State aid and covid-19 - economist perspective

Laurent Eymard
The Brattle Group Inc

Jérémie Cohen-Setton
Hexagon Economics

Shahin Vallée
German Council on Foreign Relations

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The decision to freeze the economy to limit the spread of covid-19 demanded a strong public policy response to keep workers paid and companies afloat. In the absence of a full-fledged European fiscal response, the rapid suspension of European fiscal rules and the relaxation of control regime over state aid were necessary to enable the adoption of national support programmes. However, recent evidence of state aid measures raises the question of durable consequences to the level in the single market and possible risks of growing macroeconomic divergences over time.

The corona epidemic has forced a freeze on the economy for months. As a result, governments have had to deliver substantial stimulus both to keep workers paid and companies afloat. While leaders recently agreed to a sizable European recovery package, the bulk of the policy response has been and remains predominantly national.

The European Commission has indeed allowed governments to deploy their policy tools with force, first by suspending the application of the European fiscal framework and rules and second by relaxing its control over state aid. This has allowed member states to swiftly address the many challenges that immediately faced workers and companies in the early days of the pandemic. Yet this approach also entailed a significant departure from the Commission’s objective of maintaining a playing field within the single market as national support programmes not only differ in size but also in scope, as well as in the range of instruments available. The difficulty for EU competition policy has been compounded as member states increasingly move away from support schemes with a broad and general scope to support strategic sectors and national champions.

There is, therefore, an urgent need to understand in detail the actions taken by national governments to address the covid-19 crisis and assess the extent to which they might affect the level playing field in the single market. Indeed, limited data have been published on the actual distribution of the aid measures that have been cleared by the European Commission in past months. Yet, anecdotal evidence that state aid has been used to prop up national champions and to facilitate the reshoring of economic activities suggests the need for more transparency, more stringent assessments and controls.

### I. The covid-19 economic crisis: a sudden and large shock with uneven effects across sectors

As covid-19 started spreading worldwide, governments responded by locking down the economy to avoid further increases in the number of deaths. While necessary, this decision had immediate and dramatic effects on production and income, and the EU economy is now expected to contract by at least 8.3 per cent in 2020, the deepest recession since World War II.

The economic effects of covid-19 have varied across sectors, with hospitality and tourism particularly affected by social distancing measures and travel restrictions. Figure 1 illustrates these differences by comparing levels of economic activity in France before and after covid-19. The horizontal axis shows that by the end of the second quarter, economic activity in the hospitality, construction, transportation and manufacturing sectors was more than 20 per cent lower than before the crisis. By the end of the third quarter (vertical axis), many sectors had already experienced a strong rebound. If the economy remains open, these sectors are expected to fully recover over the next quarter even in the absence of a vaccine. But other sectors such as transportation and hospitality industries appear seem likely to suffer a protracted contraction until a vaccine is found.

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The magnitude and rapid propagation of the economic shock caused by covid-19 required expedited public intervention, which in the EU could have run counter to state aid and fiscal rules. Mindful of this risk, the EU quickly vowed to do ‘whatever is necessary to support Europeans and the European economy’, which in practice led to the first ever activation of the general escape clause of the Stability and Growth Pact, which relaxed budgetary rules that would normally apply under the European fiscal framework, and to the adoption of the ‘most flexible State Aid rules yet’ with the introduction of a temporary State Aid framework.

II. Covid-19 required that EU state aid rules be relaxed to allow for a timely policy response ...

Was it necessary to relax state aid rules? The response to that question is not as straightforward as it sounds. After all, the European Commission initially emphasised that ‘Member States [could] design ample support measures in line with existing State aid rules.’ Many of the support measures such as wage subsidies, tax deferrals and direct support to households are, for example, applicable to all undertakings and as a result do not qualify as state aid under article 107 of the Treaty on the Functioning of the European Union (TFEU). But as governments contemplated using loan guarantees, various forms of subsidies and targeted aid, it quickly appeared that many, if not most, of these measures would fall under article 107 and would thus require approval from the European Commission (Box 1).

