



THE ECONOMICS OF STATE AID IN TIMES OF CRISIS: HOW LARGE IS THE DAMAGE?

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In light of the current health crisis, the world economy has come to a near halt. Businesses have asked employees to work from home, restaurants and shops have closed and travellers have cancelled their plans in an effort to flatten the projected infection curve of COVID-19.

In response, national and EU public authorities have offered immediate support to alleviate the impact that these actions have on the economy. The European Commission referred to measures including supporting fiscal flexibility, ensuring solidarity in the European Single Market, mobilising the EU budget, alleviating the impact on employment and introducing a response investment initiative. The Commission also announced, on March 12, that the COVID-19 pandemic qualifies as an “exceptional occurrence”, opening the door for the use of State aid. The last time such a qualification was made was during the financial crisis.

During the financial crisis, aid was granted, primarily to institutions in the financial sector, in the form of guarantees in order to limit any impact on the economy. The

current crisis, on the other hand, has already had a significant impact on the economy, impacting businesses in many sectors. Unlike in the financial crisis, businesses in the current crisis, will require aid in the form of direct grants to provide liquidity to the company. While this aid is necessary to support the economy, providing such grants puts significant financial pressure on Member States¹.

On March 19, the Commission officially adopted a Temporary State Aid Framework. The Framework referenced typical State aid measures, such as de minimis, GBER, and Rescue and Restructuring and highlighted the availability of specific measures for the crisis, based primarily on Article 107 (3)(b) – aimed to “*to remedy a serious disturbance in the economy of a Member State*”, but also on 107 (2)(b) – aimed to “*make good the damage caused by natural disasters or exceptional occurrences*”².

This article will discuss the application of this State Aid Framework from the perspective of **economics**.

¹ PaRR (2020) [EC State aid approach to Covid-19 reflects lessons learned from financial crisis](#)

² Both provisions allow aid for disasters such as coronavirus but under 3(b) the Commission retains its discretion to approve. Conversely,

once a measure falls under 2(b), the aid “shall” be permitted—significantly reducing the Commission’s discretion to shape policy. The distinction is esoteric now as the Commission is likely to approve a wide range of generous measures under either basis, but, as the crisis

Compatibility of State aid and the proportionality principle

The assessment of the compatibility of an aid scheme or of individual aid follows some common principles that are meant to balance the positive and negative effects of the aid. This balancing test consists of the following steps.

First, the aid measures must be aimed at a well-defined objective of common interest. This proves the necessity of the aid, usually by linking the objective to a specific paragraph of Article 107, such as (2)(b) or (3)(b).

Since 2000, over 800 State aid cases have been filed using Article 107(2)(b) or Article 107 (3)(b) as the primary legal basis. Article 107 (2)(b) has most often been employed to support specific sectors that have been impacted by natural disasters with a relatively local incidence, while Article 107 (3)(b) has been employed to support sectors in general during world systemic crises, such as the financial crisis.

Second, the aid must have an incentive effect, i.e. it should change the behaviour of the recipient in the direction of the stated objective. If it does not, it is considered a lump-sum transfer that has no beneficial effect.

Third, the proportionality test requires aid to be limited to the minimum amount necessary.

Finally, the balancing test requires the assessment of distortions in competition and the effect on trade (to identify any potential negative effects of the aid).

In the context of the current crisis, there is no doubt regarding the necessity for aid, but the big question remains around the amount of aid that is sufficient to repair the damage caused by the crisis. **The proportionality assessment will be a key element in COVID-19 related cases.** The aid must be limited to the minimum amount necessary in order to avoid distortions in competition, both in the case of targeted individual aid

to certain beneficiaries and in the case of aid schemes aimed at supporting a whole set of beneficiaries that fulfil certain eligibility criteria.

In relation to the current crisis, the Commission has approved more than 10 aid schemes in less than a week following the publication of the Framework. These are primarily schemes aimed at supporting SME's across economic sectors.

The disbursement of the funds under the schemes approved by the Commission will require significant assessment, especially because funds are limited and will be shared based on principles of equity and efficiency (the basic principles of State aid). State aid should only be given to healthy firms that would have survived without the crisis. State aid given to unhealthy firms or 'excessive' aid to certain beneficiaries could deprive other companies in need of financial support during the crisis³.

In addition, it will be necessary for companies to show how much aid is needed to cover the direct losses due to COVID-19. Thus, the proportionality test will be vital in the process for securing aid.

Quantification of the damages based on a counterfactual analysis

In order to define the correct level of aid, it will be necessary for the companies to determine the damage caused by the COVID-19 outbreak. This should, in principle, be determined through a **counterfactual analysis**. The purpose of such an analysis is to establish that the aid calculated is limited to the minimum amount necessary (i.e. that proportionality test is met) in order to prevent the distribution of illegal aid.

Standard economic tools can help establish plausible counterfactual scenarios⁴. The counterfactual determines the state of a company if the crisis, in this case the outbreak of COVID-19, did not occur. The difference between what has happened in reality and what would

progresses, using Article 107(3)(b) as the legal basis for approvals means we're likely to see the Commission start to tighten the conditions on which support is available (See <https://www.shearman.com/perspectives/2020/03/covid-19--state-aid-support-to-business>)

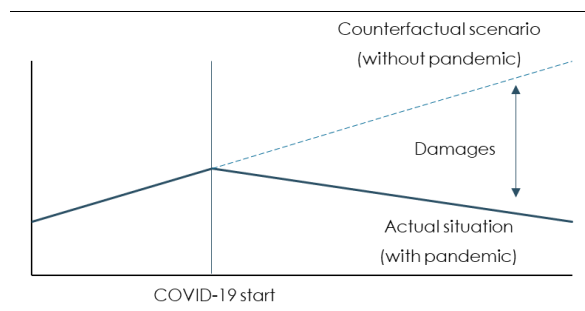
³ Decision SA.32544 (2011/C) discusses some special circumstances when it could be relevant to provide aid to unhealthy firms, for

example, if unhealthy firms going out of business causes serious disturbances/systematic implications for other firms and/or the labour market.

