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Market Failures as A Justification for State Aid in the European Union*

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Abstract

From the perspective of economic thought on State interventionism, it is important to note that State aid may be justified primarily on the grounds of social welfare if the free market mechanism does not produce satisfactory results. In such a case, the judicious implementation of State intervention can facilitate the optimisation of production factor allocation, mitigate market inefficiencies, and enable the attainment of objectives that are aligned with the collective interest. The objective of this article is to present the evolution of perspectives within economic theory on the rationale for State intervention in market mechanisms in instances of market failures. The author posits that market failures imply the non-fulfilment of the assumptions underlying the model of perfect competition, thereby hindering the attainment of both overall equilibrium and maximum total welfare. This suggests that the absence of optimal market efficiency in the Pareto sense may provide a rationale for State interventionism aimed at ensuring the optimal allocation of resources. Consequently, market inefficiencies provide a rationale for State intervention and legitimise public authorities in implementing specific legal, administrative and economic regulations within the context of enterprise aid. It is imperative to ensure that the magnitude of aid granted is judiciously balanced to mitigate potential adverse consequences that could exacerbate market disruptions.

Keywords: European Union, State aid policy, Market failures, Institutional economics, Mainstream economic paradigms

JEL codes: E62, K20, K33

Introduction

The assessment of the admissibility of State aid cannot be unequivocal. It is evident that the provision of State aid to enterprises is imperative in achieving a number of economic and social objectives that would otherwise remain unattainable through the efforts of entrepreneurs alone. Conversely, the provision of such assistance can impose a financial burden on society and may result in the preferential treatment of certain entities over their competitors. The allocation of State aid consequently impacts the conditions of competition, resulting in the beneficiaries of such aid being granted advantages that would not have been obtained through market mechanisms (Schina 1987, p. 3). This is of pivotal significance, for the absence of internal barriers to trade between individual Member States of the European Union is an indispensable condition for the smooth functioning of the internal market and the achievement of the fundamental objectives of its creation, i.e. economic growth and a consistent improvement in the quality of life in the European Union. The existence of

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such barriers would create unequal conditions for competition between companies and prevent the free play of market forces, in particular the stimulation of growth in the efficiency of economic activity (Hettne 2025, pp. 202-224). It is therefore imperative that State aid granted by Member States does not contravene the principles of free competition within the internal market (Podsiadło 2024). The present study seeks to explore the underlying justifications for the admissibility of state aid within the European Union. The purpose of this article is to present the evolution of perspectives within economic theory on the rationale for State intervention in market mechanisms in instances of market failures.

Welfare economics theory

The theory of market failure was initially based on the principles of welfare economics, which concerned the search for efficiency in resource allocation in the Pareto sense. In neoclassical economics, the Pareto optimum was defined as an allocation of resources in which no change could improve the situation of one individual without worsening the situation of another individual, and the improvement of one entity's situation could not be achieved without reducing the welfare of another entity. The Pareto principle is predicated on individualistic values, insofar as it concerns not the relative level of welfare of different individuals, but only the absolute level of welfare of each individual. In the assessment of their own welfare, the opinion of the individual concerned is the only factor to be considered.

The fundamental principles of welfare economics presuppose Pareto efficiency within any economy characterised by market competition. This is predicated on the premise that the allocation of resources can be optimised through market mechanisms, thereby facilitating the realisation of Pareto-efficient outcomes in the distribution of income. The prevailing hypothesis of a perfectly functioning market mechanism that ensures a Pareto optimum can be interpreted as follows: under specific conditions, all entities seek to maximise satisfaction. However, a change in market conditions (e.g. a change in price) will result in a deterioration in the situation of other market participants. This analysis further assumes that a market operating under perfect competition ensures the effective redistribution of goods, thereby balancing supply and demand.

