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Discretion by the Rules: European State Aid Policy and the 1999 Procedural  
Regulation

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## ABSTRACT

This paper assesses the effectiveness of the 1999 Procedural Regulation on the Commission's ability to control state aid. Using a principal-agent framework infused with insight from sociological institutionalism, the study finds that the Regulation has actually strengthened the Commission's hand, undermining the ability of member states to defy the Commission and ultimately leading to the reduction of state aid. The study has implications for the single market and the broader literatures of international delegation and bureaucratic control. Completing the single market is not a task that finds the Commission working against member states, but rather a collective effort led by the Commission collaborating and co-opting national governments.

State aid policy is the most politically contentious aspect of Europe's competition policy. Whereas in most areas of competition policy the European Commission monitors the behavior of firms, in the area of state aid the Commission [through its Competition Directorate-General (DG Comp)]<sup>1</sup> monitors the behavior of governments. It is charged with monitoring the allocation of competition-distorting subsidies (or state aid) to national industries, interpreting the rules to assess their legality, and enforcing member-state compliance with its decisions. Such powers are very important because the successful completion of the single market requires the effective cooperation of both the Commission and member governments. To the extent that state aid policy pits one potentially against the other, the single market project is likely to suffer setbacks. As DG Comp boldly asserts: "the monitoring of state aid also makes a major contribution to this effort to assist the development of the single market. The Commission takes the view that unjustified state aid leads to market distortion and inefficient resource allocation. The effect is to increase barriers to trade and hence put at risk the achievements of the single market. The continuing disparities in the levels of aid between Member States jeopardize the objective of economic and social cohesion" (CEC 1999, 20). Following this logic, more state aid retards the development of the single market.

The Commission was granted significant constitutional authority in the Treaties of Rome (Articles 92-94, now 87-89), but it only slowly acquired formal administrative powers to do so (Bütte 2007). The principle of undistorted competition, embedded in the founding treaties, simply contradicted the practice of industrial policy that was prevalent in Europe prior to the 1980s. Periodic crises persuaded governments to grant substantial aid to such sectors as steel, coal, automobiles, shipbuilding, electronics, and aerospace (Wilks 2005b, 123). The Single European Act (SEA) in 1986 finally tilted the balance, strengthening the Commission's political will to confront national governments.

Yet the institutional capacity to control state aid was until recently somewhat ambiguous and controversial because it was not codified in a single document. Case law and the Commission's gradually acquired influence in effect expanded the agency's discretionary powers under Article 88. It seemed as if the Commission was satisfied with the status quo (Lavdas and Mendrinou 1999, 37). However, under pressure by member states the Commission submitted in 1998 a proposal which was eventually adopted by the

Council of the European Union (Council from hereon) as Regulation 659/1999, also known as the Procedural Regulation (OJEC 1999). Being part of a broader effort to modernize competition policy, the Regulation is of historic importance because it codifies the process of assessing the legality of state aid, specifying criteria and exemptions, strengthening monitoring and recovery instruments, and establishing deadlines and consequences.

This paper assesses the effectiveness of the Procedural Regulation on the Commission's ability "to control state aid, [thus] consolidating the single market" (CEC 1999, 20). The Regulation on balance imposes rules on the discretionary powers of the Commission. Using a principal-agent framework I argue that "rule-based discretion" has actually strengthened the Commission's hand, undermining the ability of member states to defy the Commission and ultimately leading to the reduction of state aid. Of course, this reduction is not solely attributed to the Commission's efforts but also to domestic factors. The study concludes that completing the single market is not a task that finds the Commission working against member states, but rather a collective effort led by the Commission collaborating and coopting national governments.

The paper proceeds in four steps. First, I assess the Commission's discretionary powers to control state aid by reference to a principal-agent framework, which is also infused with insights from sociological institutionalism. Whereas the literature mostly views political control as strengthened by rules or weakened by discretion, I show that agents can enhance their capabilities to pursue organizational goals through strategies I term "rule-based discretion." Second, I summarize the relevant points of the Regulation, highlight the changes to more clearly identify the rule-based elements of discretion in the enacted legislation, and derive expectations about the Commission's powers as a result of the Regulation. Third, using data from the period 1992-2004 and pooled time series analysis, I examine empirically the impact of the Regulation on the allocation of state aid. After taking into account domestic political (ideology of governing party or coalition and election), institutional (corporatism and type of electoral system), and economic (economic growth, trade, and foreign direct investment) factors and the introduction of the euro, the analysis finds that the Regulation has enabled the Commission to reduce

state aid. Finally, the essay concludes with implications for the single market and the broader literatures of international delegation and bureaucratic control.

### Political Control and Administrative Discretion

Stripped to its bare essentials, the state aid puzzle involves on the one hand certain national governments wanting to subsidize their industries for various reasons and the Commission on the other hand wanting to reduce the amount in line with the single market and the founding European Union (EU) Treaties. The problem is designing institutional parameters through the use of regulations, directives, etc. that both control the actions of the Commission in line with what governments want and at the same time allow it to fulfill its goal, i.e., reduce state aid, even when it needs to go against member state wishes. The answer to this delicate balance of political control is discretion. Discretion is defined as the placement of effective limits on the Commission's decision-making power. This definition takes into account the powers conferred upon the agent by the principal, the relative constraints imposed upon the former (Epstein and O'Halloran 1999, 109), and the preferences of the principals (Thatcher and Stone Sweet 2003). The powers and constraints vary considerably across issues and over time depending on institutional rules, conflict within the Council and between the Council and the Commission, the role of the European Parliament, and policy complexity (Franchino 2007). I keep most of these variables constant by concentrating on the effects of a single legislative act in a single issue over time across EU members. DG Comp has been delegated the power to reduce state aid. To what extent do changes through procedural rules and regulations limit or enhance its ability to do so?

