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State Aids in the EU and the Economic Crisis

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Background

The global financial and economic crisis has posed a fresh challenge to the restrictions on state aid to businesses within the EU. The European Commission has so far successfully held the line but it has also recognised the unique nature of the problems that Member States are now facing.

The Treaty of Rome provided the European Commission with the powers to tackle state aids to industry and commerce. Such aids can (and do) distort competition in the Single Market by giving state-supported enterprises an unfair advantage over their competitors. The record of the EU in clamping down on such aid was poor until the late 1980s when a succession of Competition Commissioners enforced the existing rules more rigorously and introduced new ones. State aid as a percentage of GDP has fallen across the EU consistently since 1992; from 1.1 per cent across the EU27 in 1992 to 0.5 per cent in 2007. This general downward trend nonetheless disguises wide variations between Member States in their performance.

In the past there was a concentration of state aid in agriculture, fisheries and transport. The deregulation of air travel in 1990s and new regulations for railway operators have reduced the level of intervention in the transport sector but the accession of central and eastern European countries that until recently had entirely state-run economies, has presented new challenges.

The current economic and financial crisis has led to state aid to banks and other financial institutions – not previously large recipients of aid in most of the EU – and to increased proposals for state aid to other sectors of the economy, including car-making and other parts of the manufacturing sector. In several Member States, governments have proposed measures that amount to state aid combined with elements of protectionism. This apparent return to the economic policies of the 1970s and early 1980s marks a sharp turn away from the market-orientated policies that have developed in many, if not all, EU Member States in the last 15 years.

In this paper we do not discuss the general issue of EU competition policy – that is covered by a separate SE group paper. This paper deals with specific issues arising from the current global economic and financial crisis. It includes a brief explanation of the current rules; consideration of whether those rules have been broken by recent interventions; and asks whether, and if so how, the EU will able to return a position where state aids are once again in decline.

The State Aid Rules

Article 87 of the Treaty establishing the European Community says that "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition" by favouring particular companies or the production of certain goods, "in so far as it affects trade between Member States", is incompatible with the Single Market. A separate Article deals with public undertakings (such as water companies and energy utilities owned by a Member State) and places them under the state aid rule referred to above and the general competition provisions of the Treaty.

There are exceptions to Article 87, where the Treaty declares them to be compatible with the Single Market, including aid in the event of natural disasters "or exceptional occurrences" and a number of areas where aid "may be considered to be compatible" with the Single Market, including aid "to remedy a serious disturbance in the economy of a Member State".

Should the Commission find that a particular state aid – all such aids have to be notified to the Commission – is incompatible with these rules, then it can require the aid to be abolished or altered and its decision can only be overturned by a unanimous decision of the Council of Ministers.

State Aids and the Current Crisis

<u>Banking & Financial Institutions</u>

When the banking crisis began in 2007, it proved necessary for the Commission to approve emergency rescue plans put forward by Member States for banks and other financial institutions. Initially, the problem was relatively small with the UK's Northern Rock being an early example of a state-managed rescue in which public funds were put at risk to save the institution. But in the autumn of 2008 the number of institutions in difficulty mushroomed dramatically. In response, on 13 October 2008, the Commission produced an emergency set of guidelines on measures to support banks during the crisis which were complemented and expanded in some respects by guidance on bank recapitalisation, published on 8 December 2008.

The purpose of the two sets of guidance was to indicate to Member States how the Commission would apply the state aid rules in the Treaty to measures to rescue banks. In order to comply with the October rules, the following conditions would have to be met:

- eligibility for a support scheme could not be based on the nationality of a company or its staff;
- all state commitments were to "be limited in time in such a way that it is ensured that support can be provided as long as it is necessary to cope with the current turmoil in financial markets" but would be "reviewed and adjusted or terminated as soon as improved market conditions" permitted;
- state support was to be clearly defined and limited in scope to what was necessary to respond to the current "acute crisis in financial markets" and must exclude any "unjustified benefits" for shareholders at the taxpayer's expense;
- the banks would at least in part have to pay for the support they received;

- Member States had to prevent banks from adopting aggressive marketing strategies or other inappropriate behaviour that exploited their state guarantees;
- banking rescues were expected to be followed up by wider restructuring of the financial sector, including "restructuring individual financial institutions that had to rely on state intervention".

The December guidance reiterated that state aid for banks "must not result in recipient banks enjoying an artificially advantageous competitive position compared to banks not receiving aid *e.g.* in other Member States". It provided further guidance to deal with the two different sets of circumstances of banks that had emerged in the crisis: those that were fundamentally sound but needed temporary support to maintain liquidity in the financial system; and those that were what the Commission called "distressed banks" whose business model was broken because they had taken excessive risks. But the Commission has consistently said that the aim of all measures to support banks must be to ensure that banks resume a more normal lending pattern so that the wider economy benefits and not just the banks. Further guidance was issued in March 2009 to ensure that the purchase of so-called "toxic" assets from banks by central banks was done in accordance with state aid rules, for example, Member States must not discriminate in favour of banks based in their own country.

<u>Manufacturing & Other Sectors</u>

The European Council having agreed in October and December 2008 to EU-wide emergency measures, known as the European Recovery Plan, the Commission then set out to provide temporary state aid rules to match the plans for intervention that were developing in many countries. EU governments felt under pressure to follow the US lead and come up with a package of aid to support industries experiencing dramatic falls in business, notably vehicle manufacturing.

The Commission produced a *Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis*, in early April 2009. This was a detailed framework covering all major sectors where intervention was proposed and setting out what kind of intervention would be permitted under these temporary state aid rules.