The Pareto optimum is therefore essential for answering the question of whether perfectly competitive markets lead to the optimal allocation of resources. The origins of this approach can be traced back to the early 20th century, when A.C. Pigou, a pioneering figure in the field of economic analysis, introduced a novel concept into the discourse. Pigou's seminal contributions entailed the development of a theoretical framework that enabled the differentiation between social utility and individual utility. This intellectual advancement laid the foundational groundwork for the justification of state intervention, particularly in the context of externalities, a phenomenon that has garnered significant attention in economic literature (Pigou 2006).

Pigou demonstrated that the marginal cost functions of enterprises may not accurately reflect the social costs of production, and that individual demand curves may not accurately reflect the social benefits of consumption. In his research, Pigou concentrated on the existing discrepancies between private and social benefits and between private and social costs. The private costs incurred by a company are analysed in order to determine actions aimed at maximising profit. However, the company does not bear the social costs associated with its activities (e.g. environmental pollution), which means that there is a difference between private and social costs in extreme situations. As posited by the tenets of marginal analysis, which proffer a resolution to the paradox between the benefits procured from consumption and the costs incurred in production, the optimal solution is to produce and consume goods to the point where marginal benefits equal marginal costs. This is predicated on the premise that the demand for goods and services felt by individuals exceeds the production capacity of the economy. In the absence of considerations pertaining to income distribution and income levels, the analysis indicates that a free competitive market will ensure maximum economic prosperity and represent an optimal solution to the observed contradiction. This is predicated on the assumption that market supply and demand curves accurately reflect all costs and benefits to society. Consequently, the free market will engender a surplus of goods whose marginal social cost will exceed the marginal private cost. The existence of the aforementioned disparities, i.e. externalities, as a result of which market supply and demand curves do not adequately reflect social benefits and costs, justifies certain actions by the state.

In the context of specific conditions, a market characterised by free competition has been demonstrated to ensure an efficient allocation of resources from a Pareto standpoint. Consequently, the justification for state intervention in the market becomes evident when these conditions are not met. J. E. Stiglitz identifies six reasons why the market mechanism may not lead to a Pareto-efficient allocation of resources, and terms these reasons "types of market failure" (Stiglitz 2000, pp. 90-108). These factors encompass imperfect competition, the existence of public goods and externalities, the absence or incompleteness of certain markets, imperfect information, and unemployment and other macroeconomic disturbances. Furthermore, J. E. Stiglitz contends

that even in instances where the market is efficient in the Pareto sense, there exist two additional reasons that justify state intervention. Firstly, market competition has the potential to result in a distribution of income that is deemed to be socially undesirable. Secondly, state intervention is justified when entities do not act in their own best interests. The latter argument for state intervention in a Pareto-efficient economy is an expression of paternalism, i.e. the view that the state should intervene because it knows better than citizens what is good for them. In certain cases, entities may make decisions regarding the goods they consume that are not aligned with the principles of justice. This phenomenon can be seen as a justification for the state to introduce regulations that limit the consumption of certain goods, while simultaneously offering other goods, which are referred to as merit goods.

Assumptions of the new institutional economics

In contemporary economic discourse, the theory of market failure has undergone an expansion in its conceptual scope to encompass the tenets of new institutional economics, a paradigm that draws from the postulates of R. Coase concerning the integration of transaction costs into economic analysis. These costs, which are associated with the utilisation of the price mechanism, are identified as the primary catalyst for the formation of enterprises (Coase 1937).

Transaction costs are defined as the costs of social coordination or the costs of market functioning. They are, inter alia, defined as all costs associated with the transfer of property rights from one participant in the exchange to another. They also include the costs of searching for information and partners, negotiating contract terms, resolving any claims related to the performance of the contract, as well as costs related to uncertainty concerning, for example, price changes. Coase posited that the utilisation of the price mechanism incurs specific costs, including the costs associated with the search for and processing of information necessary to ascertain market prices, the costs of negotiating and concluding contracts, and the costs related to monitoring their performance. Consequently, it appears rational to substitute the market mechanism with administrative coordination. R. Coase's analysis of market imperfections was based on the question of why enterprises are created. It is his contention that the establishment of an enterprise is brought about when the internal coordination system is deemed to be less costly than one that relies on market mechanisms.