### *Mechanisms Designed by Principals to Control Agents*

The question is framed in the form of a principal-agent problem. I assume that DG Comp prefers to reduce the aid that individual states give. In other words, the problem is not one of creating a run-away Commission. Principals draft a contract specifying the scope of authority given to agents. In addition to identifying goals, the contract includes *inter alia* mechanisms of control whereby instruments are clearly spelled out as to how and when the agent will perform its task. Though they reflect many considerations, mechanisms of control are summarized along a single dimension: rules

versus discretion (Hawkins et al 2006, 27). The two are viewed as polar opposites where one is created at the expense of the other.

Rules detail instructions as to how the agent will carry out responsibilities. They are typically mechanisms of reducing agent flexibility because they outline the specifics of what needs to be done, when, and in what order, leaving little room for agents to pursue their agenda. In the latter case, there is usually a set of sanctions, such as cutting budgets, that punishes the agent. Examples of rules include constraints such as advanced notification, reporting requirements, appeals procedures, possible executive action, spending limits, and consultation with interested third parties and principals (Franchino 2007, 91-6). They ensure that agency decisions reflect the priorities of principals or at least dilute the power of the agent and make it easier to monitor decisions and impose possible sanctions (McCubbins, Noll, and Weingast 1987). As Pollack (2003, 40) argues, “the ability of...principals to control agency behavior should be greatest where...the procedural requirements governing agency action are most detailed and constraining.”

However, rules are inefficient and costly because they involve significant information costs. Principals must not only familiarize themselves with the issue at hand, but they must also anticipate obstacles and design procedures that take them into consideration while promoting the optimal outcome. The problem is exacerbated in cases where the procedure involves highly technical expertise and rapidly changing conditions. For this reason, rules are used only when controlling the agent cannot be effectively done by other means (Hawkins et al 2006, 27).

In contrast, discretionary delegation involves setting broad policy goals and parameters for the agent and letting it later figure out how to achieve them. Under these conditions, the agent’s role in policy-making is greatly enhanced because it now has the flexibility to introduce procedures and mechanisms that advance principal goals. Such discretionary powers are most likely in cases that have the exact opposite properties of the rule-based delegation described above; where information is highly valued or needed and where there is significant environmental uncertainty. In addition, discretionary delegation helps solve the credibility problem. States delegate substantial discretion to agents to maintain the credibility of their own commitments. Moravcsik (1998), for example, argues that member governments have delegated powers to the Commission by

various treaties primarily to establish their own credibility of commitment to collective goals, such as the single market project. Majone (2001) clarifies this point by suggesting that demand for regulation is guided by the principals' wish to insulate the agents so that the latter may implement policies to which the principals may not credibly commit. Assuming heterogeneity of preferences among principals and in order to avoid the high transaction costs resulting from negotiating to a final policy, principals find it cheaper and more credible to give the agent discretion (or autonomy) to move the policy in the desired direction without running the risk of being overturned by a group of aggrieved principals (McCubbins and Paige 1987, 418). The latter is especially true in cases where costs are concentrated and benefits are diffused (Pollack 2003). For example, in the case of state aid (or competition policy more generally) where some producers are hurt but benefits are distributed to all EU citizens, there are significant credibility problems for individual states to comply with the collective goal of reducing state aid. To mitigate this problem, agents are given a set of goals and significant discretion as to how to reach them, making it costly (but not impossible) for governments to overturn specific DG Comp decisions.

The discussion above leads to two conclusions. First, rules and discretion are two polar opposite mechanisms of controlling international bureaucracies. Being an alternative to discretion (Hawkins et al 2006, 8), more principal rules necessarily take away agent discretion. Second, in issues where credibility problems are greatest, such as state aid, agents are likely to be given more discretion.

I argue there is a third way. Mechanisms of control, such as the 1999 Regulation, may be designed in a way that more rules actually enhance rather than suppress agent discretion. This argument, infused with insights from sociological institutionalism, focuses on agent strategies to increase discretion (Hawkins and Jacoby 2006), reversing the direction of causality. Whereas most analysts using the principal-agent framework explain agent discretion in terms of principal preferences and mechanisms of control, I show that agents also take matters into their own hands, strategically acting to gain more discretion. The analysis below is not intended to imply that all control mechanisms that increase or solidify principal rules necessarily lead to greater agent discretion. The

evidence merely shows that under conditions of multiple principals with changing preferences and in the case of Regulation 659 this is a likely outcome.

### *Strategies Used to Increase Rules and Discretion*

The main insight I use from sociological institutionalism is that rules “both limit behavior and provide freedom” (Pfeffer 1978, 49). While ostensibly constraining the agent’s action, every rule also reduces the flexibility of the principal to pursue its own preferences. In organizational settings where power asymmetries are present, it is the less powerful that seek the establishment of formal rules. To use Pfeffer’s example, asking the instructor to spell out how grades are computed empowers students because it protects them from the arbitrary exercise of power by the instructor. Rules have substantive and symbolic dimensions. More rules, such as formal participation by member governments in the formulation of rules pertaining to state aid criteria, may ostensibly protect member states from an arbitrary Commission. More importantly, however, the rule legitimizes the decisions made by DG Comp. In a situation whereby power is distributed unevenly, principals typically enjoy more flexibility and consequently more discretion. Linking the agent and principal together in a more clearly spelled out contract actually liberates the agent (DG Comp) from political pressure to which the agent is doomed to succumb because of power asymmetries and changing preferences. In this sense, more rules enhance the agent’s discretion by protecting it from external pressure and by permitting it to pursue its organizational objective with greater vigor. Given that member states have incentives to cheat in state aid cases, more principal rules should enhance rather than weaken DG Comp’s discretion and result in fewer subsidies.

Focusing on strategies to increase their own discretion (autonomy in their terms), Hawkins and Jacoby (2006) spell out two strategies: reinterpretation and permeability.<sup>2</sup> I examine each to tease out implications as it relates to rules and discretion, and use the term rule-based discretion to refer to them collectively.

