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COMPETITION, STATE AIDS AND SUBSIDIES

Contribution from Peru

-- Session I --

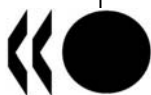
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COMPETITION, STATE AIDS AND SUBSIDIES: THE CASE OF PERU

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COMPETITION, STATE AIDS AND SUBSIDIES: THE CASE OF PERU

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INTRODUCTION

This paper presents an overview of the uses, justifications and legal restrictions on State Aids in Peru. It has been written to be presented as a country contribution to Session I of the IX Global Forum on Competition, organized by the OECD Competition Committee.

State Aids are an important part of the policy tools used by Governments elsewhere to achieve different goals such as inducing firms to innovate or to export, alleviate economic deprived regions or palliate market failures. In the context of the current financial crisis, the use of State Aids have been multiplied as Governments have faced the need to rescue financial institutions and other industrial firms through direct transfers and even taking the temporary ownership of these distressed firms.

While the goals of State Aids are varied and perhaps justified in certain circumstances, it is widely recognized that State Aids could also distort competition. The EU rules on State Aids and The World Trade Organization rules on Government subsidies are clear examples of these concerns at an international level. At a national level, there is less evidence regarding the existence of legal restrictions on State Aids.

Through various State Aid examples, this paper shows the different uses and justifications for State Aids in Peru. It also analyses the legal restrictions currently in place for controlling the use of State Aids, in particular when the Government proposes to develop business activities either directly or indirectly. However, it is worth stressing that this paper does not intend to provide an exhaustive list of the different State Aids currently in practice or a judgment about their benefits or their impact on competition. Following the suggested questions provided by the OECD Competition Committee, the paper has been structured as follows:

- Section 1, presents an overview of the types of State Aids currently used in Peru as well as the goals that support the introduction of these aids;
- Section 2 describes the current types of State Aids used for palliating the effect of the international financial crisis, and;
- Section 3 presents an analysis of the legal restrictions currently in place for controlling State Aids and their impact on competition. The final section summarizes the paper and presents our conclusions.

1. THE USE OF STATE AIDS IN PERU

1.1. Overview of State Aids used in Peru

Since the nineties, Peru has undertaken several market reforms with the aim of levelling the playing field for the development of private businesses, reducing the State's role as a business agent and reserving the Government participation only to specific areas such as health, education, promotion of employment, national security, utilities and infrastructure.

The Peruvian Political Constitution of 1993 recognizes the principle of free private enterprise within a social market economy. Legislative Decrees 668 and 757 further approved measures to guarantee the freedom of foreign and domestic trade, eliminated monopoly practices in the production or selling of goods and services, established that the State guarantees the freedom of private initiatives based on free competition and access to economic activities and abolished any exclusivity rights granted to the State for the development of economic activities, stressing that private and state-owned firms would receive the same legal treatment.

Although overall it is possible to sustain that, compared to previous decades, the use of State Aids in Peru has declined since the nineties; there are various forms of State Aids (especially tax breaks) still functioning in Peru.

Tax breaks

In the case of tax breaks, a report for the Ministry of Economy and Finance by Apoyo Consultoría (2003) detected up to 193 tax breaks. According to Apoyo Consultoría (2003), most of the tax breaks were concentrated in two taxes: the general sales tax (35,5%) and the income tax on legal persons (33,5%). The study also showed that tax breaks were common for taxes that applied to all the economy (21,2%), as well as for the financial industry (17,2%), businesses located in the jungle (11,3%), education (11,3%) and agriculture (6,4%). Table 1 summarizes the tax breaks situation up to year 2003 taking into account the name of the tax, the type of benefit and the economic sector involved. It is worth noting that the study concluded that the access to tax breaks was independent of the investment level and, in some cases, they did not promote the increase in value added of the sector or region benefited.¹

¹ Apoyo Consultoría (2003). *Análisis de las exoneraciones e Incentivos Tributarios y Propuesta de Estrategia para su Eliminación*. Document prepared for the Ministry of Economy and Finance. Available in:

Table 1
Tax Breaks in Peru up to 2003
(number of benefits by tax, type and sector)