Another option was to simply suspend the rules. But that possibility was rejected. The solution that was chosen to balance the need to provide timely support while preserving the level playing field was to maintain the application of the rules but use the ‘full flexibility’ enshrined in the Treaty. In particular, article 107(2)(b) TFEU authorises state aid granted ‘to make good the damage caused by … exceptional occurrences’ and article 107(3) (b) TFEU allows state aid granted ‘to remedy a serious disturbance in the economy of a Member State’.

The European Commission further adopted on 19 March a ‘Temporary framework for state aid measures to support the economy in the current COVID-19 outbreak’ (the Temporary Framework). The reasoning was that...
by clarifying ex ante which aid measures were likely to be considered compatible under article 107 TFEU, the European Commission would then be able to substantially accelerate its approval process.

In normal times, the assessment of whether a given state aid measure is compatible with the Treaty involves a detailed, case-by-case assessment of its necessity, incentive effect, proportionality and effect on trade and competition. Such detailed – and at times lengthy – assessment was clearly impossible in the context of covid-19. The approach chosen was thus to specify in the Temporary Framework minimum requirements for state aid to be cleared by the European Commission without the need for such detailed assessment.

For liquidity measures such as public guarantees, subsidised loans and support to trade credit insurance, the Temporary Framework, for example, required that a maximum amount per beneficiary be specified. When the Temporary Framework was extended on 3 April to include targeted aid to support the research, testing and production of coronavirus relevant products, the European Commission required that public support do not exceed a certain share of eligible costs. For recapitalisation measures that were included in the Temporary Framework on 8 May, the European Commission required minimum remuneration for public investments and restrictions on beneficiaries’ commercial expansion.

As of 30 September 2020, the European Commission had already adopted 293 clearance decisions for covid-related aid, the majority of which under the Temporary Framework (249 decisions), totalling over €3 trillion in potential support to EU businesses. Massive rescue packages have been cleared with expedited review: while standard state aid reviews can take up to several months, it took the Commission four working days to adopt a clearance decision on France’s €300 billion guarantee scheme and just a weekend to clear Germany’s subsidised loans scheme. The relaxation of state aid control is particularly evident in some of the clearance decisions, which are rather vague: the German subsidised loans scheme cleared on 22 March, for example, does not specify a maximum budget. It is also clear from the fact that national plans have for the most part been accepted without or with limited remedies or control over the actual distribution of the aid.

BOX1. What part of member states’ rescue packages fall within the scope of state aid control?

In theory, both above the line (additional spending and tax cuts) and below the line (liquidity support, subsidised loans and equity injections) measures may fall within the scope of state aid control, provided that they meet the four criteria defining state aid in the meaning of article 107 TFEU. In practice, the bulk of covid-related measures with a direct budgetary impact have fallen outside of state aid rules, while guarantee (and subsidised loans) schemes were for the most part notified to the European Commission. Figure 2a compares the size of the off-budget liquidity support as summarised by the International Monetary Fund (IMF) to that of the loans, guarantees and recapitalisation schemes authorised by the European Commission. It shows that, with the notable exception of the UK, national liquidity support schemes have by and large been notified to and cleared by the European Commission. On the other hand, Figure 2b shows that only a small share of the budgetary measures introduced to cope with the crisis qualify as state aid in the meaning of article 107 TFEU and ended up being notified to the European Commission.

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9 The Temporary Framework also relaxes some rules that are normally applied in normal times like the “one time last time” principle, which foresees that restructuring aid may only be granted once over a period of 10 years for undertaking that had already received rescue aid in the past 10 years (Temporary Framework, §15).
10 On June 29 the Temporary Framework was further extended to include support measures for micro and small companies. The Commission is considering further amendments to the Temporary Framework to prolong it by six months to 30 June 2020 and to include additional types of aid https://ec.europa.eu/commission/presscorner/detail/en/statement_20_1805.
11 According to the State aid Scoreboard 2019, the average duration of notification and prenotification procedures in 2014-2018 has been 4.5 and 7.1 months respectively.
14 The four criteria are (i) involvement of public resources, (ii) presence of an economic advantage, (iii) selectivity and (iv) effect on trade and its potential to distort competition (Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016XC0719(05)&from=EN).
Figure 2a: Bulk of Liquidity Schemes Have Been Notified to European Commission

Source: IMF Fiscal Policies Database and DG Comp. Authors’ calculations.