In the context of an economic system founded upon economic liberty and competition, the viability of a company as a "small planned society" is contingent upon its ability to execute a coordination function at a cost that is lower than the transaction costs incurred by the market for the acquisition of the goods in question. This suggests that, in circumstances characterised by elevated transaction costs, enterprise-level coordination is often adopted as a substitute for market regulation. However, should the costs of organisational structure within the enterprise exceed the transaction costs, regulation through market mechanisms once again assumes primacy over administrative regulation. This has resulted in the market and the enterprise being recognised as alternative and complementary means of coordination. Optimal enterprise management was therefore the result of comparing the costs of coordination within the company and the transaction costs associated with using the market, with the enterprise itself being a tool for reducing market operating costs. From the standpoint of marginal analysis, this signifies that the enterprise internalises transactions until the internal marginal cost of management is equivalent to the marginal cost of market transactions. These assumptions led to the conclusion that an effective system of competition is necessary not only for the existence of given markets, but also for shaping the appropriate scope of the planning process within the company and thus minimising management costs.

The new institutional economics is predicated on the notion that the determining factor of behaviour, both individual and collective, and the functioning of the socio-economic system in its entirety, is institutions; that is to say, rules that arise from the desire to organise human interactions and reduce uncertainty. Rules of conduct in social life, aimed at limiting opportunistic behaviour, are introduced by both formal and informal institutions (North 2004, pp. 3-72). The former include legal norms that regulate political and economic relations, among which property law and contract law play a special role. Informal institutions encompass a variety of elements, including moral norms, customs, traditions, religious beliefs, and the mentality of individuals, which is shaped by their cultural heritage. This concept underscores the notion that institutions serve to mitigate uncertainty in transactions between entities, thereby concomitantly reducing transaction costs between contractors. The function of the State in this context is to minimise transaction costs by establishing economic and social systems of legal contracts or social rules that facilitate straightforward procedures and reduce transaction costs.

Mainstream economic paradigms

In the analysis of the admissibility of State aid, the existing relationships between transaction costs and market failures are important, which mainstream economics includes market power, externalities, public goods and imperfect information. Asymmetries, distortions and information gaps give rise to issues concerning knowledge of private benefits and costs, i.e. they engender externalities and their specific cases in the form of public goods. These factors also increase transaction costs, which means that it is not possible to solve the problem of externalities through private contracts. This creates a need for state intervention, provided that the benefits of such intervention outweigh its costs. The concept of transaction costs can be employed to argue for market failure and as a premise for government failure, as restrictions on private contracts are strongly dependent on the quality of formal regulations for which public authorities are responsible. Transaction costs, regarded as the costs of operating the economic system, are a more general category than market failure, as in some cases they constitute a barrier to the creation of markets (Arrow 1969).

The theoretical foundations of the concept of market failure were formulated in the 1950s by P.A. Samuelson, J. Medea, and F. Bator (Cowen and Crampton 2002, p. 3). P. Samuelson's considerations encompassed the notion of public goods and their effective allocation (Samuelson 1954, pp. 387-389). In contrast, F. Bator's perspective asserts that market failure occurs when the price mechanism is incapable of promoting favourable activities and hindering unfavourable ones (Clifford 2006, p. 2). Market failure is characterised by a deviation from the conditions of perfect competition and market completeness. The latter is defined as the existence of markets for all goods and services, which would ensure Pareto efficiency (Acocella 2002, p. 99). The functioning of modern markets is far from the model of perfect competition promoted by classical and neoclassical economists, as perfectly illustrated by J.E. Stiglitz, who stated that: "[...] the hand that Smith wrote about is invisible simply because it does not exist, and if it does exist, it is paralysed" (Stiglitz 2004, p. 78).