Reinterpretation is a strategy whereby agents reinterpret rules imposed by principals in ways that increase the cost of control or decrease the likelihood of principal override. The greater the number of rules imposed, the higher the chance they may be reinterpreted, leading to greater agent discretion. Agents can pursue a variety of

strategies of reinterpretation, of which formalized adjudication is particularly relevant to this study. Formalized adjudication refers to the infusion of legal certainty into the process and substantive criteria used by DG Comp when it comes to examining the compatibility of state aid. Because the Commission decides on the compatibility of aid schemes, it is subject to pressure by individual member states to render a positive decision without the benefit of other member states collectively applying pressure in the opposite direction. As Howard and Jacoby (2006, 207) note, “formalizing a practice that agents developed informally...may simply solidify their [agent] foundation for further efforts to change the contract.” This is so in cases where agent preferences deviate from those of certain principals. More informal rules of adjudication privilege powerful members because they can pressure the Commission to make a decision closer to their interests. Informality increases the imposition of sanctions on agents if they make the “wrong” decision. Formalization of adjudication increases the number of rules that have to be followed, to avoid selective interpretations, but it also increases the leverage of weak agents who now have stronger legal standing to pursue their organizational goal. In this way, more rules through formalized adjudication lead to more agent discretion. Because the Commission’s task is to facilitate the reduction in state aid against some member state wishes, more discretion enhances its power to do so.

Permeability refers to giving increased access of the agent’s decision-making process. By necessity the Commission needs to collect information to pursue the tasks it has been delegated. Despite its high reputation, DG Comp is especially understaffed, some 300 senior staff in 2003 to monitor the entire spectrum of competition policy—abuse of dominant position, merger control, prohibition of antitrust agreements, state aid, and liberalization of utilities—throughout the EU. By way of contrast, Wilks (2005b, 130) reminds that in the UK alone in 2002 competition agencies had as many staff and a bigger budget than DG Comp. Monitoring is especially cumbersome and expensive. To ameliorate this problem, the Commission initiated in years past a forum for interested third parties to launch formal complaints. Doing so increases the discretion of DG Comp for two reasons. First, it establishes another source of credible information. Because member governments are not likely to offer much information about giving state aid or its effects, despite their obligation to do so, this increased permeability to

interested third parties allows DG Comp to decrease reliance for information solely on the potential targets of investigation. Second, increased permeability legitimizes the interests of interested third parties and it gives additional leverage to the Commission vis-à-vis member states. Firms who are aggrieved by state aid may not only lobby the Commission to pursue reductions more vigorously, but they can also exert pressure on their respective governments to nullify aid. When such permeability exists in practice but is not codified into law, it runs the risk of being reversed. When it is formalized into a procedure that principals, agents, and third parties accept, it increases monitoring rules and strains the resources of the Commission in the sense that staff must be diverted to this task to coordinate the activity. But it is also legitimized and its findings may be harder to ignore. This gives DG Comp more discretion to pursue its goal of reducing state aid by diluting the power of the principals and by pushing decisions to be closer to what third parties want, which is also reduction in state aid.

#### *More Rules, More Discretion, and Less State Aid*

Principals (member governments) adopted Regulation 659 to better regulate DG Comp's (agent) efforts to control state aid. Although it did not substantially change the process, the Regulation contained more rules, which were intended to limit DG Comp's discretion. I present evidence that it had the opposite effect. DG Comp acted strategically to increase its discretion. More rules led to more discretion, which in turn strengthened the Commission's ability to broker reductions of aid in member states. Thinking counterfactually, evidence that relaxes instead of tightening the rules disproves the argument. Uncovering procedures to decrease participation by third parties, for example, runs contrary to the strategy of permeability. The Commission is charged with invigorating the single market and fostering reductions in aid. Evidence that DG Comp has anything other than a strong negative effect on subsequent aid allocations contradicts and further weakens the argument that the Regulation enhanced the Commission's ability to overcome state objections and broker further decreases in state aid.

#### Modernization and the Procedural Regulation

To gain insight into the Regulation's impact on state aid policy, I will first briefly explain what constitutes state aid. Evidence is presented in two steps. I first specify the essential elements of state aid policy before and after the Regulation in order to highlight

changes in the Commission's discretion. Then I assess the effect of such rule-based discretion on state aid disbursements.

### *What is State Aid?*

State aid involves any assistance paid for by national treasuries to industry, whether public or private, which distorts competition. It is precisely the element of unfair advantage to competitors that makes state aid incompatible with the single market. By definition, it is granted by national treasuries on the basis of national considerations. For this reason, the EC Treaty generally prohibits aid, such as restructuring and rescuing firms. To ensure this prohibition is respected by all member states, the Treaty gave the Commission the authority to monitor compliance. DG Comp may make negative decisions and demand repayment, but as the next section notes, it wisely prefers a process of political negotiation and persuasion (Wilks 2005b, 123). Aid may come in numerous forms including grants, tax incentives, loans, guarantees, equity participation, and provision of services on preferential terms. On the other hand, not all elements of aid have pernicious effects (Cini and McGowan 1998, 137). The EU treaty permits the granting of aid in some instances—such as research and development, assistance to small and medium enterprises, and regional and energy-saving aid—to bolster economic development and guarantee social cohesion. With some exceptions, aid needs to be notified with the Commission which has established legal frameworks to deal with its compatibility with existing treaties.<sup>3</sup>

### *Before and After the Regulation*

Rules are attempts by states to limit DG Comp's discretion. The agent does not operate in a political vacuum; its principals are member states who also happen to be its targets of investigation. In the case of state aid, there are multiple principals some of whom have changing preferences in the sense that their collective preference is to reduce state aid but their individual preference is to retain maximum flexibility so that they may pursue their individual incentive to cheat. Using rule-based discretion, however, DG Comp was able to evade detailed control. To a large extent and like other areas of competition policy, the Procedural Regulation may be viewed as an agency escape from the threat of detailed control by its principals (Wilks 2005a).