Tax	Type / Sector	Sector														
		General application	Agricultural	Jungle	CETICOS	Construction	Education	Energy	Financial	Hydrocarbons	Industrial	Mining	Other Sectors	Transport	Tourism	Total
Solidarity tax for Helpless Children	Exemptions	3														3
Ad Valorem Customs Duties	Exemptions				1					1						2
	Temporary Importation									1				1		2
	Unaffected	4	1		1		2						1			9
	Other Tax Expenses		1													1
	Special or Reduced Rates	1														1
Income Tax on Legal Persons	Credits			1			1									2
	Deductions	2	1	1			1			1		1				7
	Deferments		1			2			2	4		2	1		3	15
	Exemptions	4		1	2		4		13							24
	Unaffected	5					1									6
	Simplified Regime	1														1
	Reduced Rates		1	7												8
Income Tax on Natural Persons	Deductions	1		1			1									3
	Exemptions						2		9							11
	Unaffected	6														6
Special Solidarity Tax	Exemptions		1	1	1											3
	Unaffected	1					1									2
	Differential Rates					1										1
General Sales Tax	Credits			1												1
	Deductions					1										1
	Returns	3	1	2						2		2	3		3	16
	Exemptions	2	2	4	2	1	3		9	1	2	2	1	3		32
	Temporary Importation									1					1	2
	Unaffected	4			2		4		2	1			1		2	16
	Other Tax Expenses	2	1													3
Excise Tax	Returns			1									1			2
	Exemptions			3	3			1								7
	Temporary Importation														1	1
	Unaffected	1								1						2
	Reduced Rates				1								1			2
Other taxes	Other Tax Expenses	1														1
Total		41	10	23	13	5	20	1	35	13	2	7	9	3	11	193

Source: Apoyo Consultoría (2003).

http://www.mef.gob.pe/INFECO/documentos/DOCUMENTO_FINAL_JUNIO03.pdf (Last visited: 3 January 2010).

Direct subsidies

Direct subsidies are used in social programs for the poor and are focused to the target population. To our knowledge, no direct subsidies are currently granted to state-owned and/or to private companies. Moreover, the Ministry of Economy and Finance is implementing a budget for results for the national budget, which will further contribute to make any direct subsidy transparent and linked to a performance measure.

Government purchases

Government purchases are ruled by the State Procurement Law (Legislative Decree N° 1017) and its Regulations (Supreme Decree N° 184-2008-EF). According to these laws, all public procurement contracts must consider criteria of speed, economy and efficacy, thereby ruling out the possibility of the Government purchasing at above market price to benefit certain sector or companies.

Notwithstanding this, there are some other forms of State Aids in Government purchases aimed to help small enterprises. For example, according to the State Procurement Law, winning bidders must give to the contracting authority a Guarantee of Faithful Compliance equivalent to ten percent (10%) of the original contract amount before signing the contract. However, in the case of regular supply of goods or services, as well as in consulting contracts and public works, small enterprises can ask the contracting authority to retain ten percent from the contract payment, in practice waiving the need of presenting the Guarantee of Faithful Performance in advance of signing the contract.

The granting of Government-owned inputs

Government-owned inputs such as land and bandwidth are granted to private companies through concession processes, some of which involve auctions. PROINVERSION is the Peruvian investment promotion agency in charge of promoting private initiatives that involve government-owned inputs. In addition to PROINVERSION, other sector specific laws rule the concession of other natural resources such as forest lands, oil and gas, fisheries, etc. For instance, in the case of forest lands, the main objective of the concessions is to ensure the sustainable management and conservation of forest resources.² Forest concessions are given to

² Law N°27308, Forest and Wildlife Law.

private parties for the preferential use of wood through a public auction or a public tender for a renewable period of up to 40 years.³

When the concession process involve the setting of a regulated price, this is not normally set below market prices. However, it is worth mentioning the concession of a landmark natural gas project in the late nineties, where the Government established a price for the natural gas which is lower for electricity generators than for other gas users (petrochemical, industrial and commercial users).

The granting of loans

Regarding the granting of loans, the Peruvian government does not grant loans at below-market rates and it does not provide loan guarantees at below-market rates. It does, however, intervene in the financial market mainly through four institutions: Banco de la Nación, COFIDE, Agrobanco and Mivivienda.

