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State Aid Policies in Response to the COVID-19 Shock: Observations and Guiding Priciples

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State Aid Policies in Response to the COVID-19 Shock: Observations and Guiding Principles[1]

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Abstract: The drastic economic shock suffered around the world has led many countries to roll out support programmes to its economies. Firms in difficulties may have part of their labour costs covered by the state, may be allowed to postpone due tax payments, and may be beneficiaries of sector-specific or company-specific support programmes. In this article, the authors reflect on the general challenges when designing state aid policies and set out some guiding principles on state aid programmes by EU member states. They address the challenges that arise within the European Single Market when individual EU member states implement their own, non-harmonised programmes. In particular, such programmes run the risk to the distort competition in the Single Market. This risk is particularly pronounced for state support that goes beyond short-run liquidity provision and employment support. Oversight by the European Commission and EU-wide programmes for critical sectors are seen as essential to maintain the Single Market intact.

Keywords: state aid, recapitalisation, COVID-19, European Single Market

JEL-Classification: L52, L53, H25

[1] This article is based on, but reorganises and adds to, Motta and Peitz (2020a,b). Some parts have been taken literally. Martin Peitz gratefully acknowledges financial support from the Deutsche Forschungsgemeinschaft through CRC TR 224 (project B05).

Thanks to COVID-19, markets have disappeared from one day to the other, and in most sectors firms' assets have been rapidly depleting. This has increased many firms' needs to obtain funding. However, the ongoing economic uncertainty has made it even more difficult for firms to obtain credit from the financial sector. Thus, firms which are profitable in normal times face liquidity problems as a result of a negative supply and/or demand shock, and the financial sector does not satisfy the individual needs for liquidity support because of the large macroeconomic risks. In such a case, governments have to step in and provide liquidity support or the appropriate guarantees such that banks and other financial institutions insert the needed liquidity. Governments may also design other support schemes that protect workers or help demand to recover. In the current crisis, there are no doubts that state support is necessary to avoid long-run consequences for firms, workers, and their human capital.

Many countries, including most member states in the EU, have announced various measures (and consider new ones) against the economic crisis due to the COVID-19 pandemic and the subsequent efforts to control the health crisis. State aid can be seen as a response to a system failure in response to a severe economic shock, either hitting one sector (with possible contagion effects in other sectors) or – as in the case of COVID-19 – simultaneously hitting several sectors.

As a general principle, state aid to firms and sector-specific support schemes 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. While there seems to be wide agreement that government inaction is suboptimal during the COVID-19 crisis, a few observations help when designing and revising state support schemes.

1. Sectors are hit differentially by the COVID-19 crisis.

It has been documented that supply chain disruptions and demand shocks have had differential effects on sectors (for the UK, see, for instance, Bloom et al., 2020). This implies that some sectors do not need any or very little support, while others are in dire need. Clearly, liquidity support can then be targeted in the sense that only those firms in need of such support should sign up for the support programme. This requires that firms not hit by the shock do not have the incentive or the ability to move under the umbrella of a liquidity support scheme. This also applies to the state covering part of the labour costs of a firm (in particular, covering a fraction of the costs of furloughed employees). Keeping viable firms alive and enabling them to keep their staff in the books makes it possible to quickly restart and scale up economic activities when demand picks up again and supply constraints have disappeared. By covering part of the wage bill for unemployed or underemployed staff, this creates an incentive for firms hit by the shock to participate in this support scheme, while firms not hit prefer not to do so. Thus, well-designed liquidity support and employment subsidies can be applied across the whole economy, while they are effectively targeted in the sense that only those firms negatively affected will participate in the program.

2. Some firms were struggling even before the COVID-19 shock.

Some firms would be in difficulty in any case, and the risk of a badly designed, too generous support scheme is to keep those firms alive. Entry and exit of firms is an important process for an economy to flourish, as it leads to a better allocation of resources in the economy. Since such a view may be dismissed as “neoliberal” in the public debate, it is important to reflect on what happens when non-viable firms are kept alive. Consider the following constructed example: A village has a zoning law in place such that two restaurants have a license to operate. Suppose that one of the restaurants serves lousy food and cannot pay its bills, while the other serves decent food. If the village authorities provide support to the former so that it can cover its losses, the villagers will continue to be served lousy food in this restaurant. If this restaurant were to exit the market, a different restaurant may serve the villagers better food. This increases the competitive pressure on the other restaurant and encourages it to strive even harder.

Therefore, state support schemes and in particular state aids that apply to a particular sector or particular firms run the risk to support firms that are not viable in the long run even absent the COVID-19 shock. It is therefore important that support schemes are temporary in nature. Also, to be eligible, firms that have been around for some time should provide evidence that their business was not loss-making prior to the outbreak of the covid-19 pandemic.

In line with these two observations, the European Commission adopted a “Temporary Framework” to state aid schemes aimed at ensuring firms’ access to liquidity and finance, and at preserving employment (see European Commission, 2020a and 2020b). This framework provides some limiting principles, establishing the temporary nature of such public interventions, and favouring their effectiveness and their incentivising nature. 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 EUR 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); and 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.

3. Sectors and firms hit by a temporary shock may also be subject to a long-term shock.

Some industries may never look the same after covid-19. The larger the part of the temporal shock becoming permanent the more problematic is state aid for the respective sectors or firms that aims to preserve the status quo ante. Given the large fiscal strains on many countries, we submit that such support schemes for sectors which are unlikely to fully recover should not go ahead. We admit that such decisions are politically particularly hard to sell if the respective sectors are labour-intensive and have powerful trade unions or industry lobby.

