j]ustification of a derogation by the "nature or general scheme of the system"', that the Commission, at least, considers the non-taxing of profit tax of non-profit-making undertakings to constitute a derogation from the tax system – that is, a derogation from the profit tax system.

However, this view is difficult to reconcile with the Commission's own argument in Case T-67/94, Ladbroke Racing; the CFI's judgment in the same case;[36] and the previous conclusion that it is a Member State's existing tax system or the tax system to be applied that is consid-

[36] Case T-67/94 Ladbroke Racing Ltd *v* Commission [1998] ECR II-1.

ered to be the benchmark in the assessment of the derogation method. In Case T-67/94, Ladbroke Racing, the Commission argued that PMU was not subject to corporation tax because PMU was a *groupement d'intérêt économique,* and, as such, has no capital of its own. The financial result is integrated directly in the results of its members and the tax is therefore payable not by the group as such but by its members. In paragraph 89, the Court pointed out that the exemption of the PMU from corporation tax was a consequence of the normal application of the general fiscal regime in so far as no such tax applies to *groupements d'interêt économique.* Thus it seems that because the *groupements d'interêt économique* had no capital of their own, they were not covered by the scope of the tax:

Consequently, what the Court appears to hold is that the different treatment of PMU was not a derogation, but a consequence of the scope of the existing tax system. As a result, it appears that, in the CFI's view, the non-taxing of profit tax of non-profit-making undertakings would not constitute a derogation according to the application of the derogation method but would be considered a consequence of the fact that the scope of the tax system is to tax profit-making undertakings.

This reasoning is appealing. Taking into account the fact that it is the existing tax system or the tax system to be applied that is considered the benchmark in the assessment of the derogation method and, more specifically, it is within the sovereignty of the Member State to determine the scope of the tax, it would seem more logical to consider the identification of the nature of the tax system as a subjective part of the application of the derogation method, as part of establishing the existing tax system ought to include the identification of the tax system's scope.

Accordingly, the application of the derogation method would thus contain two assessments: one objective, according to which all types of measures referred to as derogations are identified; and one subjective, according to which the measure classified as a derogation according to the objective assessment was scrutinised with regard to the purpose and the scope of the tax system. If the measure in question was referred to and treated as a derogation in the tax system but proved to fall out side the scope of the purpose of the tax, the measure ought not to be considered a "true" derogation and would not constitute a derogation for the purpose of Article 87(1) EC. An example may be illuminating.

In Section 5.5 the Commission Decision in Case NN 161/2003 regarding the re-notification of exemptions from the Swedish waste tax was cited as an example of a derogation from a tax in the form of a deduction that was considered justified by the nature and general scheme of the system, on the basis that the derogation followed from the logic

and nature of the tax system.[37] It was mentioned in the ruling that the tax system contained the following types of tax relief:

(i) a reduction in the tax base with regard to material aimed to be used for running the landfill or material necessary for construction projects and for waste that should be composted or treated according some other method without being deposited;
(ii) a reduction in the tax based in the form of full deduction for certain types of waste, originating from the running of the landfill or from construction projects on the landfill brought out from the landfill, and;
(iii) a reduction in the tax base in the form of full deduction for certain categories of waste because depositing the waste was considered the most environmentally friendly treatment available or that depositing is preferred on the basis of the dangerous and harmful character of the material.

Moreover, in its decision in Case NN 161/2003 regarding the re-notification of the exemptions from the Swedish waste tax, the Commission considered all reductions justified on the basis of the nature or general scheme of the system as all three categories followed from the logic and nature of the tax system.[38]

It appears that the Commission considered these measures to be justified on the basis of the nature or general scheme because they were considered to fall outside the scope of the waste tax. These measures should not have to be justified according to the assessment of justification, however, because they should not be regarded as derogations for the purpose of Article 87(1) EC in the first place. Taking the first reduction mentioned above as an example, we see that it concerns a reduction in the tax base with regard to material aimed for use in running the landfill or material necessary for construction projects as well as for waste that should be composted or treated according to some other method without being deposited. It may be considered a derogation in the sense that the reduction from tax for these materials is articulated in the law. One question of immense significance is: Is this derogation selective in the way selective nature was discussed in Sections 2.5.3.2.2 to 2.5.3.2.6?

[37] Commission Decision concerning Case NN 161/2003 of 19 May 2004 regarding *Förlängning och ändring av stödordningen för avfallsskatt*, C (2004) 1810fin.
[38] Ibid.

As the reduction concerns material intended for use in running the landfill or in construction projects or material that should be composted or treated according some other method without being deposited, it does appear rather general. Thus this reduction would not have been classified as State aid in the first place had the requirement of selectivity not been considered automatically fulfilled as a result of the application of the derogation method.

In Section 4.5.3, it was established that, although the application of the derogation method sometimes seems to fulfil the requirement of selectivity automatically, a derogation from a tax system may sometimes be general and open to "all" economic operators. This seems to be the case in the example dealing with the Swedish waste tax.

Moreover, because the example of the reduction in waste tax does not appear to be selective, it does not seem logical that this type of measure could be justified on the basis of the nature or general scheme of the system; it is the selective nature of the measure that should be justified.