- Banco de la Nación⁴ is a government owned bank which manages the accounts of the Treasury and the Central Government in order to provide banking services for the administration of public funds. Through this bank, the State grants loans to both firms (MSEs) and citizens. Loans are provided at market-rates, which depend on the type of loan and are not necessarily are the lowest in the market.
- COFIDE (Corporación Financiera para el Desarrollo)⁵ is a second-tier development bank that is partially owned by the government (98,7%)⁶ and channels resources from multilateral agencies, government agencies, commercial banks and local capital market to intermediary financial institutions. COFIDE does not require guarantees and it does not set the interest rates that are charged to the final beneficiaries of the loans, since these are responsibilities of the first-tier banks, which are also responsible for the risk of the credit transactions.
- AGROBANCO (or Banco Agropecuario) is a bank that grants direct and indirect loans to firms devoted to agriculture, livestock, aquaculture and the processing and marketing of products of agriculture and aquaculture. Direct loans are granted to small producers who are organized in supply chains and receive supervision, technical assistance programs and agricultural insurance in order to achieve economies of scale, reduce costs, maximize profits and promote the existence of better credit subjects. Indirect loans are granted through special financing programs with financial intermediaries (such as banks, multiple banks, rural banks, local banks and EDPYMES⁷).
- Finally, Fondo Mivivienda is a mortgage fund for the promotion of housing. Its objective is to engage in the promotion and financing of the acquisition, improvement and construction of housing, especially in cases of social interest. It also aims at organizing activities related to

³ The Surveillance Agency of Forest Resources and Wildlife (<http://www.osinfor.gob.pe/>) is the entity responsible for the management and administration of forest resources and wildlife nationwide.

⁴ <http://www.bn.com.pe/>

⁵ <http://www.cofide.com.pe/>

⁶ The remaining 1,3% belongs to Corporación Andina de Fomento (CAF), a multilateral financial institution that mobilizes resources from international markets to Latin America, in order to provide multiple banking services to both public and private clients of its shareholder countries.

⁷ EDPYMES are financial firms that are dedicated to granting loans to small and medium enterprises.

enhancing the flow of capital to the housing finance market, participating in the primary and secondary market of mortgage loans and helping the development of the mortgage market.⁸

1.2. Goals pursued by State Aids in Peru

There are several goals that are usually pursued by governments when providing State Aids. As it will become clear from the following selected examples, in Peru the granting of State Aid have followed different purposes.

Attracting firms to economically distressed regions

With the objective of promoting investments in the Peruvian jungle, Law N° 27037 “Law on Investment Promotion in the Amazon”, establishes tax exemptions to firms that are located in the Amazon⁹ and perform the following economic activities: agriculture, aquaculture, fisheries, tourism and manufacturing activities related to processing, transformation and commercialization of primary products from the above activities, provided that such activities are performed in the area.

This law provides four types of tax breaks:

- The income tax is reduced to 10%, 5% and 0%, depending on the province and the economic activity.
- The sales tax is not charged in the following cases: (i) the sale of goods that are produced in the same region, (ii) the services provided in the region, and (iii) the construction contracts or the first sale of properties that were built by the builders in that area. For all the other activities named above, there is a special tax credit for the determination of the sales tax that applies to the sale of goods outside this area.
- The sales tax and the excise tax on oil, natural gas and its derivatives is not charged to firms that are located in the departments of Loreto, Ucayali and Madre de Dios.
- Firms that are located in the jungle are exempted from the Extraordinary Solidarity Tax and Special Tax on Net Assets.

⁸ <http://www.mivivienda.com.pe/>

⁹ The law is applied in the following regions:

- a) The departments of Loreto, Madre de Dios, Ucayali, Amazonas and San Martín.
- b) In the department of Ayacucho: the districts of Sivia and Ayahuanco in the province of Huanta, and the districts of Ayna , San Miguel and Santa Rosa in the province of La Mar.
- c) In the department of Cajamarca: the provinces of Jaén and San Ignacio.
- d) In the department of Cusco: the district of Yanatile in the province of Calca; the province of La Convención; the district of Kosñipata in the province of Paucartambo, and the districts of Camanti and Marcapata in the province of Quispicanchis.
- e) In the department of Huánuco: the provinces of Leoncio Prado, Puerto Inca, Marañón and Pachitea; the district of Monzón in the province of Huamalis; the districts of Churubamba, Santa María del Valle, Chinchao, Huánuco and Amarilis in the province of Huánuco, and the districts of Conchamarca, Tomayquichua and Ambo in the province of Ambo.