To the extent that this is foreseeable, support schemes should not use the status quo before the shock but the conditions that will prevail afterwards for reference. Thus, forward-looking state aid may also apply to sectors which were in decline before the shock or which will feel a long-run effect of the shock. Such sector-specific support schemes may include measures that facilitate scaling down and restructuring (e.g., in the case of the car industry, a move away from fossil fuels). Such state aid has to be carefully designed so as to avoid spending funds on a lost cause and preserving an outdated industry structure.

4. In the EU Single Market, some countries have more fiscal freedom for support programmes than others.

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. State aid programmes by EU member states require the approval by the European Commission (EC). The founders of the EU had understood very clearly that the internal market has to be protected from member states favouring their own companies, introduced provisions in the Treaty to this effect, and awarded the European Commission the task of state aid control.

The size of the economic shock and the ability to cushion the impact through state aid often do not go hand-in-hand: In the COVID-19 crisis most countries hit severely by COVID-19 are not in a strong fiscal position. This negatively affects the functioning of the Single Market. In particular, there are the risks of tilting the level-playing field and of a "domino effect" (see Motta and Peitz, 2020a). 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 as-efficient or more efficient rival companies, and 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.

The EC extended the state aid temporary framework well beyond liquidity support and employment preservation, so as to include the recapitalisation of businesses (see European Commission, 2020c). In some circumstances, short-run liquidity support may not be enough, and lack of finance may have long-run consequences: 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 (we proposed this in Motta and Peitz, 2020a; and this is also the position taken in European Commission, 2020c).

If recapitalisation takes the form of partial state ownership, as a matter of principle, this should be temporary and fully repaid shortly after recovery of the sector, that is, after a period of at most, say, a couple of 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.) The EC has adopted these principles in the extension of the temporary framework (European Commission, 2020c).

Taking into account the arguments made at point 3 above, a credible restructuring plan should be approved before any recapitalisation, also to avoid that public money aims at supporting a level of activity by a firm or in an industry which is unlikely to be viable in the long-run.

Another instrument to revive a sector is a demand-side stimulus, e.g. in the form of vouchers for particular purchases. Such an instrument has been used in the past to stimulate car sales and is also on the table in the aftermath of the COVID-19 crisis. There are several problems with a broad demand-side stimulus (e.g., covering car purchases broadly): (i) demand expansion may be limited if vouchers are redeemed mostly by people who would buy in any case – this is clearly the case if transaction prices are increased by the amount of the voucher in which case the instrument simply leads to a cash transfer from the government to the firms in the sector; (ii) if consumers pay less after redeeming the voucher and demand picks up, this increased demand may come at the loss of future demand because of intertemporal substitution. To a certain extent, such intertemporal substitution may be socially desirable, but it should be kept in mind when introducing the subsidy. Furthermore, a programme introduced in one member state, but not in others, may still be distortive even if applied to all purchases within the country in case there is a home bias in consumption. For example, in the car industry, the home bias is well documented.

In any case, a voucher programme for an industry is an indirect subsidy to the firms in the industry. It may be popular as it may be communicated as benefitting primarily consumers. And it may be the preferred instrument by industry lobbyists, as the firms operating in the industry may get the support with few strings attached (e.g. on managerial compensation and dividend policies). Strings can more easily be attached in case of state aid directly going to firms. It should be stressed that a voucher programme might have further pitfalls. For instance, if vouchers for the purchase of cars running on fossil fuels were introduced, this would also be in conflict with the EU's climate objectives and other environmental goals (reduction of NOx emissions).

A truly EU public support programme would not suffer from the risks to the functioning of the internal market, since funding decisions would be made at a European level, based on commonly agreed goals; and all companies operating in a sector covered by such a programme could be beneficiaries, independently of the country they originate from, as pointed out in Motta and Peitz (2020a). In line with this observation, the European Commission (2020c, p. C164/4) stated that "[i]f support were to be granted at EU level, taking into account the EU common interest, the risk of distortion to the Internal Market could be lower, and may therefore require less stringent conditions to be imposed. The Commission considers that additional EU level support and funds are necessary to make sure that this global symmetric crisis does not transform into an asymmetric shock to the detriment of Member States with less possibility to support their economy and the EU's competitiveness as a whole."

5. In some EU member states some companies and sectors enjoy strong backing by the state.

In some countries, some individual companies are particularly close to political decision-making and may lobby for particularly generous support programmes with few strings attached. While an individual company's influence at the member state level may be strong, its position is much weaker at the EU level. This provides another strong argument in favour of EU-wide programme, as the EC is less likely to be captured by special interests than individual member states. For the sake of well-functioning economies in all member states, it would help if member states publicly acknowledged the advantages of EU-wide programmes.

Based on observations at points 4 and 5, an advantage of an EU-wide sector support system compared to national programmes is that all firms in that particular sector would be eligible for aid, which would eliminate a source of distortion, namely, that only firms from some member states (and possibly the wrong ones) may receive aid within the sector.

One of the advantages of the EC playing a central role in designing a European aid programme is that it would reduce horse-trading between member states. The track record of the EC in this regards gives some reasons for hope: over the years the EC has (in general) been able to resist the recurrent pressure for it to relax state aid control.

In addition to competition policy objectives, there are other policy objectives that are linked to EU-wide goals of society and may justify a leadership role by the EC. Individual member states may not have the resources or, because of cross-country externalities, may not be willing to provide sufficient resources to pursue objectives, such as climate and digital ones, or resilience in times of crisis, which generate benefits also in other member states (see Bénassy-Quéré et al, 2020, and Motta and Peitz, 2020b). State aid in the member states and EU funding schemes should then also be aligned with those goals.

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