Prior to the late 1990s, state aid policy was characterized by informality. The Council actually refused to adopt regulations proposed by the Commission in 1966 and again in 1972 (Lavdas and Mendrinou 1999, 29-30). Lacking implementing legislation, the Commission's institutional apparatus included a mixture of case law, past practice, informal Commission-issued guidelines, and treaty provisions, what analysts have termed soft law (Aldestam 2004). The general description of DG Comp's approach was flexible and practical, infused with considerable legal ambiguity and political conflict (Cini and McGowan 1998; Lavdas and Mendrinou 1999).

Some have argued that the state of affairs actually increased DG Comp's discretion because it afforded it maximum flexibility to pursue its objectives within the political environment under which it operated (Hancher 1994). However, others pointed to its lack of political weight. "The Commission is not always in a position to act in those areas in which it has a legal right" (Warnecke in Cini and McGowan 1998, 155). Given the complexity and political sensitivity of the process, some critics have gone as far as to assert that "in state aids matters the Commissioners can be expected to prostitute themselves to political interests unless and until the Court requires otherwise" (Bishop 1995, 331). While the latter assessment may be too harsh, it still points to political power asymmetries in the relationship between states and the Commission.

The situation began to change in the 1990s. Member states pressed the Commission to draft legislation that would clarify the process of declaring the incompatibility of aid schemes and DG Comp's role and prerogatives in the process. The White paper that preceded the SEA boldly asserted that "a strong and coherent competition policy must ensure that the partitioning of the internal market is not permitted to occur as a result of protectionist state aids" (quoted in Lavdas and Mendrinou 1999, 34). This served as a signal that states wanted clarification of the process. The Commission initially resisted the request to draft legislation (Cini and McGowan 1998, 157). This was because of bureaucratic inertia and because DG Comp feared losing its flexible discretion. The very fact that the system was developed by the Commission, giving it a fair amount of flexibility in applying the rules, meant that new legislation might have the opposite effect. New "contracts" are pursued and adopted by

principals in order to better monitor their agents. A new piece of legislation runs the very real risk of reducing agent discretion.

Nevertheless, the Commission changed its mind and embarked on a broad modernization effort to streamline the process with the aim of increasing transparency and efficiency (Sinnaeve 1999). Regulation 659 is part of this effort. Initial reaction was mixed; some analysts thought it would not have much impact (e.g., Ahlborn 1999). While its elements reflect the political and legal dimensions of the state aid process, the calculations about its likely consequences are part of broader political realities that cut across the entire competition spectrum (Wilks with Bartle 2003). Agent strategies to increase rule-based discretion explain this change of heart.

In light of pre-existing conditions, conventional wisdom leads to the conclusion that a new regulation imposing new rules would limit the Commission's discretion. I show it has not in four crucial areas: state participation, third party participation, transparency, and aid recovery. The Regulation fleshes out and clarifies the procedure outlined in Article 88 of the EC Treaty.

Article 28 of the Regulation sets up an Advisory Committee made up of representatives of member states and headed by the Commission. Such a committee already existed as a concession to the Council; it was set up to formalize the informal multilateral meetings of national experts on state aid issues (Cini and McGowan, 1998, 155). The important innovation is that the committee's purpose was institutionalized. Highlighting largely their symbolic dimensions, the creation of advisory committees has long been viewed by sociologists as a means of coopting the opposition (Pfeffer 1992). Viewed from this perspective, institutionalizing the Committee implies institutionalized cooptation. Representatives from member states have a voice in any measures the Commission plans to initiate related to the implementation provisions outlined in Article 27, such as form and content of notifications and annual reports, time limits, extensions, and interest calculations. This is far reaching because it gives member states a formal say in an area that the Commission previously zealously guarded as its own. The point should not be overstated, however. It does not amount to a veto; "the Commission shall take the utmost account of the opinion delivered by the Committee. It shall inform the Committee of the manner in which its opinion has been taken into account." On the face of it, this

seems like an “intrusion” because the Commission must explain to states how it deals with procedures and aid schemes in formal ways that it did not previously. It is an example of a monitoring rule designed to get the Commission more in line with principal wishes. In practice, the reporting rule cuts both ways. It also binds member states into a system whereby they have a voice and a responsibility. The more involved they become in the process, the more legitimacy the process acquires, and therefore the greater the pressure will be to accept the eventual outcome. This institutional innovation imposes costs on the Commission and on the principals, reducing the likelihood of overturning the Commission’s decision. As a result, DG Comp acquires more discretion, and that should lead to fewer state aids.

Article 88 of the Treaty does not contain much room for interested third parties. Their role was informal and followed the basis of precedent and case law (Rodger and MacCulloch 2004, 269). The Regulation now formalizes their role, and most importantly it gives them institutional voice. By making the process more legally permeable, the Commission gains an advantage by diluting the powers of those member states who intend to “cheat.” Article 1, par. h, defines interested parties as member states, firms, persons, or associations “whose interests might be affected by the granting of aid.” Article 20 gives those parties the right to complain to the Commission about unlawful aid that has been disbursed or to provide more information when the Commission decides to formally investigate a case. In addition, it raises the possibility of third parties challenging aid decisions in national courts (Sinnaeve 1999, 223). Again the Regulation institutionalizes permeability by adding voice to competing firms and by potentially splitting member states. Institutionalization creates hard law, which can then be used to ensure compliance (Aldestam 2004; Cini 2001). Both elements add to the legitimacy of the outcome on the basis that aggrieved parties are consulted. They also make overruling the Commission’s decision less likely, thereby increasing discretion and power. Previously, DG Comp stood more or less alone against individual states in a power game where principals held most of the cards. Institutionalizing permeability by adding formal voice to entities with competing interests limits state power and enhances the Commission’s discretion.