The rationale for State intervention in the economy can thus be delineated as the incapacity of private markets to furnish certain goods in a satisfactory manner or in the anticipated manner, which is concomitant with the issue of inadequate supply of specific products or services (Pearce 1992). Market imperfections are frequently interpreted as circumstances in which the decisions made by market participants do not result in the optimisation of benefits that would otherwise be derived from the most efficient allocation of resources. Market imperfections emerge when an unrestricted market system, left to free mechanisms, fails to achieve optimal resource allocation, appropriate prices or production, thus generating outcomes that are deemed to be socially unacceptable. From the standpoint of state aid analysis, the following market failures are of the greatest importance (Meiklejohn 1999, pp. 25-31):

- *market power*,
- *external effects*,
- *economies of scale* (*increasing returns to scale*),
- *public goods*,
- *merit goods*,
- *imperfect or asymmetric information*,
- *institutional rigidities*,
- *imperfect mobility of production factors*,
- *frictional problems of adjustment to changes in markets*,
- *subsidisation by foreign* competitors.

Market power is associated with imperfect competition, and in particular with the existence of monopolies in certain markets, the violation or distortion of competition (Pęciak 2010, p. 560). The term "abuse of market power" refers to a scenario in which one or more entities have the capacity to exert influence over the price system or the level of production. Consequently, in the context of operating within an imperfectly competitive or monopolised market, these entities can attain a more advantageous market position, which, in turn, engenders inefficiency in the allocation system and elevated prices.

In many cases, the market mechanism is distorted by external effects in the form of social benefits and costs associated with the fact that the activities of market participants affect external third parties, i.e. persons other than direct producers or consumers (Neven and Verouden 2008, p. 105). The effects of positive externalities (benefits) and negative externalities (costs) are borne by third parties and are not compensated for in the price of goods on either the consumer or producer side. This indicates that the production of such goods by enterprises does not guarantee that the condition of maximising benefits will be met. Consequently, the state is required to supply these goods, given the lack of profitability of their production from the point of view of individual producers. The underproduction of certain products or services may be attributed to a number of factors,

including the inability to assign private benefits and costs, the discrepancy between social and private benefits, and the presence of benefits and costs that also impact entities other than those directly involved. In such circumstances, state intervention is justified by the need to stimulate the desired allocation of resources and the fair distribution of the costs of goods that are socially important and occur on a sufficiently large scale. Furthermore, state aid will be permissible when the effect of support granted from public funds is a surplus of social benefits over private benefits as a result of diffusion, i.e. the "spread" of benefits beyond the group of direct beneficiaries.

It is important to note that certain markets may also be inefficient due to the nature and character of broadly understood public goods. These are characterised by the inability to exclude anyone from their consumption and the absence of competition, which means that consumption by a given entity does not affect the consumption possibilities of other entities. The existence of public goods can result in manifestations of market inefficiency. These include, firstly, insufficient supply of public goods, since such goods do not allow for the achievement of economic efficiency. Secondly, there is the "free rider problem", which arises from limited exclusion possibilities. The absence of exclusion in the context of public goods, or the limited possibility of exclusion in the context of socially desirable goods (merit goods), results in private entities demonstrating a reluctance to supply them. Conversely, a paucity or absence of such products and services would precipitate a diminution of social benefits, thus providing a foundation for the justification of state intervention in the economy (Kasper and Streit 1998).

In a model of perfect competition, market participants possess complete information. However, in reality, this information is often imperfect, meaning that entities possess differing levels of information, with some market participants having superior information over others. This imperfection may be attributed to a number of factors, including incomplete information, lack of access to it, incorrect transmission, uncertainty and risk, or the problem of information asymmetry. The presence of asymmetry and distorted information has been demonstrated to result in prices that do not accurately reflect the true value of goods and services. This phenomenon was empirically substantiated by G. Akerlof through an analysis of the used car market. In this market, the presence of incomplete information regarding product quality led to a phenomenon where both high-value and low-quality products exhibited similar prices. This, in turn, resulted in the market being predominantly influenced by defective goods (Akerlof 1970, pp. 488-500).