Note: IMF data available for 14 out of EU28 countries, accounting for 90% of the bloc’s GDP. Small differences may come from different estimation of the schemes’ size and measures announced between June 2020 (last update of the IMF fiscal monitor) and September 2020.
III... but the relaxation of state aid rules raises long-lasting challenges for the single market

Assessing the compatibility of state aid with the treaty is by nature a balancing exercise, in which a measure’s positive effects are weighted against potential distortions of competition. There is little debate that public intervention was necessary in the wake of the pandemic, and that it produced positive economic effects by softening the impact of an already devastating crisis. And yet, the compatibility of the massive aid packages cleared under the Temporary Framework raises important questions.

The fact that member states have for the most part only published limited data on the actual distribution of the aid measure makes it difficult to assess the degree of possible competitive distortions. However, anecdotal evidence that state aid has been used to prop up national champions and to facilitate the reshoring of economic activities suggests the need for more stringent assessments now that the most acute phase of the crisis is over.

Data on actual support is scarce, and more transparency is required to assess potential distortions

In the first few weeks of the crisis, a first wave of corporate support was introduced to cope with the liquidity crisis facing European businesses. In March 2020, Germany announced a massive extension of public guarantees for firms through the newly created Wirtschaftsstabilisierungsfonds, economic stabilisation fund and the public development bank KfW. While it initially indicated that these would provide for up to €819.7 billion in guarantees (25 per cent GDP), Germany later clarified that the volume of federal guarantee would in fact not be limited and could even exceed these already staggering figures. Also in March 2020, the European Commission cleared France’s guarantee programme, designed to cover up to €300 billion in loans. The staggering headline envelopes of these guarantee schemes initially raised the concern that only member states with more fiscal space would be able to support their corporate sectors, putting firms in more indebted countries at a disadvantage. By the end of April, other large European countries had, however, completed their response packages with the deployment of similar public guarantee schemes aimed to support credit to firms (€565 billion in Italy, £331 billion in the UK and €129 billion in Spain).

Distortions can, however, arise in other forms. For example, through the allocation of funds across sectors and firms. The clearance decisions provide limited information regarding how schemes’ beneficiaries are selected. Because the schemes are largely horizontal, covering all sectors (except for financial services), one would expect actual distribution to be demand-determined, and to be directed to sectors that suffered the hardest blow.

However, one cannot rule out that the allocation of credit is also used strategically to support certain industries or favour specific companies. Only granular data can help. In the United States, loan-level data information is, for example, provided for the Paycheck Protection Program. In fact, section 4 of the Temporary Framework provides that member states have an obligation to publish comprehensive data on individual aid above certain thresholds on a dedicated website but only within 12 months. With few exceptions, such as Estonia, Latvia or to a lesser extent the United Kingdom, member states have yet to comply with this obligation. In fact, even aggregated data on actual take-up numbers can be difficult to obtain, with France being the only country providing a breakdown at the sectoral level is available (Box 2).

To assess the risk of long-term competitive distortions, greater transparency is needed, and the European Commission could tighten and harmonise reporting requirements. Data on the role played by national development banks and commercial banks in allocating covid-19 credit support should also be provided.

BOX2. The relationship between output contraction and aid intensity

France publishes sectoral data on the actual allocation of guarantees by sector. As expected, the data reveal a strong link between the extent of the output collapse in a sector and the amount of credit support received (Figure 3). There appear however to be some exceptions. While the output contraction due to covid-19 has been comparable in the trade, finance and insurance, agriculture and energy sectors, firms in the trade and financial sectors benefited, in relative terms, from a much greater level of support. Conversely, the transportation sector has received less support that what its output contraction predicted.