⁴ Economists have developed numerous methodologies for damage estimation in claims that follow cartels or other dispute cases.

have happened in the hypothetical counterfactual is equivalent to the damage to the company that constitutes the basis in the application for aid, see Figure 1.

Figure 1 Calculation of damages using a counterfactual scenario



Note: The figure is illustrative.

Source: Copenhagen Economics

One important and often difficult exercise in the counterfactual assessment is isolating the negative effect of the crisis from the overall development of the company. This is necessary in order to rule out aid to unhealthy firms and to rule out overcompensation to otherwise healthy firms for reasons unrelated to the crisis.

It is important for a company to get an accurate estimate of the amount of aid that they require because anything beyond the necessary amount can be considered distortive, and hence illegal. Moreover, the disbursement of illegal aid could lead to sanctions from the Commission or from competitors, which can ultimately lead to demands for the return of aid and damage claims. A sound basis for the counterfactual can pre-empt any such distortions and ensure that the level playing field stays intact during and after the crisis. Thus, a thorough analysis minimises this risk, ensuring the best outcome for the common good.

When submitting a request for aid it is necessary to include a detailed description of the damages and how they were calculated. In particular, it is necessary to outline the **causal links both between the COVID-19 outbreak and the damage suffered and between**

the damage and the aid. It is also necessary to provide a description of the type of damages that should be compensated, for example, loss of income or additional costs related to the outbreak.

Along with the description of the damages defined, the company will also need to provide the methodology used for assessing the damage. Of course, in light of the short timelines around filing for aid in the current crisis, there is an added challenge related to developing more complex and detailed counterfactual scenarios swiftly. In such a situation where more complex calculations cannot be developed due to time pressure, it is still relevant to ensure that the economic principles of a counterfactual scenario are present and addressed in the assessment.

What next?

We expect many more schemes will be notified to the Commission in the coming weeks. On average, the approval of schemes was very quick up to this point. Unlike during the financial crisis when the approval of schemes took a median of 27 days, during the current crisis, the Commission has approved most schemes in one or two days so far⁵. We should not forget however, that the approval of aid schemes does not mean an automatic disbursement of the aid⁶. Schemes only provide eligibility frameworks within which, individual companies will still have to apply to get effective support.

So far, schemes have been the only type of aid notified and approved. Here economics can be a relevant tool for determining how aid should be distributed within the scheme. Given that funds are limited, public authorities should apply the proportionality principle in disbursing the aid in order to provide a fair and efficient distribution.

Soon we will see applications for individual aid from relatively large companies. The lack of applications for individual aid is most likely related to the fact that these companies are still in the process of estimating the effects of the pandemic. These notifications are expected to be more complex and to have a larger potential for distortions. Thus, these applications will require a more

⁵ PaRR (2020) [EC State aid approach to Covid-19 reflects lessons learned from financial crisis](#)

⁶ Of approximately 450 State aid decisions during the Financial Crisis €802 billion of aid was approved while €453 billion was disbursed.

(See European Banking Authority (2016) [Banks stabilization and resolution: an assessment of State aid rules and of their past and present enforcement](#))

thorough assessment by the Commission. In these cases, economic analysis can be of vital importance.

One sector that was immediately and significantly impacted by the pandemic due to an almost complete travelling ban across the world is aviation. Airlines are already in negotiations with their respective governments to prepare notifications that could reach the

Commission imminently. Moreover, it is quite likely that various waves of support will be required, given the need for immediate action but also the uncertainty in the magnitude of the total damage. The Rescue and Restructuring aid guidelines provide a good framework for such circumstances.

The aviation sector

One of the sectors that has been most greatly affected by the COVID-19 outbreak is aviation. Airlines were forced to ground planes and stop operations, which has already triggered discussions about individual aid to these companies. In addition to putting a hold on their operations right now, airlines will most likely also have to reshuffle their networks in the future given the uneven spread of the virus and the varying levels of public response to the outbreak. Aviation companies have, in the past, received aid to reimburse them for damages resulting from grounding planes due to terrorist attacks or natural disasters. We summarize below one of the past cases of aid to airlines as it constitutes a relevant reference for the calculation of the damages based on a counterfactual scenario.

SA.32163 – State aid to Slovenia aviation companies following a natural disaster (2010)

Following a volcanic eruption in Iceland, Slovenian aviation companies filed for State aid to recover the damages from grounding their planes during the period of the volcanic eruption. The Slovenian authorities assessed the total amount of the damage to amount up to almost €3.309M. Further it was determined that the affected companies should be compensated to a maximum of 60% of the claimed damage through a direct grant.

In order to estimate the damages, the Slovenian airlines provided a counterfactual scenario which defined the value-added¹ to the company had the natural disaster not occurred. This was calculated using the average monthly value-added for the year before, multiplied by the number of months (prorated to the number of days) during which the airlines were not able to fully resume their activity.

To accurately prove the value-added calculations, the company provided profit and loss statements from the period prior to the affected period. Through the use of a reference period and the counterfactual scenario the Slovenian airline companies were able to support their claim for aid. In this case, the Slovenian authorities were able to validate the amount of the damages, while drawing a direct link to the natural disaster that caused the damage. This reduced the risk of overcompensation.

Note: 1) In line with the method used by Eurostat, the 'value added' was calculated as gross operating revenues less cost of goods materials and services, and other business expenditure.

Source: European Commission, SA.32163

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