In a reference to Copernicus-Gresham's law of "bad money driving out good", G. Akerlof described the displacement of inferior goods in favour of poor-quality goods as adverse selection, which defines the interaction between the difference in the quality of goods and uncertainty about that quality. This indicates that price does not guarantee the transfer of information between market participants, thereby ensuring the selection of products and services corresponding to the offered price. Consequently, decisions regarding the purchase of specific goods may be inappropriate. In order to posit information asymmetry as a prerequisite for market failure, economic theory sets an additional condition, i.e. the separation of ownership from control. The relationships between the behaviour of entities in this case are explained by agency theory, which points to the relationships between the "agent" and the "principal" that arise when one party (the agent) acts on behalf of the other party (the principal). In the context of the principal-agent relationship, the pivotal element pertains to the information that is exclusively available to the principal. The essence of this relationship is characterised by the transfer of the principal's authority to the agent. This contract involves the transfer of some of the signing party's powers to the other party, who then performs services on the signing party's behalf. This is the most common codification of modes of social interaction (Ross 1973, pp. 134-139, Ross 1979, pp. 308-312).

Moreover, within the context of a principal-agent relationship, there exists the potential for abuse arising from information asymmetry. This will occur when the agent, operating on behalf of the principal, possesses more information regarding their actions and intentions, and the principal is unable to exercise complete control over the agent. Consequently, the agent may engage in decisions that are perceived as risky and incorrect by the principal. The propensity for such behaviour may thus emerge in circumstances where the parties responsible for decision-making do not fully internalise the consequences of their actions, thereby exhibiting reduced caution and an increased propensity for risk-taking. The propensity to engage in such behaviour can be interpreted as a tendency to take calculated risks, driven by the belief that the potential consequences of these decisions will not be personally or financially significant. This belief is further compounded by the anticipation of high rates of return on investments.

Manifestations of information asymmetry are therefore: 1) *adverse selection*, which occurs when, due to a lack of information about a good with greater utility, a good with lesser utility is chosen (the above-mentioned example of the used car market), 2) *agent opportunism*, which occurs when an agent, having an information advantage, does not provide the principal with adequate information in order to maximise their own benefits (e.g. due to an employee's information advantage over their employer regarding the value of their work and

actual effort, both valuable and unreliable or uncompetitive employees may receive similar remuneration) (Stiglitz 2002, pp. 31-40), 3) *the risk of abuse*, which refers to a situation where an entity, having greater knowledge and not bearing the full costs of its decisions, acts in a manner that is disadvantageous to other market participants. For example, excessively high interest rates on bank loans attract unreliable customers who assume in advance that they will not repay their debts, which makes banks inclined to reduce interest rates in order to lower the repayment barrier, and when the demand for money increases, it becomes necessary to limit the granting of loans, i.e. to reduce the money supply (Stiglitz 2002, pp. 6-7).

The State's role should be to address the root cause and reduce information asymmetry. State intervention is justified due to the significant scale and importance of market failure and the market's inability to ensure the supply of certain goods. Furthermore, the state has a greater capacity to create effective incentives and apply coercive mechanisms to suppliers to ensure they publish reliable information about their offerings. Furthermore, public institutions possess more comprehensive knowledge and a greater capacity to coordinate the market than individual market participants (Greenwald and Stiglitz 1986).

When analysing market failure, its main sources of imperfection include institutional rigidities, evident in legislation and the low, imperfect mobility of production factors, as well as structural problems related to adapting to changes in individual markets ("frictional problems of adjustment to changes in markets") and subsidisation by foreign competitors. These justify restructuring processes. Other major manifestations of market failure include the need for income redistribution in society, the emergence of economic imbalances associated with inflation, unemployment or a decline in production, and market shortages, in addition to market power, positive and negative externalities, and the existence of public goods and imperfections in information (Pęciak 2010, p. 561).