Thus it would seem more logical to view the application of the derogation method more distinctly as an assessment separate from the selectivity criterion. Accordingly, and as mentioned previously in this section, the derogation method would thus contain two assessments; one objective assessment, according to which all types of measures referred to as derogations are identified and one subjective assessment, according to which the measure objectively classified as a derogation is scrutinised against the background of the purpose and the scope of the tax system.

Finally, assuming that the example mentioned had benefitted a particular sector or a certain group of undertakings, it would still not be considered a "true" derogation and a derogation for the purpose of Article 87(1) EC, because it would be outside the scope of the tax system to tax materials that are not intended to be deposited for more than three years.

6.4 Concluding remarks

As concluded in Section 6.1, the selectivity criterion applied to taxes seems, at present, to contain two parts: 1) the application of the derogation method, sometimes supplemented with an assessment establishing whether the measure may be considered a general measure; and 2) the assessment of the possibility of justifying a measure on the basis of the nature or general scheme of the system.

One of the most delicate problems regarding the application of the derogation method seems to be that of defining the benchmark against which to establish derogations. Because the method applied to identify

tax expenditures was and is similar to the application of the derogation method, the concept of "norm" was analysed with reference to the tax expenditure debate.

It seems that the assessment of justification shows some resemblance to the second function of Surrey's normative tax model, and that, in this context, the Commission has been inspired by the tax expenditure debate. Against this background, it could also have been assumed that the Commission's view with regard to the question of what constitutes the benchmark had also been inspired by the first function of Surrey's normative model. An examination of the ECJ's and the Commission's application of the derogation method and a comparison with the norm discussion held in the tax expenditure debate during the 1970s and 1980s, however, seems to illustrate that the benchmark used as the point of departure in the application of the derogation method is the existing tax system actually applied in a Member State, or the tax system to be applied – rather than a norm corresponding to the first function of Surrey's model of a normative tax structure.

In Section 6.3, the logic of considering those measures that follow from the logic and nature of the system (discussed in Section 5.5) justifiable on the basis of the nature or general scheme is questioned against the background that: 1) it seems to be a Member State's existing tax system actually applied or the tax system to be applied that is considered the benchmark in the application of the derogation method; and, 2) the Commission's own arguments as well as the CFI's judgment in Case T-67/92, Ladbroke Racing. It seems, at least, that the examples provided for in Section 5.5, if they are selective at all, they fall outside the purpose, and thus outside the scope of the tax system, and would therefore be considered not as derogations from the existing tax system but as a consequence of the application of the tax system.

Accordingly, the Commission's view that the exemption of non-profit making undertakings from profit tax constitutes a derogation that needs to be justified, a position that is articulated in paragraph 25 of the Commission notice on tax measures ought to be questioned.

Finally, and as a consequence, it would be more logical to view the application of the derogation method more distinctly as an assessment separate from the selectivity criterion.

7 Final comments

The assessment of the selectivity criterion applied to taxes raises several intricate questions. In order to analyse it, it is necessary, first, to distinguish the assessment of the selectivity criterion in general from the other criteria of Article 87(1) EC. Such an analysis seems to show that the criterion of distorted competition and the intra-Community trade criterion are treated as one, but that the remainder, although closely connected, should be treated on their own merits, and not mixed with other assessments. Thus the advantage criterion appears to be an assessment in which the situation of the undertaking in and of itself is compared before and after the grant of aid. Moreover, it seems reasonable to assume that the assessment of the selectivity criterion is a purely national assessment, whereas the criterion of distorted competition is an assessment pursued on the European level.

The selectivity criterion in general is the criterion requiring that the measure must be addressed to a specific sector or group of undertakings or has the effect of benefitting a sector or a certain group of undertakings.

In applying Article 87(1) EC to taxes, a derogation method is applied, according to which only derogations from a generally applicable tax system are classified as State aid. As mentioned in Chapter 4, the method to identify and establish tax expenditures is similar to the derogation method. In the same chapter it was also suggested that the discussion in the tax expenditure literature with regard to the question of when a measure constitutes a derogation is more sophisticated than are the discussions in the EC State aid literature, the Commission notice on tax measure, the Commission Decisions, and the case law of the CFI and the ECJ. Against this background, it was suggested in Chapter 4 that this part of the tax expenditure discussion may contribute to the understanding of when a measure constitutes a derogation to be classified as State aid.

As established in Chapter 4, the current view on the assessment of the selectivity criterion to taxes seems to be that this assessment contains two parts. Accordingly, the first part is the application of the derogation method, sometimes supplemented with an assessment determining if the measure may be considered a general measure; and the second part is the

assessment of justifying the selective nature of a measure on the basis of the nature or general scheme of the system.

It seems that the assessment of justification on the basis of the nature or general scheme is an assessment comprising several assessments. Thus the first assessment is to establish if the measure can be considered to be based on external objectives or on objectives inherent in the tax system. Only if the measure is based on objectives inherent in the tax system can that measure be justified. Examples of external objectives are social, regional economic and industrial policy objectives as well as employment policy objectives. The chances of justifying exemptions on the basis of objectives inherent in the system contain three different possibilities: 1) that the measure is based on basic or guiding principles of the tax system, 2) that the measure is based on objective differences between the tax payers, or 3) that the measure follows from the logic and nature of the tax system.