The Law on Investment Promotion in the Amazon was first enacted on December 30th 1998 and, even though it was attempt to terminate the tax breaks benefits in March 2007, the Law returned into force on 1 October 2009.

Another recent example of the use of tax breaks as a mean for attracting firms to economically distressed regions is Law N° 29482 enacted on December 18th 2009 to promote the development of productive activities in the Highlands of Peru. This law establishes an exemption from three types of taxes to all micro and small enterprises, cooperatives, community and multicomunity enterprises that are located 2 500 meters above sea level and higher, as well as to all firms that are located 3 200 meters above sea level and higher. The taxes that are exempted are:

- The income tax on the third-income category.¹⁰
- Tariff rates on the import of capital goods.
- The sales tax on the import of capital goods.

Inducing firms to supply goods or services deemed to contribute to the general interest in cases when market incentives alone were insufficient to ensure that these goods or services would be provided.

The Political Constitution of 1993 allows the participation of the State in the provision of goods and services in cases where market incentives alone are insufficient to ensure that these goods or services would be provided, as long as the State intervention is authorized by means of a special law, the Government activity is “subsidiary” and there is an overriding “public interest” or “manifest national benefit” supporting the State intervention.

A recent example of the use of this type of justification for granting the State participation in business activities is a proposed law, currently debated in the Congress, for creating a commercial airline through a public-private partnership, where the State will end up having a control stake in the airline. The aim of the proposed law is to create an airline that could provide trips to destinations currently not covered by private airlines. In addition, the proposed law also aims at reducing the fares currently charged by the private airlines in other destinations served by private airlines.

¹⁰ The third category income includes: (i) the income from commerce, industry and mining, as well as from the exploitation of natural resources, services and any other regular businesses of production or sales; (ii) the income from activities of intermediary trade agents, auctioneers and all other similar activities; (iii) the income from Notaries.

Remedying competition distortions created by the granting of aid by foreign governments.

The Anti-Dumping and Countervailing Duties Commission of the National Institute for Defense of Competition and Protection of Intellectual Property (INDECOPI) is in charge of enforcing the rules addressed at preventing and correcting competition distortions generated by the goods imports that are either subsidized or imported with a dumping price, according to the rules and procedures as stipulated in the World Trade Organization agreements and Supreme Decrees N° 006-2003-PCM and 133-91-EF.¹¹

Under these laws, national producers who consider that they have been damaged or threatened by the import of similar products which are subsidized by foreign governments can submit a request to the Commission for the opening of an investigation to determine the existence of the alleged practice, as well as the damage caused to national production as a result of such import. The Commission can impose countervailing duties to the subsidized imports as a remedy.

The Commission started its activities in 1992 and since then it has conducted nine investigations about subsidies, three of which are still under investigation.¹² Furthermore, countervailing duties were imposed in three cases: candies from Argentina; vegetable oils, refined and packaged, from Argentina and olive oil from the European Union.

Other goals

Other goals typically pursued by governments when extending State Aids are the protection of employment, preventing strategic firms from being purchased by foreign companies and fostering innovation and the development of new sectors.

Regarding these other types of State Aids, it is worth mentioning a State Aid program recently created as a result of the Free Trade Agreement signed with the United States. This State Aid programs aims to increase the competitiveness of small and medium agricultural producers, fomenting the adoption of new technologies. The program has duration of five years and consists of transfers to incentive the association of small and

¹¹ http://www.indecopi.gob.pe/0/modulos/JER/JER_Interna.aspx?ARE=0&PFL=1&JER=852

¹² The second and administrative instance of INDECOPI (Defense of Competition Chamber N° 1) is reviewing one of these investigations.

medium producers, the adoption of best management practices and the implementation of new technologies.¹³

¹³ This program, called “Programa de Compensaciones para la Competitividad” was created by Law Decree 1077.