Greater transparency in procedures and agent reporting rules ensures that agents behave in ways that are in line with principal wishes. In this particular case, however, greater transparency has symbolic value that is used to also control principals. Lacking a single legal document, the Commission had to issue several memoranda over the years interpreting the outcome of cases and their impact on the assessment process. These memoranda, however, had no legal certainty in that they were based on the Commission's interpretation. The more clarification memoranda it issued, the less transparent the system became, from legal and administrative points of view (Sinnaeve 1999, 215). To an extent, intimate knowledge of the process helped the Commission in dealing with individual states, but legal uncertainty diminished its discretion. While the Procedural Regulation also specifies time limits designed to speed up decisions, thus putting pressure on an understaffed agency to make a decision, it also enhances transparency. More rules codify the process without changing it much; but more importantly they enhance agency discretion through the infusion of legal certainty. While the Regulation does not explicitly call for the creation of the *Scoreboard* whereby the Commission is charged with publishing all aid-related information in a given year, it does lay the foundations for this shift. It does so in two ways. First, the Regulation enables the Commission to demand data on all existing aid schemes on an annual basis. This is different from previous practice where some governments, such as Greece in the 1980s, refused to cooperate with monitoring requirements. The power of transparency gives the Commission, states, and other entities harmed by aid, leverage and timely information to assess progress on an annual in lieu of the previous triennial basis. Second, the Commission is given authority to conduct on-site monitoring to ensure compliance. Because the agency itself is severely understaffed and cannot possibly do it alone, Article 22 gives it the power to enlist independent experts. These new rules give the Commission leverage to reduce aid.

Another aspect of the Regulation that gives greater discretion to DG Comp refers to compliance and aid recovery. The Regulation does not innovate in the direction the Commission had hoped, e.g., there is no provision for independent national authorities as the Commission proposed. But it does clarify rules for compliance. First, it formalizes the ability of the Commission to issue injunctions. Article 11 allows the Commission to

demand the member state suspend the disbursement of aid until the Commission makes a decision and Recovery of aid and to pursue in Court recovery of funds if certain conditions are met: aid is unlawful, there is urgency, and competitors are irreparably damaged. The very fact that aid is considered unlawful if it impedes competition strengthens the hand of the Commission. Second, compliance is also strengthened by formal mechanisms of recovery in the Court of Justice or in national courts. In this sense, the Regulation continues opening the door to more involvement by national courts in the recovery of unlawful aid. This formalization of adjudication creates hard law which in turn strengthens compliance with soft law (Cini 2001). National courts play complementary and distinct roles in the recovery of aid. They don't rule on its compatibility but they allow interested parties to pursue recovery. More importantly, they diffuse norms that generally privilege EU law, which limits the ability of national governments to allocate aid. Most illuminating is a statistic produced by consultants to the Commission. In their survey on aid recovery in national courts, they note "a significant increase in the number of cases [since 1999] (from 116 to 357)" (Jestaedt et al 2006, 33).

Although rule-based discretion is an agent activity, it is not meant to imply that all principals are necessarily against it. The Regulation was adopted by the Council, which by definition means that member states thought it was beneficial to them as well. Some principals, e.g., the UK as Wilks (2005b) notes, are very much in favor of reducing state aid, in line with both their collective and individual interest. Rather the argument I make is that rule-based discretion is an important antidote to collective principal efforts to increase individual principal discretion vis-à-vis the Commission.

All in all, the Procedural Regulation codified the status quo and gave additional discretion to the Commission. Some commentators contended at the time that the powers of DG Comp were not sufficiently augmented by the Regulation to make a significant difference on state aid control; "it may well be better to continue with the existing regime, with all its imperfections, rather than to introduce an even less perfect Procedural Regulation" (Ahlborn 1999, 241). In the next section, I demonstrate pessimism was misplaced. While the state aid regime was not substantially altered, additional rules gave the Commission more rather than less discretion to control state aid.

## Measuring the Impact of the Regulation

Discretion is pointless unless it is used. What matters is not whether the Commission has more discretion but whether such discretion leads to fewer state aids. Having presented evidence that shows more principal rules actually led to more DG Comp discretion, I now proceed to evaluate the impact of Regulation 659 on annual state aid disbursements. The dependent variable is aid to industry in each EU member state during the period 1992 to 2004 (14 countries by 13 years).<sup>4</sup> I exclude Luxemburg from the analysis because of its unusually small size and the lack of diversified economy. The data, published by DG Comp, begin in 1992, making it impossible to extend the analysis to previous years.<sup>5</sup> For reasons that will be discussed below and having to do with other Regulations, the time period ends in 2004. All data are taken from the European Commission's *Scoreboard* and are expressed as percentages of GDP (CEC 2006).

### *The Independent Variable*

The main independent variable of interest is Regulation 659. I assess whether any decrease in state aid since its adoption may be attributed to the Commission's ability to effectively implement the Regulation and not some other political or economic reason. The problem is how one may capture the complexity of discretion imbued in the Regulation with a single indicator. Previous studies of agent discretion in the EU, following Epstein and O'Halloran (1999), calculate the amount of delegation given in one issue area, compute the amount of relative constraints, and finally express a discretion index as the net difference between the delegation and the relative constraint ratios. Although he does not explicitly single out state aid, Franchino (2007, 176) computes an average index of discretion for the European Commission in secondary legislation of competition policy (rules and undertakings and mergers) of 15.19 percent. He proceeds to emphasize that "the top five laws with most discretion are in the area of competition policy" out of a sample of 158 major directives and regulations in many EU areas (102). Pollack (2003, 94) calculates a discretion index of 26.19 percent in provisions of the Treaties (primary legislation) regarding state aid. This is the third highest among the 35 issue areas he examined.

There is considerable usefulness in these index numbers but the costs outweigh the benefits in my case. First, the numbers are more useful and vary widely when

comparing agent discretion across issue areas. This is not the purpose of the present analysis. Second, they are average numbers over a period of time, which makes them unusable for my purposes. Finally, I am only interested in the impact of a single regulation, which affects the ability of the agent to fully achieve its objective. Whether discretion is set at 26.19 percent and then it goes up by a margin of, say, 2 percent due to the Regulation, is not very useful because discretion remains constant at 26.19 percent, before the 1999 Regulation was adopted, and 28.19 in the period since.

