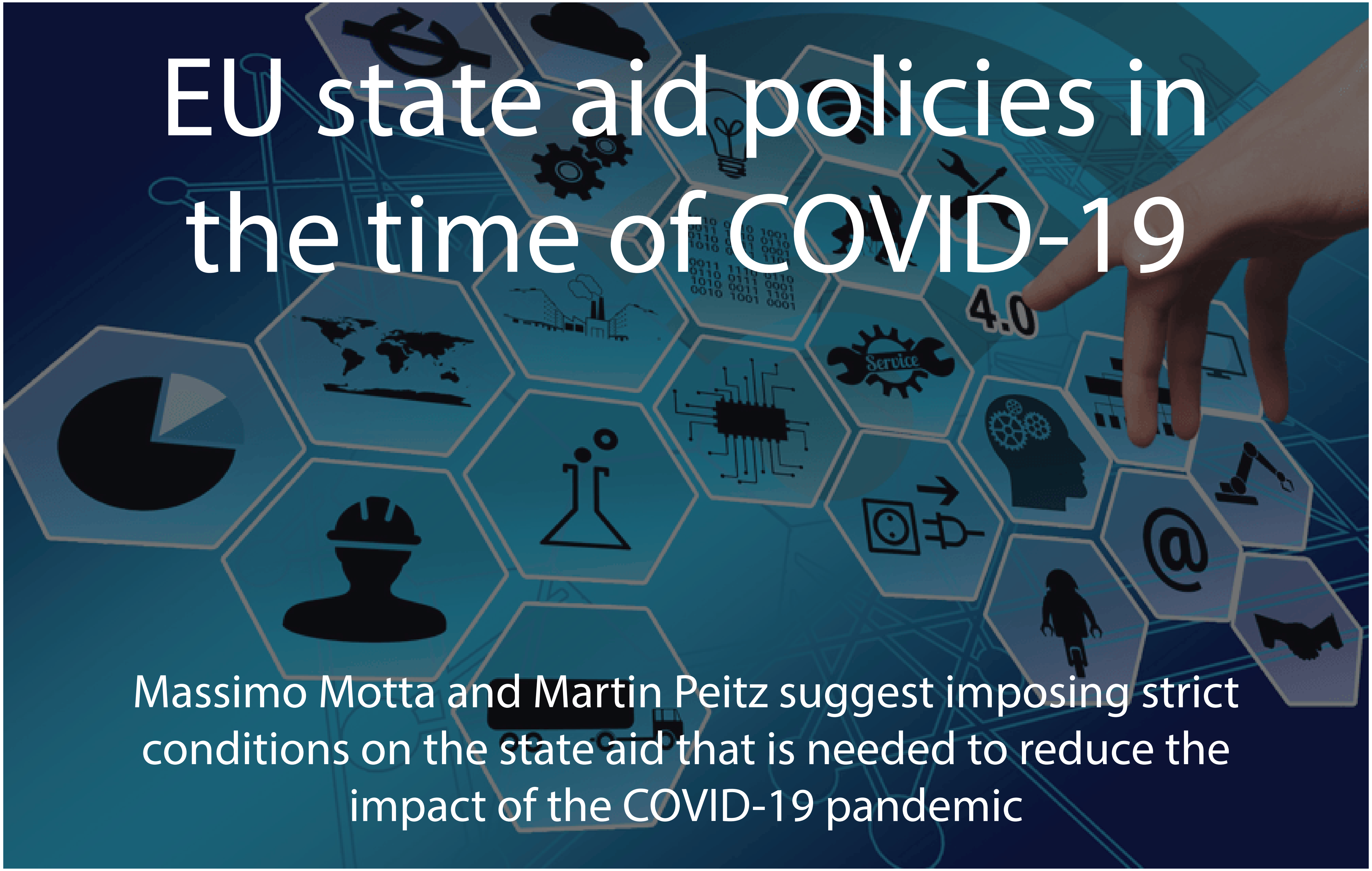

EU state aid policies in the time of COVID-19

Massimo Motta and Martin Peitz suggest imposing strict conditions on the state aid that is needed to reduce the impact of the COVID-19 pandemic

State aid is essential to reduce long-run harm to the EU economy as a result of the COVID-19 crisis. However, non-harmonised programmes across EU member states generate serious risks to the functioning of markets, particularly if they go beyond short-term liquidity provision or employment support.

This column suggests imposing strict conditions on state aid for recapitalisation of firms and argues in favour of an EU-wide programme for critical sectors. Such a programme would prevent harmful market distortions and maintain a level playing field for EU companies.

In recent days, a lot of media attention has been devoted to the different instruments that may allow EU member states – and in particular those most affected by the coronavirus outbreak – to raise funds for the economic policy response to the crisis (eg. Galí 2020).

The crucial issue is how to use such funds – however they are raised – to provide support to European businesses. We focus here on the severe distortionary risks created by state aid policies which are heterogeneous across EU member states.

State aid to firms should be used only when there are market failures. That is, when there are good reasons to believe that the market would not result in efficient and/or equitable outcomes. It should also be effective, and proportional to the aims it intends to achieve.