2. AID TO AILING COMPANIES IN THE CONTEXT OF THE FINANCIAL CRISIS

The financial crisis certainly affected the Peruvian economy; however, according to several sources, Peru was one of the least affected countries in Latin America¹⁴. In fact, it was because of its ability to withstand external shocks that Moody's Investors Services recently raised the credit rating of Peru to investment grade, following other credit ratings agencies.¹⁵ Taking this into account, there was no need to provide transfers to banks or any other financial institution or firm, as it have been the case elsewhere due the financial turmoil. In contrast, the measures adopted by the Peruvian government in order to face the financial crisis were a mix of fiscal and monetary stimulus plus programs targeted to small and medium exporting and agricultural firms.

One of these programs was the creation of Fondo AGROPERU¹⁶, a PEN 200 million fund destined to give a guarantee for farmers that intend to invest in planting new crops. The fund is managed by AGROBANCO and aims at reducing the negative impact of financial crisis in agriculture, enhancing technological change and modernizing fields in order to increase the supply of exportable agricultural products to international markets.

Another example of State Aid in the context of financial crisis was the Business Guarantee Fund (*Fondo de Garantías Empresariales* – FOGEM) amounting a total of PEN 300 million in order to ensure that the national financial system grants credit for micro and small enterprises devoted to services and trade, and for median enterprises which are engaged in the production of goods or services within non-traditional exports chains.¹⁷ This is a temporary fund which is supposed to last only two years and since its creation it has been guaranteeing up to 50% of loans for working capital or fixed asset acquisition, taken by micro, small and medium enterprises, whose direct or indirect sales abroad exceeding 30% of their annual income. Nonetheless, because of the relatively low impact of the crisis on the Peruvian economy, the demand for guarantees has been low.¹⁸

¹⁴ For instance, see: <http://www.globalviewc.com.ar/files/article/file/30.pdf>.

¹⁵ See: <http://semanaeconomica.com/articulos/47923-moody-s-otorga-grado-de-inversion-al-peru-por-su-capacidad-para-resistir-shocks-externos>

¹⁶ The fund was created by means of the Emergency Decree 027-2009, which was published on 23 February 2009.

¹⁷ Emergency Decree N° 024-2009, published on 20 February 2009.

¹⁸ See: <http://gestion.pe/impres/impres/noticia/crisis-no-golpea-mucho-empresas-lo-que-banca-no-pide-mas-garantias/2009-09-15/8936>

3. LEGAL RESTRICTIONS ON STATE AIDS

State Aid is defined in the European Union (EU) legislation as “any aid granted by a Member State, or through State resources, which distorts or threatens to distort competition by favoring certain firms or the production of certain goods”.¹⁹ State Aids are controlled in the EU to ensure that government interventions do not distort competition and trade inside the union, however recognizing that, in some circumstances, government interventions is necessary for a well-functioning and equitable economy.²⁰

Unlike the EU, where the impact on competition is crucial on assessing the granting of a State Aid, in Peru there is no specific legislation that requires considering the impact on competition when granting a State Aid. Instead, the Peruvian Constitution requires the State to follow three criteria for assessing its participation (directly or indirectly) in business activities.²¹

- First, the State participation in business activities should be authorized by a special law;
- Second, the State participation in business activities should be **subsidiary** to private businesses; i.e., the State intervention should not foreclose private businesses from the market.
- Third, State participation in business activities can only be allowed for reasons of overriding **public interest** or manifest **national benefit**.

In contrast to the EU State Aid rules, the above criteria as applied in Peru does not specifically address competition concerns, although some sort of competition advocacy analysis should be involved in analyzing whether the State intervention is foreclosing private businesses or not. The **subsidiary** criterion is also less broad than the EU State Aid concept, as it is only applied to situations where the Peruvian State develops entrepreneurial activities; i.e., it does not cover other types of State Aids.

In mid 2008, a new Law regulating unfair competition acts as well as infringements to rules that regulate commercial advertising was enacted (Legislative Decree No. 1044 - Law on Overseeing of Unfair Competition). Under this Law, The Overseeing of Unfair Competition Commission of INDECOPI is in charge of analyzing the subsidiary role of State agencies or firms.

To date, there have been six cases brought to this Commission under the new Legislative Decree N^o. 1044, in which the plaintiffs claimed that a State-owned hospital was providing medical services to patients which otherwise will be attended in private hospitals.

¹⁹ Article 87 EC.