Problems in coordinating the activities of various market participants can also lead to market malfunction, where the costs of concluding contracts, uncertainty about the outcome of cooperation, and network effects prevent the effective drafting or conclusion of contractual agreements. This results in inefficiently low levels of coordination and production. According to the literature, coordination problems mainly arise in the setting of technological standards, transport infrastructure and innovation (David 2002). The essence of this mechanism is that the market selects a product characterised not by the most advanced technology or optimal parameters, but by popularity. This means that the preferred standard is not the most technologically advanced, but rather the most common. This is the primary manifestation of market failure in terms of network externalities. In such a situation, public authority intervention is justified by the state's ability to coordinate the market, slow down the adoption of the standard, provide reliable information about the technology, stimulate a change to a better standard and protect weaker market players from monopolies through antitrust regulations and case law.

Although market failure is a condition that Member States must demonstrate in order to justify granting State aid, it should be emphasised that a situation in which a given undertaking is unable to implement certain measures without State aid does not necessarily indicate market failure. For example, a company's decision not to invest in a low-profit project, a region with low demand, or a region with weak cost competitiveness does not necessarily result from market failure, but may instead be a sign of a well-functioning market. Aid aimed at increasing production or lowering prices cannot be justified by market failure, as excess production capacity or excessive consumption may be inefficient from a market perspective and harmful to the economy and society as a whole. Market failures can only be recognised if an efficient outcome cannot be achieved by market forces alone, without state aid. R. Coase referred to this principle when he argued that market inefficiencies resulting from externalities could not always justify state intervention because each party, whether benefiting from or harmed by them, could negotiate with others to eliminate these effects (Coase 1960, pp. 1-44). In this case, Coase raised the important issue of externalities and their social costs, emphasising the importance of property rights and transaction costs. According to Coase's theorem, the application of clearly defined and specified property rights in markets where externalities occur enables entities to negotiate lower costs, making transaction costs negligible. Consequently, resource allocation becomes efficient because market resource allocation is only disrupted by the transfer of property rights when transaction costs are high and limit the ability of entities to engage in mutually beneficial transactions, at which point state regulation can reduce these costs. However, one must also consider situations where introducing regulation may reduce the benefits of a transaction if it imposes higher costs on market participants. Therefore, state interventionism is only effective when transaction costs exist and the cost of complying with the regulation does not exceed the benefit of regulated behaviour.

Coase's new approach to the problem of social and private production costs leads to a modification of the conclusions regarding state involvement in the economy. It challenges the assumptions on which A.C. Pigou's analysis of the discrepancy between social and private costs was based, thereby weakening the arguments that justify state interference in the market mechanism in the presence of negative externalities. However, negative externalities cannot be a determinant of state interventionism if they are considered a problem of choice in

conditions of resource scarcity. The thesis implies that, in the absence of transaction costs, negotiations within the exchange process — understood as the exchange of property rights or the transfer of legal rights — lead to welfare maximisation, regardless of the distribution of responsibility for externalities. Free market allocation of resources is therefore justified in the absence of transaction costs, though this is a purely theoretical assumption in reality. Consequently, the so-called Coase theorem should not be equated with the assertion that State intervention in economic processes cannot enhance welfare. Rather, it suggests that the effectiveness of state intervention should not be presumed in advance, given that it incurs costs which must be weighed against the potential benefits of implementing specific state regulations.

Conclusions

The considerations presented in this article lead to an important conclusion. The basic criterion for granting State aid should be rationality, as this is the most important factor in determining the acceptability of aid measures. This is because competition is essential for the proper functioning of a market economy and the protection of its participants' interests. State aid should not distort competition unless the distortion is offset by positive market effects resulting from the aid. Aid instruments enable the State to pursue objectives that it deems important for socio-economic development.

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