In the EU context, there is also the risk that public support for national companies creates trade and competition distortions within the internal market, and for this reason the European Commission has been given powers to control state aid.

In the current situation, markets have disappeared on a daily basis, and in most sectors firms' assets are rapidly depleting, thereby further undermining their ability to obtain funding. Thus, there are no doubts that state aid is necessary to avoid long-run consequences for European firms, workers, and their human capital.

In line with this, the European Commission adopted a 'Temporary Framework' to state aid schemes aimed at ensuring firms' access to liquidity and finance, and at preserving employment (European Commission 2020a,2020b). This framework already provides some limiting principles, establishing the temporary nature of such public interventions, and to favour their effectiveness and their incentivising nature.

The longer the participation of the state, the bigger should be the dilution for current shareholders. If a hybrid instrument allowing converting debt into equity was the chosen form of state support, similar principles should apply

For instance, firms which were already in difficulty by 31 December 2019, and hence before the crisis, cannot have access to most measures. Credit guarantees for loans beyond €800,000 cannot apply to more than 90% of the loan; the loan principal should normally not go beyond certain amounts (25% of yearly turnover, or twice the yearly wage bill). Lastly, wage subsidies given to workers which would have otherwise been laid off because of the crisis should not exceed 80% of the monthly gross salary.

While such state aid in support of liquidity is certainly justified, we note that not all member states will be able to provide the same level of support to their firms, creating the risk of market distortions. Although we understand this option is not feasible at the moment, it would have been much better if such liquidity interventions had been offered by an EU-wide fund, so as to maintain the level playing field among EU companies.

The European Commission is now considering the extension of the state aid temporary framework well beyond liquidity support and employment preservation, so as to include the recapitalisation of businesses (European Commission 2020c).

In some circumstances, short-run liquidity support may not be enough, and lack of finance may have long-run consequences. For example, a firm which just about keeps up with its payment obligations may have to abandon or postpone investment and innovation plans. To the extent that such plans meet important EU policy objectives – for instance in energy transition and digital agenda – aid which allows to roll them out may exceptionally be allowed.

There are several risks if public money is used well beyond providing firms with liquidity and helping them to maintain their human capital intact. In particular, there are the risks of tilting the level playing field and of a 'domino effect'.

If only some firms in a given industry are eligible for aid, while others are not – something inevitable when aid is provided by some countries and not by others (for instance because only some member states can afford such aid, or because different states support different industries) – competition will be necessarily distorted. A firm that is generously funded by its home country becomes artificially more competitive, to the detriment of other equally or more efficient rival companies.

As a result, the latter may be relegated to niche markets, or even forced out of business. Or, to the extent that some of these rivals come from a home country which can afford offering state aid as well, a subsidy race among member states may be triggered, with significant waste of public money.

A truly EU public support programme would not suffer from these risks, since funding decisions would be made at a European level, based on commonly agreed goals. In addition, all companies operating in a sector covered by such a programme could be beneficiaries, independently of the country they originate from.

It goes without saying that an EU programme should also be well targeted and take into account that market conditions after the crisis may be different than before it.

Absent a programme at the EU level, distortions are hard to avoid. The European Commission should then limit state aid schemes which go beyond liquidity and employment support as much as possible and impose stringent conditions onto them.

In our view, firms which receive state aid must have constraints on their managerial remuneration, must not distribute dividends, and should not engage in mergers and acquisitions.

If recapitalisation takes the form of partial state ownership, this should be temporary, and fully repaid after a period of at most, say, two years. Shares should be assessed at the market valuation after the crisis has hit but before the rumour of state aid support has spread.

The longer the participation of the state, the bigger should be the dilution for current shareholders. If a hybrid instrument allowing converting debt into equity was the chosen form of state support, similar principles should apply.

Further, and importantly, a credible restructuring plan should be approved before any such recapitalisation, also to avoid that public money goes into firms and industries which are unlikely to be viable in the long run. After the crisis, market conditions will not return to the ex-ante status quo in many industries, including transportation and tourism.

On 27 March, the German Parliament enacted a law that allows partial state ownership as part of its state aid programme. The press has reported that the German government expects hundreds of companies to seek such support.

In other countries, governments are also envisaging public recapitalisation of firms (eg. in support of airlines). And we should not forget that even before the coronavirus outbreak, several member states had called for a relaxation of EU antitrust and state aid rules so as to foster national champions.

If these developments are not discouraged, we shall see an unprecedented volume of state aid which is likely to disrupt the internal market with dramatic long-run consequences.

The founders of the EU understood very clearly that the internal market should be protected from member states favouring their own companies. The Treaty introduced provisions to this effect, and awarded the European Commission the task of state aid control. Now it is the time for the Commission to raise its guard, and make sure that those principles are fully respected.

As believers in the European project, we argue in favour of a well-funded EU aid programme backed by EU money. Such a programme should pay particular attention to sectors such as energy and mobility that are of European importance and faced important structural changes even before the current crisis.

Notwithstanding the legal constraints to raise European debt, this is the right time to push for such a proposal (Benassy-Quere *et al*. 2020). A key advantage of an EU programme over national ones backed by so-called Eurobonds is that the former would avoid the moral hazard problems some fear in the latter case, and may therefore receive wider support among member states. ■

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