²⁰ http://ec.europa.eu/competition/state_aid/overview/index_en.html

²¹ Article 60 of Peru Constitution:

“The government recognizes economic pluralism. The national economy is based on the coexistence of several forms of ownership and enterprise.

Authorized solely by an express law, the government may subsidiarily engage in business activities. directly or indirectly, for reasons of overriding public interest or manifest national benefit.

Business activity receives the same legal treatment, whether public or private.”

Other cases involved the participation of a State-owned company in a concession process for developing a new power plant and a State-owned university which operated a restaurant outside the campus, competing with similar restaurants in the area. In all these cases the Commission supported the plaintiff's claims because the State-owned entities failed to meet the first criteria of having a special law enabling the defendants to develop private businesses. Therefore in all these cases it was not necessary for the Commission to analyze whether the services provided by the State-owned entities were **subsidiary** and in the **public interest**.

Before Legislative Decree N° 1044 was enacted, INDECOPI was required by FONAFE (a holding of state-owned firms) to assess whether 13 state-owned companies²² meet the above three criteria. In seven cases it was concluded that at least one of the activities developed by these firms could be offered by the private sector without the need of these state-owned firms. Only two of these companies are currently not operating: TANS (a former state-owned airline) and CONEMINSA (a multiservice firm). According to INDECOPI's analysis, some of the activities of these firms could be partially covered by the private sector in the case of TANS and fully covered by the private sector in the case of CONEMINSA.²³

It is worth mentioning that the Peruvian Defense of Free Competition Commission (also part of INDECOPI) has no specific powers for exerting control over State Aids in Peru. Notwithstanding this, the powers of this Commission for detecting and sanctioning anticompetitive conducts are applicable to private as well as state-owned firms.

At an international level, as member of the Andean Community Peru must comply with The Andean Community Regulations, which include both a Decision concerning the protection and promotion of free competition (Decision 608²⁴) and a Decision which aims at preventing or correcting the distortions in competition generated by subsidies in imports that are produced in Member States (Decision 457²⁵). None of these decisions directly limit the amount and nature of State Aids. There is, however, a provision in the first one according to which Member States should not impede, hinder or distort competition in the regional market (see Article 36), but to date there has not been any case relating to the matter of State Aids.

²² Servicios Postales del Perú – SERPOST S.A., Transportes Aéreos Nacionales de la Selva – TANS S.A., Editora Perú S.A., Servicios Industriales de la Marina - SIMA Perú S.A., Servicios Industriales de la Marina - SIMA Iquitos S.R.L., Inmobiliaria Milenia S.A., Empresa de Administración de Infraestructura Eléctrica – ADINELSA S.A., Empresa Nacional de la Coca – ENACO S.A., Perupetro, Corporación Financiera de Desarrollo – COFIDE S.A., Compañía de Negociaciones Mobiliarias e Inmobiliarias - CONEMINSA, Banco de la Nación S.A. and Banco de Materiales S.A.C.

²³ A overview of the methodology followed to determine the subsidiary role of these State-owned companies is provided in the Appendix.

²⁴ <http://www.comunidadandina.org/normativa/dec/D608.htm>

²⁵ <http://www.comunidadandina.org/normativa/dec/D457.htm>

CONCLUSIONS

This paper presents an overview of the State Aids uses in Peru. It has been shown, based on various State Aid examples, that the uses of State Aids in Peru are varied and, although overall, the number of State Aids appears to be reduced compared to previous decades, there are still in place many forms of State Aids, in particular tax breaks.

The many uses of State Aids in Peru are supported by different goals; these are mainly related to the promotion of economic activities in specific regions (such as the highlands and the jungle) and/or for specific sectors (agricultural firms or small-medium exporters).

State Aids in the form of Government-owned inputs granted at below-market levels or loans and loan-guarantees granted at below-market rates are less commonly used in Peru. It has been shown that in the case of Government-owned inputs, these are normally transferred to private operators through a concession process and, depending on the scarcity of the input, through an auction. In the case of loan and loan-guarantees, the Government intervenes directly through first and second-tier state-owned banks; however the rates charged are not below market rates.

In the context of the current financial turmoil, State Aids in the form of specific rescue measures to financial institutions and other industrial firms have not been used in Peru. Instead, the Government has focused its strategy on a mix of fiscal and monetary policy, combined with target aids to agricultural and small exporters firms, through special funds: The Business Guarantee Fund (*Fondo de Garantías Empresariales* – FOGEM) and Fondo AGROPERU.