Using the rule “simplicity is best when the cost remains the same” and in order to capture budgetary effects (see below), I code *discretion* as a dummy variable; 1 for the years since 2000, and 0 otherwise.<sup>6</sup> The indicator measures an increase in discretion due to the Regulation, and it makes the reasonable assumption it has remained constant since.<sup>7</sup> Besides, the dummy variable eases interpretation of the slope as it helps us focus more clearly on the additional effects of the Regulation on the disbursement of state aid. I do make one crucial assumption, however. I assume that Regulation 659 is the only major piece of EU law during the period under investigation that changes the Commission’s discretion. Indeed, major implementing revisions were made to Council Regulation 659/1999 by the Commission (Commission Regulation [EC] 794/2004) in 2004, which has been further corrected (Corrigendum to EC Regulation 794 on 28 January 2005 and, yes, Corrigendum of the Corrigendum to EC Regulation 794 on 25 May 2005) and amended (EC Regulations 1627/2006, 1935/2006, and 271/2008). No other major piece of legislation that might affect allocations of state aid has been enacted in the period under investigation, 1992-2004.<sup>8</sup>

#### *Controls and Methods*

Besides the Regulation, there are other factors that explain state aid allocations. States after all disburse aid, not the Commission. Factors can be divided in three categories: institutional, political, and economic. The type of *electoral system* structures the incentives of politicians to supply subsidies. Because politicians strive to maximize constituent loyalty, which involves campaign contributions, they have an incentive to maximize the benefits distributed to their supporters (McGillivray 2004). The higher the marginal benefits, the greater the likelihood of support and loyalty will be. There are two fundamental ways to structure any electoral system, with several variations within each:

proportional representation (PR) with multimember districts, where votes directly translate into seats; and majoritarian systems with single member districts, where a plurality or majority of votes wins the sole available seat. Rogowski (1987, 209) argues that PR affects the power that producer groups have in influencing policy. In cases where the electoral system tends to reward votes with seats, e.g., a PR system, large coalitions are needed to supply subsidies. Policy makers are more likely to offer higher amounts of overall protection in PR systems because more groups with diverse interests need to coalesce to elect candidates.

Lijphart (1999) constructs an index of electoral disproportionality, which takes into account the degree of deviation from the ideal polar opposites (majoritarian and PR) that systems may exhibit. In essence the index takes into account the squared differences between the percentage of seats and the percentage of votes parties receive in national legislative and presidential elections. In the case of more proportional representation, the score tends toward one. The number increases as the system becomes more skewed toward majoritarianism.

Analysts have also concluded in many studies that in systems where trade unions are institutionally weak, e.g., in pluralist systems, worker demands don't translate automatically in changed economic policies. The government may be able to resist them either because it pays closer attention to more powerful industrial groups or because it can insulate itself from unions, given their relative weakness. Conversely, in more corporatist countries, unions are well organized and have formal powers in negotiating the direction of policy. They are, therefore, expected to demand and get more protection. Zahariadis (2008) finds that interest groups make a difference in the disbursement of subsidies. Governments in more corporatist systems tend to allocate more state aids. *Corporatism* is measured as a standardized average score per country, taking into account social partnership, degree of industry-level coordination, and national-level coordination. Higher numbers indicate more pluralist arrangements and lower numbers signify more corporatist interest mediation. Data are taken from Lijphart (1999).

In addition, McKeown (1984) argues that the state of the economy triggers protectionist calls. When the economy is in recession, workers and industrialists are more

likely to demand aid to offset losses. *Growth* measures annual GDP growth in constant prices, using dollars deflated by the consumer price index found in the OECD (2006).

A sizable literature has demonstrated that governing parties have an impact on government expenditures in general and industrial subsidies in particular. Garrett (1998) provides empirical support of the importance of left parties in the face of increasing economic globalization. Not only do left parties aligned with labor generally spend more under increasing trade openness, but they also spend more on industrial subsidies. Dutt and Mitra (2005) find a positive relationship between left ideology and industrial subsidies and tariffs in the developed and developing worlds. Zahariadis (1997) similarly confirms the argument using state aid data from the European Commission in the 1980s, although the argument is reversed using EU data from later years (Zahariadis 2007).

*Ideology* is measured as the partisan composition of the cabinet by assigning different values to different parties. The end result is a five-point scale (1 = a hegemonic right-wing affiliation—left holds no cabinet positions; 2 = dominance of right and center parties—left has less than 33.3 percent; 3 = balanced situation where either center has more than 50 percent or neither left nor right dominate the cabinet; 4 = dominance of social-democratic and other left parties—left has more than 66.6 percent of cabinet portfolios; 5 = hegemony of left-wing parties—left holds all cabinet positions. To also assess the impact of *elections*, I include a dummy variable taking the value of 1 if the country held an election at year  $t$  and 0 otherwise. Data are found in Armingeon et al (2007).

Actor preferences (and by consequence demands) are likely to vary according to the gains or losses they experience. The more exposed actors are to the international economy the higher the gains/losses are likely to be. Groups witnessing domestic price drops, in textiles or steel for instance, will prefer protection. Domestic prices have to increase or groups will cease those activities. Those groups in high-end machinery or complex medical equipment, who experience gains from exposure, i.e., domestic prices increases, will oppose subsidies in favor of greater liberalization. Classical trade theory suggests that in countries specializing in more capital intensive products, such as EU members, domestic groups will on balance prefer less protection; as a result, less aid is likely to be disbursed with increasing trade and foreign direct investment (FDI). This is

particularly true in the EU case where treaties specifically prohibit most types of state intervention that may affect trade between member states. *Trade* is measured as percent merchandise exports plus imports over annual GDP. *FDI* is measured as percent of incoming and outgoing FDI over annual GDP (OECD 2006).

Effects of passed legislation are rarely instantaneous. To capture budgetary logic I lag all independent and control variables by one year. Governing parties this year, for example, decide on subsidies that appear in next year's budget. The only exceptions are *corporatism* and *electoral system*, which are time invariant. Pooled time series analysis reveals variance inflation factors of 2.30 or less, indicating little multicollinearity and no significant outliers. The data also suffer from serial correlation and heteroscedasticity, so the Prais-Winsten specification is used with robust standard errors.