The framework was emphatic about the need to maintain proper control over state aids even in these unusual circumstances: "In the current financial situation, Member States could be tempted to go it alone and, in particular, to wage a subsidy race to support their companies". Past experience, the Commission said, showed that "individual action of this kind cannot be effective and could seriously damage the internal market". It was crucial when granting support, to "ensure a level playing field for European companies and to avoid Member States engaging in subsidy races which would be unsustainable and detrimental to the Community as a whole". Competition policy was there to ensure that there was such a level playing field.

"While State aid is no miracle cure to the current difficulties, well targeted public support for companies could be a helpful component in the overall effort to unblock lending to companies and to encourage continued investment in a low-carbon future", the Commission said. It was these twin aims – freeing up lending to companies to keep them solvent and the encouragement of low-carbon technology and its development – that the

Commission used to justify limited state aid during the current crisis. But the Commission was careful to remind Member State governments that they had existing powers to use state aid to help companies under the permanent rules even without this temporary framework and other powers that did not amount to state aid (the latter including extending payment deadlines for social security contributions or taxes or grants to companies to help with up to 80 per cent of training costs, for example).

The Commission believes that current economic circumstances meet the test of "a serious disturbance in the economy of a Member State" required by Article 87 of the Treaty referred to above and that therefore justifies the use of temporary state aid.

It drew up the criteria under which temporary state aid may be granted now, these include:

- grants of no more than €500,000 per business;
- the aid is granted as part of a scheme, is not export aid and does not favour domestic over imported products;
- the aid is granted to businesses that were not in difficulty on 1 July 2008;
- firms will have to declare any other aid and total aid must not exceed €500,000;
- all grants must be made by 31 December 2010.

In respect of guarantees on loans offered by the state to businesses, there are strict rules as well which restrict the amount the state can pay to subsidise the premium on the loan and the guarantee cannot exceed 90 per cent of the value of the loan. The temporary state aid scheme also covers subsidised interest rates.

A key part of the temporary state aid rules is the new provision in respect of "green" products. As the EU wants to continue to adhere to its environmental goals despite the economic crisis, the rules permit the payment of grants to firms to develop green products but do so under specific conditions. The temporary framework said that "additional measures in the form of subsidised loans could encourage production of 'green products'" but it warns that "subsidised loans may cause serious distortions of competition and should be strictly limited to specific situations and targeted investment". The temporary framework permits interest subsidy for such loans for a limited period and in accordance with specific criteria. These criteria include a limit of two years on the subsidised loan; aid is limited to new products with environmental benefits (although existing products could be eligible in certain circumstances); and the interest rate subsidy is limited to 25 per cent for large firms and 50 per cent for small and medium-sized enterprises. It is expected that the car industry will be one of the major beneficiaries of this part of the temporary state aid framework through grants to develop greener cars.

Have the Rules been Broken?

The Commission has acted in cases where it thinks Member States have gone beyond what is necessary in the current situation. For example, when the French Government proposed last November to inject capital into its six main retail banks when they were not in difficulty, it was rejected by the Commission despite the French Government's objections.

In the case of the German bank, Commerzbank (Germany's second largest bank), an injection of €10 billion was permitted in May 2009 provided that it disposed of its investment banking division and its major property business and refrained from takeovers for three years.

Additional state aid from the Belgian and Luxembourg governments to Fortis Bank was allowed by the Commission against the objections of some of Fortis Bank's investors. The Commission permitted the injection of funds in order to enable Fortis to be sold to the French bank BNP Paribas.

In cases such as these, the Commission has had to make hard judgements whilst often under pressure to permit state aid from a Member State government and with the future of important national institutions uncertain. It is hard to judge whether the Commission has made the right decision in every case but it is certainly fair to point out that many of the state aids permitted in recent months would have been rejected before the current financial crisis developed. The normal rules have not been applied but it would have made no sense to apply them in cases such as bank rescues because these were abnormal situations.

What Future of State Aids Now?

The culture of the EU has changed since the economic crises of the 1970s triggered a wave of state interventions in European economies. Market economics is now firmly established in many Member States who may find their electorates unwilling to pay the costs of propping up ailing businesses in future. The level of national debt built up during the banking rescues may also force countries to sell off their share of these assets when times improve in order to reduce debt; this in turn will lead to a return to more normal competition conditions over time.

In the case of the banks, the EU Competition Commissioner, Neelie Kroes, has made it clear that the concentration of ownership (and business) that has resulted from bank mergers cannot be allowed to continue indefinitely. Such conglomerates will have to be restructured in Ms Kroes's view, in order to reduce the anti-competitive situations that have arisen as a result of the financial crisis.

The dramatic events of the last year have led to emergency measures within the EU and in its Member States in response to an unprecedented banking crisis and a related economic crisis. It is too early to say that these crises have been exploited to create unfair advantages for some companies in some Member States. What can be said with some degree of certainty is that without the provisions of the Treaty, and the Commission powers to apply them, the situation would have been far worse. But the pressure on governments to act improperly is strong and will remain so at least as long as unemployment is on a steeply rising trend. Political pressure to save jobs and preserve important national businesses could lead to Member States acting – as they have in the past – in a manner contrary to the rules of the EU. It is up to DG Competition in the Commission to enforce the rules using the extensive powers they have, including recourse to the European Court of Justice and the fining of Member State governments.

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The Senior European Experts Group is an independent body consisting of former high-ranking British diplomats and civil servants, including several former UK ambassadors to the EU, and former officials of the institutions of the EU.

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