Finally, at a national or international level, there is no legal restriction imposed on the Peruvian Government on the use of State Aids (aside for the case where the State Aid is in the form of a subsidy that affects a third country under the rules of the World Trade Organisation).

Although there is no legal binding to the use of State Aids, the Government has restrictions on the developing of business activities. According to the Peruvian Constitution, the Government have to follow three criteria for assessing its participation (directly or indirectly) in business activities.²⁶

- First, the State participation in business activities should be authorized by a special law;

²⁶ Article 60 of Peru Constitution:

“The government recognizes economic pluralism. The national economy is based on the coexistence of several forms of ownership and enterprise.

Authorized solely by an express law, the government may subsidiarily engage in business activities. directly or indirectly, for reasons of overriding public interest or manifest national benefit.

Business activity receives the same legal treatment, whether public or private.”

- Second, the State participation in business activities should be **subsidiary** to private businesses; i.e., the State intervention should not foreclose private businesses from the market.
- Third, State participation in business activities can only be allowed for reasons of overriding **public interest** or manifest **national benefit**.

In contrast to the EU State Aid rules, the above criteria as applied in Peru does not specifically address competition concerns, although some sort of competition advocacy analysis should be involved in analyzing whether the State intervention is foreclosing private businesses or not. The **subsidiary** criterion is also less broad than the EU State Aid concept, as it is only applied to situations where the Peruvian State develops entrepreneurial activities; ie, it does not cover other types of State Aids.

APPENDIX: METHODOLOGY FOR THE ANALYSIS OF THE SUBSIDIARY ROLE OF GOVERNMENT BUSINESS ACTIVITIES

The analysis included three steps: analysis of competition conditions, analysis of the availability of supply by private firms and analysis of possible results if the state-owned firms ceased to operate (scenario analysis) .

1. Analysis of Competition Conditions

The analysis of the competition conditions starts with the identification of the main physical and technical characteristics of the product or service supplied by the state-owned firm, as well as its final uses. This first step aims at determining if there are private firms competing with the State-owned company. Afterwards, two aspects are assessed:

- a) *Characteristics of the market and current market conditions.*
 - Size and trends in demand, that is, if the demand is increasing or decreasing given that this influences the number of potential or actual participants in the market.
 - Dynamics of entry and exit of competitors in the market in order to characterize the firms in the market, market power and the importance of potential competition.
 - Specific demand characteristics (existence of seasonality, regular or occasional purchases, market segmentation, exclusive supply contracts, etc.) that may influence the competition conditions and the definition of markets.
- b) *Existence of barriers to entry and exit.*
 - Legal and/or administrative barriers.
 - Structural barriers: absolute cost advantages, economies of scale and scope, existence of essential facilities, network externalities, sunk costs.
 - Strategic or behavioral barriers: strategic behavior aimed at deterring entry by potential competitors (price limit, over-investment in capacity, product differentiation, integration and vertical restraints) and barriers aimed at excluding competitors and market place (increase in costs of rivals, predatory pricing).

2. Analysis of supply conditions of private firms

Two alternative methods are used in order to assess the supply of private firms:

- a) *Comparing the available private supply (APS)²⁷ against the total market demand.* Three cases can be identified:

²⁷ The available private supply is defined as the maximum supply of private firms currently participating in the market, given their installed capacity:

$$APS = \sum_{i=1}^n IC_i$$

APS > Maximum demand	→	No subsidiary role	→	End of the analysis
APS > Average demand	→	Supply capacity of private firms is not proved	→	The analysis continues
APS < Maximum demand				
APS < Average demand	→	Supply capacity of private firms is not	→	The analysis continues

b) *Evaluating whether private companies can meet the demand of the state-owned firm, if the latter cease to operate in the market.* In this case the capacity of private firms to cover the market demand is determined by taking into account the margin between installed capacity and capacity utilization of each company; that is, between the maximum potential supply and the current supply of private companies involved in the industry.²⁸ Afterwards, the absorption capacity is compared with the demand covered by the state-owned firm (which would have to be covered by private firms in case the state-owned firm left the market) in order to determine if the company is playing a subsidiary role or not.