### *Findings*

The results of the analysis are displayed in Table 1, equation 1. The model has a modest fit, explaining 26 percent of the variance in state aid during the period 1992-2004. At the Stockholm European Council in 2001, member states pledged to reduce their subsequent disbursements of state aid as a percent of GDP. Taking into account all competing explanations, Regulation 659 facilitated the downward trend. Negative and statistically significant at the .05 level, the Regulation contributed to the decline in state aid of more than .09 as percent of GDP since its introduction, even after accounting for alternative explanations. Though modest in relative terms, the absolute amount of decline is reasonably big, 9,818.26 constant million in 2004, or 667.5 constant million per country on average.<sup>9</sup> Keeping in mind that total state aid minus agriculture, fisheries, and transport in 2004 stood at 43,636.7 constant million (EU-15 minus Luxembourg), or 3,116.91 constant million per country, the average decline is significant.

Table 1 about here

While some analysts maintain the Commission generally does not do enough to entice member states to lower their aid disbursements, others disagree. The findings here support to the voice of dissent although they show that the Commission's power strengthened relatively recently. McGowan (2000, 131) maintains that despite some successes "in practice [the Commission's] bark is worse than its bite." Examining data in 1980, 1990, and 2004, Obinger and Zohlnhöfer (2007) similarly conclude that the

Commission has failed to decisively exert additional pressure on members to reduce state aid. In contrast, Wilks (2005b, 123) maintains that the Commission “has consolidated an historic move away from state subsidization of industry.” The findings lend support to Wilks’ argument although “consolidation” is recent. In pursuit of the goal to create the most competitive (liberalized) market economy in the world, enshrined in the Lisbon Declaration in 2000, and the pledge to reduce state aid that was made in the Stockholm European Council in 2001, member states seem to have done their part. A one percent increase in trade openness has led to reductions in state aid disbursements by .01 percent of GDP. However, the Commission has played an important role as well, facilitating the decrease by .092 percent of GDP during the same period. The findings confirm the argument that the Regulation in 1999 has given more discretion to DG Comp. It in turn used the additional leverage to seek more reductions and further consolidate the single market.

Despite the finding of significance, however, the astute reader may point out that the analysis still suffers from validity threats because it does not take into account an important event: the introduction of the euro. It happened to be contemporaneous to the time of the Regulation. After all, the goal of reducing state aid forms one of the bedrocks of the single market, “which is the foundation of economic and monetary union” (CEC 1999, 20). In other words, the need to control state aid is also justified in the name of the broader objective of monetary union. The Stability and Growth Pact, which grew out of the introduction of the single currency, calls for tightening fiscal policy and reducing budget deficits in order to maintain currency stability. These conditions logically limit the flexibility of national governments to generously subsidize their industries in the name of domestic imperatives. One may argue that statistical significance really captures the macro-effects of the euro and not the micro-impact of the Regulation.

The introduction of the euro is certainly a monumental event that could conceivably have an impact on the propensity of governments to disburse state aid. The point that the two events, the Procedural Regulation and the euro, were introduced at the same time unfortunately presents a serious problem of measurement. Fortunately, not all countries are part of the eurozone. Therefore, the effects of the euro, unlike that of the Regulation, should not be felt uniformly throughout my sample. In essence, if the euro

made a big difference, the countries which are not part of the eurozone should behave differently from the others. The relationship should be positive and significant because these countries are not bound by the stability pact and are therefore more amenable to the siren song of state aid. In this case, the impact of the Regulation should be minimized, and the variable should at least lose its significance, which is now captured by the effects of the euro. The *euro* is measured as a dummy variable that takes the value of 1 for the countries of Sweden, the United Kingdom, Denmark, and Greece and 0 otherwise.<sup>10</sup>

The results are displayed in Table 1, equation 2. Explanatory power goes up marginally, but the results remain almost identical; both sign and significance are identical except for the case of the non-significant election variable. It is clear that the euro does not exercise an appreciable effect on state aid. The indicator is negative but not statistically significant, contradicting the expectation that non-eurozone countries should behave differently from the rest of the sample. More importantly, the Regulation continues to exercise a significant negative effect on state aid; the Regulation brought on average a reduction in subsidies by more than .09 percent of GDP after taking into account all competing explanations. As in equation 1, trade openness and now the type of electoral system exercise negative effects. As trade openness goes up by one percent of GDP, state aid is reduced by .012 percent of GDP. It confirms Aydin's (2007) finding that greater levels of trade openness lead to less aid. Interestingly, corporatism does not have a significant effect, but countries with more majoritarian systems systematically give out fewer subsidies. Counter to Rogowski's (1987) claim, systems that tend closer to PR are associated with more protectionism, i.e., state aid. However, the finding is not robust; while the sign remains negative, the coefficient becomes significant only when the effects of the euro are taken into account. Clearly, more research is needed to disentangle this relationship.

### Conclusion

In this paper, I have assessed the impact of the Procedural Regulation 659/1999 on the Commission's ability to reduce state aid. Using a principal-agent framework and focusing on agent strategies, I argued that despite more rules in the Regulation, the Commission's discretion was actually enhanced. As a result, the Commission was able to help reduce the disbursement of aid in member states.

The study has implications for models of international delegation and bureaucratic control. Rules and discretion may not be polar opposites. Rules impose costs on both agents and principals. Used strategically by agents, principal rules may actually give agents more rather than less discretion. As Perrow (1986, 24) boldly claims, “rules protect those who are subject to them [by serving as] means of preserving group autonomy and freedom.” The principal-agent literature usually examines control through the prism of principals (e.g., Pollack 2003). However, there is a need to more closely examine the reverse: under what conditions do agents actually influence principals. Discretion in the presence of delegation cuts both ways. Principals attempt to influence agents and the latter the former. We need more complex models to disentangle the link between discretion and control.