Whether the surprisingly large amounts of credit support received by the trade, financial, and insurance sectors was warranted is beyond the scope of this analysis. But establishing such patterns is a first necessary step in the monitoring of aid measures.

Figure 3: Output contraction and aid intensity by sector in France

Targeted aid, the risk of a subsidy race, and the temptation of helping national champions

Early support measures for the corporate sector were largely horizontal, open to all sectors (except credit and financial institutions, as per article 20-bis of the Temporary Framework). Yet subsequent help has been increasingly targeted at specific sectors and undertakings. This can be seen in Figure 4, which shows the amounts of above the line aid and sector-specific help cleared by the European Commission every month. Clearly, sector-specific support measures have taken over the importance of horizontal support scheme over the summer. Targeted schemes are more likely to represent a challenge to the level playing field, especially when they include conditions designed to promote domestic economic interests at the expense of foreign economic interests.

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21 Because financial institutions are precluded from accessing the French guarantee scheme, beneficiaries in the financial and insurance sector are likely to be insurance companies.

22 Above the line support corresponds to measures with a direct impact on member states' budgets, such as additional spending and tax cuts, as opposed to below the line measures such as liquidity support, subsidised loans and equity.
As part of the third amendment to the Temporary Framework, the European Commission introduced a provision that explicitly forbids that aid ‘be conditioned on the relocation of a production activity or of another activity of the beneficiary from another country within the EEA to the territory of the Member State granting the aid’. And yet, several packages display such features. The €5 billion of government loan guarantees for the automobile manufacturer Renault was, for example, conditioned on limiting the number of factory closures in France. Finance Minister Bruno Le Maire explicitly stated that the reshoring of the production of electrical and hydrogen-fuelled vehicles and batteries was a condition for accessing help under the government’s automobile plan. Beneficiaries of the €15 billion aerospace plan were also required to think about ways to bring production and strategic technological know-how back to France. Finally, the €100 billion stimulus package announced by the French government on 3 September 2020 earmarked €1 billion to the relocation of strategic industries and the support to industrial investment in France.

The case of Lufthansa’s €9 billion support package illustrates another way state aid can be used to promote domestic economic interests at the expense of foreign economic interests. Here the issue was not that the help was conditioned on repatriating production. But the sheer size of the package, which suggested that some of the covid-19 money was used to subsidise a national champion. In fact, even Lufthansa’s own CEO, Carsten Spohr, admitted that the total envelope was more than strictly necessary to deal with the losses associated the crisis and instead reflected the government’s desire to reinforce Lufthansa’s ‘global leading position’. Yet Germany’s

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25 Our translation. In French, beneficiaries are asked to ‘engager une réflexion sur le rapatriement de productions ou de savoir-faire technologiques stratégiques pour la filière française et européenne’. See https://mineli.hosting.augure.com/Augure_Mineli/ContenuEnLigne/Download?id=94C9F0D9-0CB4-4D85-9026-7B015E7F1E7&filename=2196%20DP%20-%20Plan%20de%20soutien%20%C3%A9l%C3%A9ctrique%20%C3%A9lectrique%20%C3%A9lectrique.pdf.

support package to Lufthansa was cleared under the Temporary Framework, with what appear to be relatively mild remedies.27

In terms of their compatibility with the single markets, targeted covid-19 aid raises two main issues.

1. **Proportionality of the rescue measures.** Under normal circumstances, aid measures that go beyond what is strictly necessary to achieve the objective pursued (which in this case is to alleviate the effect of the covid-19 crisis) would not meet the criteria of proportionality and be considered as incompatible with the common market. In the current context, conducting such proportionality assessment would require one to disentangle the effect of the crisis from that of other factors. Such a detailed assessment is not always conducted for measures notified under the Temporary Framework, however, and it is unclear whether the safeguards included in the Temporary Framework (in the form of a maximum aid amount, loan and guarantee maturity) are enough to ensure that aid measures are indeed proportionate.