3. Analysis of scenarios

Depending on the number of private firms participating in the market, the analysis is performed in four different scenarios:

- a) *Scenario 1:* Only the state-owned firm provided the good or service.
- b) *Scenario 2:* A state-owned firm and a private firm provided the good or service.
- c) *Scenario 3:* A state-owned firm and two private firms (which are not part of the same economic group) provided the good or service.
- d) *Scenario 4:* A state-owned firm and three or more private firms provide the good or service.

The existence of enough private supply to cover the market demand is presumed when two or more private companies operate in the market, that is, in Scenarios 3 and 4.²⁹ However, if in Scenarios 3 and 4 there is a reasonable doubt about the ability of private firms to supply the market, then the analysis continues in order to find evidence as to whether the business activity of the State plays a subsidiary role to private initiative or not. Figures 1 and 2 show the analysis performed by INDECOPI in each scenario.

Where: APS = available private supply

IC_i = installed capacity of firm *i*

²⁸ The absorption capacity of private firms was calculated in the following manner:

$$AC = \sum_{i=1}^n (IC_i - UC_i)$$

Where: AC = absorption capacity of private firms

IC_i = installed capacity of firm *i*

UC_i = used capacity of firm *i*

²⁹ This assumption was derived from See Supreme Decree N° 034-2001-PCM.

Figure 1

Analysis of the subsidiary role of state-owned firms in Scenario 1

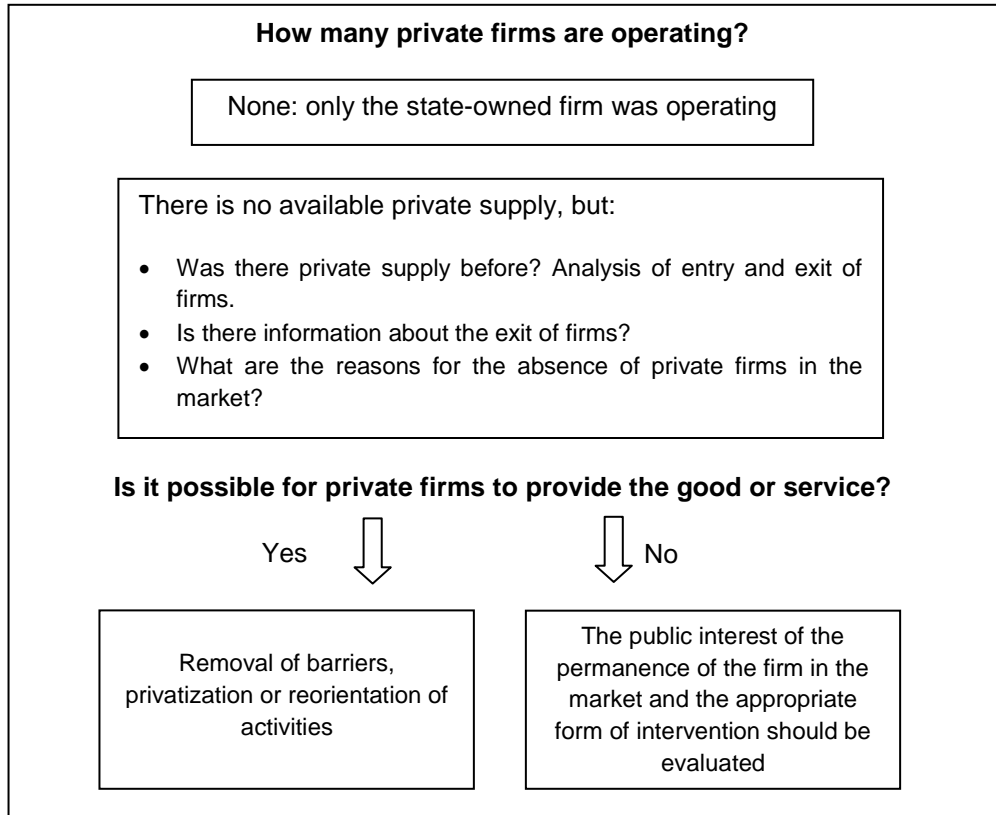


Figure 2

Analysis of the subsidiary role of state-owned firms in Scenarios 2, 3 and 4