Examples of basic or guiding principles of the tax system seem to include at least the principle of tax neutrality and probably the ability-to-pay principle. As not all taxes are based on the principle of tax neutrality and, as it is, more or less, only the individual income tax that is based on the ability-to-pay principle, this possibility of justification seems to be of limited importance.

Moreover, the logic of the possibility of justifying measures on the basis that they follow from the logic and nature of the tax system must be questioned. It is, after all, established in Chapter 6, that it is the existing tax system or the tax system to be applied that is considered the benchmark in the application of the derogation method rather than a norm corresponding to the first stage of the normative model established by Surrey. This conclusion, taken together with the statement by the CFI in its judgment of Case T-67/94, Ladbroke Racing,[1] in which it was pointed out that the exemption of the PMU from corporation tax was a consequence of the normal application of the general fiscal regime and not a derogation therefrom, raises the question of whether or not it would not be more logical to consider the identification of the scope of the tax as a subjective part of the application of the derogation method. Some of the measures currently being justified on the basis that they follow from the logic or nature of the system are not of selective nature. As the aim of the assessment of justification is to justify the selective nature of the measure, this interpretation of 'justifying a measure on the basis of the nature or general scheme of the system' is not logical.

[1] Case T-67/94 Ladbroke Racing Ltd *v* Commission of the European Communities [1998] ECR II-1.

The fact that the existing system is the benchmark in the application of the derogation method and that it is reasonable to conclude that part of establishing the existing system surely must contain the identification of the purpose and the scope of the system are other arguments that support the view that the possibility of justifying exemptions following from the logic or nature of the system should not be considered a possibility of justification, but rather should be considered as a subjective part of the derogation method.

If the possibility of justifying exemptions following from the logic or nature of the system was not considered a possibility included in the assessment of justifications but was viewed as a subjective part of the derogation method, it would also be possible to separate the application of the derogation method from the assessment of the selectivity criterion, resulting in a solution for some of the confusion with regard to the assessment of the selectivity criterion applied to taxes. For example, non-selective measures would not be classified as State aid in the first place and would not require justification.

Consequently, the application of Article 87(1) EC to taxes would contain the following steps. First, the derogation method would have to be applied in the way it is currently pursued, in order to establish if, objectively speaking, there are any derogations to the tax system at issue. This assessment involves an identification of any measure referred to as a derogation in the tax system. As a second part of the application of the derogation method, the purpose and the scope of the tax would have to be established. Measures falling outside the purpose and thus outside the scope of the tax system would not be considered as "true" derogation and would not be classified as derogation for the purpose of Article 87(1) EC. Measures falling within the purpose and the scope of the tax measure would, however, be considered to constitute "true" derogations.

The second step in the application of Article 87(1) EC to taxes would be to assess the various criteria of Article 87(1) EC, of which the selectivity criterion is one. In the assessment of whether or not the measure is selective in any of the ways described in Sections 2.5.3.2.2 to 2.5.3.2.6, it would still be possible to justify the selective nature of the measure, either on the basis of the basic or guiding principles of the tax system or on the basis of objective differences between tax payers.

As a result of the view that the derogation method should be treated as a separate assessment from the selectivity criterion, the application of the derogation method would only be an assessment according to which it is determined whether or not the measure remains within the sovereign powers of the Member States.

To some readers, this entire issue may be of nothing more than purely

theoretical interest. It does, however, have important implications for determining if the measure at issue falls under the notification obligation in Article 88(3) EC. Thus according to the suggestion brought forward, only measures which were considered "true" derogations would have to be notified to the Commission in advance.

Thus to return to the example of the re-notification of the Swedish waste tax, mentioned in Section 6.3, none of the measures considered as State aid and justified on the basis that they followed from the logic or nature of the tax system would have fallen under the obligation to notify, as they, according to the view proposed here, would not be considered as derogations and the obligation to notify only covers measures constituting derogations from a tax system. This suggested interpretation of the application of Article 87(1) EC to taxes does not, however, cure the dilemma of the Member States mentioned in Section 3.2.4.

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IT IS COMMON KNOWLEDGE among EC tax lawyers that various rules in the EC Treaty prohibiting discrimination limit the tax sovereignty retained by the Member States. It is less known, however, that the EC State aid rules also limit the ability of Member States to engage in tax manoeuvring. It has been common knowledge among State aid lawyers since the early 1960s that State aid rules also apply to taxes. Within this group of lawyers, the struggle has been to interpret the application of the EC State aid rules to taxes – an application encompassing its own particular problems.

This book addresses the current interpretation of *a*) the effect of EC State aid rules on the right of Member States to apply taxes and *b*) the application of EC State aid rules (in particular the selectivity criterion) to taxes. Moreover, the author questions the logic of the current interpretation of elements essential in the application of the EC State aid rules to taxes. One result of the author's alternative interpretation is that, at least in theory, some of the tax sovereignty of the Member States is recaptured.

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