2. **Effect on competition.** The effects that a given aid measure may have on competition are often difficult to predict ex ante, even in normal times. In the context of a global pandemic, these difficulties are compounded by the significant uncertainty regarding what would have happened absent the aid (the ‘counterfactual’ scenario, the definition of which is an essential part of the Commission’s assessment). In addition, the effect of a given measure may not be analysed in isolation, as the various components of member states’ rescue packages (including measures that do not constitute state aid in the meaning of article 107 TFEU) may complement and reinforce one another.

**IV. Conclusion**

Covid and public intervention represented a challenge for economic policy in general and for state aid control in particular. Policymakers are faced with the difficult need to meet short-term objectives by allowing generous and expedited rescue packages while ensuring longer-term objectives, such as the level playing field in the single market or economic convergence across the EU.

The Commission should be commended for its swift reaction, which made it possible for governments to deploy the full force of their policy instruments to address the unprecedented macroeconomic challenges of the covid-19 crisis. Enforcement of state aid rules has been adapted so that it would not stand in the way. Yet concerns about the single market are growing as it appears evident that both member states are unevenly able to deploy rescue instruments (because of fiscal space but also because of a lack of tools such as national promotional banks) and that policy is becoming more and more targeted to support individual companies or sectors.

This calls for some reaction from the EU to ensure that this first-order objective of responding to the economic shock does not leave lasting scars on the European economy and the single market. To avoid this pitfall, it should start by expanding its transparency and disclosure requirements and enhance the set of European tools so as to gradually take over from national governments and avoid a hidden subsidy race.

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27 To secure the Commission’s approval, Lufthansa had to waive landing rights for six out of 300 planes in total at Frankfurt and Munich airports (https://www.euractiv.com/section/aviation/news/ryanair-challenges-lufthansa-s-bailout-package/).
Laurent Eymard
The Brattle Group Inc

Mr. Eymard has more than 10 years of experience advising clients in a wide range of competition cases and civil litigations across a wide range of sectors.

He has been involved in several merger, antitrust, and state aid cases before the European Commission and other European jurisdictions – primarily in France and Belgium.

Mr. Eymard has extensive experience advising clients on notifying competition authorities of complex mergers, especially in cases requiring an analysis of local competition dynamics or bidding data. He has also provided expert economic evidence in civil litigations in numerous sectors, including telecommunication, air transportation and fast-moving consumer goods. His experience includes working for both defendants and claimants in high profile litigations concerning concerted practices and complex abuse of dominance issues.

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Rond-Point Schuman 6
7th Floor
1040 Brussels,
Belgium
Tel: +32.2.234.6365
Fax: +32.2.706.5477

www.brattle.com

Laurent Eymard
laurent.eymard@brattle.com
Jérémie Cohen-Setton is a macroeconomist specialising in fiscal policy. Jérémie worked as an economist at the Peterson Institute for International Economics, in the global economics team of the UK Treasury that prepared the G20 London Summit, at Bruegel, and in the European Economics Team of Goldman Sachs. He holds a PhD in economics from the University of California, Berkeley.

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Square de Meeûs, 35
B – Brussels 1000
Tel: 32 2 895 36 21

www.hexagon-economics.com
Shahin Vallée is a senior fellow in DGAP’s Alfred von Oppenheim Center for European Policy Studies. Until June 2018, he was a senior economist for Soros Fund Management, where he worked on a wide range of political and economic issues. He also served as a personal adviser to George Soros. Prior to that, Vallée was the economic adviser to Emmanuel Macron at the French Ministry for the Economy and Finance, where he focused on European economic affairs. Between 2012 and 2014, he was the economic adviser to President of the European Council Herman Van Rompuy. This experience has put Vallée at the heart of European economic policy discussions since 2012, in particular on issues related to the euro area and international policy coordination (IMF, G20). Having started his career working for social investment vehicles and entrepreneurship in Africa, he has also worked as a visiting fellow at Bruegel, a Brussels-based economic think tank, and as an economist for a global investment bank in London.