The study shows that the principal-agent framework is a useful device to assess EU policy-making, but its strict utilitarian logic may yield limited results. Although rational (in its principal-agent form) and sociological institutionalism are frequently treated as competing arguments, this paper shows they can also be fruitfully employed in a more complementary manner. Sociological institutionalism has much to offer in the form of analyzing feedback effects, that is, “how the environment, especially the zone of discretion, structures the interaction between N[on]-M[ajoritarian] I[institutions]s, their principals, and other actors” (Thatcher and Stone Sweet 2003, 18). It not only stresses the need to illuminate the cultural and historical context within which delegation takes place (McNamara 2003), but also sheds light into the “liberating” dimensions of rules and agent strategies. In other words, sociological institutionalism points to the need to also explore reversals in the direction of power; attempts to control agents may actually result in increasing agent power.

With some exceptions (e.g., Pollack 2003, Franchino 2007), the literature has generally tended to view European competition policy in dichotomous terms. In his review, Doleys (2000) finds that neo-functionalists and supranationalists (e.g., Büthe 2007) have tended to see the Commission as a strong (albeit not the only) engine of integration, whereas intergovernmentalists have maintained that the scope and type of integration still remains a member government prerogative (e.g., McGowan 2000). Framed in terms of state aid and the single market, this implies a relationship whereby

the Commission pushes integration in one way and states pull it in another, be it in terms of more or less or different integration. The present paper reveals a more synergistic relationship of cooperation and cooptation, more accurately described by mutual adjustment rather than political conflict. Starting from the premise that they are committed to the single market and monetary union, member states have nevertheless incentives to cheat. Domestic groups demand compensation to offset losses for a variety of political or economic reasons. The very fact that states continue to subsidize their industries attests to this point. However, the Regulation has created a system whereby political agreement between the Commission and individual states continues to be the preferred mode of policy-making in pursuit of invigorating the single market. To a large extent, states collectively and formally participate in the formulation of new rules and continue to negotiate with DG Comp on individual cases. As Wilks (2005b, 124) perceptively reports, “the Commission found itself frequently working *with* the grain as national governments, especially the UK, made greater efforts to reduce the use of subsidies” (emphasis added). The very fact, however, that the Regulation has effectively given DG Comp additional discretion to independently help reduce state aid, implies the system also involves some degree of state cooptation. DG Comp successfully works *against* the grain, to use Wilks’ term.

The end result is a complex political relationship that finds the Commission becoming more than just a simple agent of member state wishes. DG Comp frequently understates its role, viewing itself more like a facilitator of change. For example, DG Comp aims to increase transparency and has decided to publish aid data on the *Scoreboard* to catalyze discussion between member states as to best practices, trends, future problems, and desirable policies (CEC 2001, 76). The analysis here reveals the Commission is more than that; it is a participant and a broker for change. The quest to reduce state aid and the need to further consolidate the single market depend to a large extent on the Commission’s ability to continue using this power judiciously.

Table 1

## The Commission's Impact on State Aids

	(1)	(2)
Regulation	-.092 (.032)**	-.095 (.036)*
Election	-.042 (.035)	.044 (.035)
Ideology	-.057 (.044)	-.049 (.041)
Trade	-.010 (.005)*	-.012 (.005)*
FDI	.001 (.001)	.001 (.001)
Electoral System	-.031 (.021)	-.027 (.014)*
Corporatism	.031 (.119)	.016 (.113)
Economic Growth	-.004 (.011)	-.002 (.011)
Euro		-.323 (.179)
Constant	1.56 (.485)**	1.72 (.458)**
Adjusted R <sup>2</sup>	.2613	.2911
Rho	.6696	.6404

N = 159; Prais Winsten with robust standard errors in parentheses

\* .01 < p < .05, \*\* p < .01; two-tailed

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## Endnotes

<sup>1</sup> I use the term DG Comp throughout the period under study although prior to 1999 it was called DG IV. I also use the articles as renumbered by the Treaty of Amsterdam.

<sup>2</sup> The authors list interpretation of the rules as a strategy to influence delegation. I don't deal with it because it is outside the purview of my study. While they label buffering and permeability as separate strategies I collapse them into one category because by the authors admission, greater permeability also leads to more buffering from principal control mechanisms.

<sup>3</sup> Hancher et al (2006) provides a good legal overview of the entire system of state aids in the EU.

<sup>4</sup> The sample includes Belgium, Denmark, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Spain, and the United Kingdom since 1992 and Austria, Finland, and Sweden since 1995.

<sup>5</sup> Aid numbers are included in *State Aid Surveys* published in years past but only in period averages.

<sup>6</sup> I also ran the equations without the one-year lag. The results were identical in sign and significance.

<sup>7</sup> It is possible that the power of the Commission also has a chilling effect in the sense that less aid today weakens the rationale for more aid tomorrow, which should logically lead to an acceleration of reductions in subsequent years. Hathaway (1998) makes this argument regarding general measures of protectionism. I modeled this possibility by measuring the Regulation as a dummy variable whose value accelerates after its adoption. The results show no statistical significance, suggesting this is not the case here.

<sup>8</sup> This is not to say that other regulations regarding block exemptions and the *de minimis* rule are not important. However, whether aid schemes are exempted from notification or are considered *ex ante* in line with EU treaties does not alter the point that they will appear at the end of the day as state aid.

<sup>9</sup> I arrived at this number by multiplying the amount of total aid in EU-14 for 2004, 43,636.7, by the slope, .09 percent, and dividing the product by .42025 percent, which was the percent of total aid over GDP for 2004.

<sup>10</sup> I also ran the equation without Greece in the non-eurozone countries on the rationale that it wanted to join the eurozone in 1999 but couldn't. Because they wanted to join as quickly as possible, the Greeks closely followed the imperatives of the Pact, reducing deficits and tightening government expenditures among other objectives. Greece officially became part of the eurozone in 2002. The results did not change substantively. The impact of the Regulation remained negative and statistically significant. The effects of the euro also remained negative but are now significant. The latter's significance, however, does not alter the point that the Regulation has a major impact in reducing state aid.