Phedon Nicolaides* and Michael Kekelekis**

An Economic Analysis of EC Guidelines on State Aid for the Rescue and Restructuring of Companies in Difficulty

The present Community guidelines on state aid for rescuing and restructuring firms in difficulty, a type of aid that is widely regarded as particularly distortive to the single market, will expire on 9 October 2004. The Commission has already identified a number of issues which it regards as problematic. This article draws attention to a number of further issues which also require clarification.

The Commission has repeatedly expressed its concerns about rescue and restructuring aid given to individual recipients on an ad hoc basis. This kind of aid is particularly distortionary as it enables recipient firms to remain in the market. Under normal conditions of competition they would either exit the market or go bankrupt. This is the essence of competition.[1]

In order to minimise distortions and prevent repeated granting of restructuring aid, in 1999 the Commission adopted guidelines on state aid for rescuing and restructuring firms in difficulty.[2] Briefly, the most important provisions of the guidelines are the following:

- restructuring aid should be granted only once in 10 years ("one time, last time" principle), in order to prevent firms from being unfairly assisted;
- the definition of firms that are to be considered as firms in difficulty excludes newly created firms, even if their initial financial position is insecure;
- member states are not allowed to give aid approved for other purposes (such as regional aid) to companies undergoing assisted restructuring.

* Professor, European Institute of Public Administration, Maastricht, The Netherlands.

** Researcher, European Institute of Public Administration, Maastricht, The Netherlands. The autors are grateful to Onoufrios Koulla and Stamatis Drakakakis for comments on an earlier draft and to Philip Buyskes for research assistance.

The current guidelines will expire on 9 October 2004. In the 2003 Autumn edition of the State Aid Scoreboard, the Commission for the first time made public its views on the issues it thought problematic in relation to rescue and restructuring aid. According to the Commission, an internal review of the guidelines had identified a series of problems, the main ones of which are:[3]

- *When is a company in financial difficulties?* There is no Community definition of a "firm in difficulty" and it seems very difficult to derive any definition from the practice of member states because of differences in national insolvency laws and procedures.
- *Groups of companies.* The guidelines state that a company belonging to a group is not normally eligible, except where the difficulties are the company's own and are not the result of an arbitrary allocation of costs within the group, while the difficulties are too serious to be dealt with by the group itself. These criteria are not easily applicable and raise a number of questions, for example

[1] XXVIIIth Report on Competition Policy, 1998, p. 91. See also European Commission: State Aid Scoreboard, COM(2003) 636 final, 29/10/2003.

[2] They are applicable to all sectors except motor vehicles, air transport and shipbuilding (OJ 1999 C 288/2). These guidelines revised the original version of 1994 (OJ 1994 C 368/12).

[3] State Aid Scoreboard, op. cit., p. 18.

where a subsidiary in one member state is in financial difficulties but whose parent company appears unwilling to support it.

- *Urgency.* Whereas the current guidelines are based on the premise that aid is notified in advance, rescue aid often has to be granted prior to Commission approval in order to avoid the collapse of the company. However, any possible solution to this situation should comply with the notification obligation under Art. 88 (3) EC Treaty.
- *One time, last time* principle. The guidelines provide that rescue aid is a one-off operation and that repeated rescue aids should be avoided. However, there have been cases of companies obtaining new rescue aid which were not eligible for restructuring aid because of the "one time, last time" principle.
- *Various time-limits.* The different time-limits in the current framework are unclear and thus need to be clarified.
- *Compensatory measures.* When are the compensatory measures proposed sufficient in scope "to mitigate the potentially distortive effects of the aid on competition"?

In addition to the problems and weaknesses stressed by the Commission, the section below identifies a number of issues that have not been identified as problematic by the Commission and which, in our view, need to be clarified further and enforced more strictly.[4] We thus examine the internal consistency of the guidelines themselves and consider how they may be put on more solid economic foundations.

Three Internal Economic Inconsistencies

The guidelines state that aid for rescue or restructuring may be exempted when it falls within Article 87(3)(c) EC. That is, it should promote the development of certain areas or economic activities. Does the financing of rescue or restructuring of companies promote regional or economic development? We shall argue in this section that it is rather unlikely because of the conflicting objectives of the guidelines.[5]

The internal consistency of any set of rules indicates whether the particular rules are compatible with each other and whether they are compliant with or support the proclaimed overall objectives of the rules. The proclaimed objective and rationale of the rescue and restructuring guidelines are spelled out in paragraph 3 as follows:

"[S]tate aid for rescuing firms in difficulty from bankruptcy and helping them to restructure may only be regarded as legitimate subject to certain conditions. It may be justified, for instance, by social or regional policy considerations, by the need to take into account the beneficial role played by small and medium-sized enterprises (SMEs) in the economy or, exceptionally, by the desirability of maintaining a competitive market structure when the disappearance of firms could lead to a monopoly or to a tight oligopolistic situation."

This is further elaborated in paragraph 28:

"[A]id for restructuring raises particular competition concerns as it can shift an unfair share of the burden of structural adjustment and the attendant social and economic problem onto other producers who are managing without aid and to other Member States. The general principle should therefore be to allow the grant of restructuring aid only in circumstances in which it can be demonstrated that it does not run counter to the Community interest. This will only be possible if strict criteria are met, and if it is certain that any distortions of competition will be offset by the benefits flowing from the firm's survival (in particular, where it is clear that the net effect of redundancies resulting from the firm going out of business, combined with the effects on its suppliers, would exacerbate local, regional or national employment problems or, exceptionally, where the firm's disappearance would result in a monopoly or tight oligopolistic situation) and, where appropriate, there are adequate compensatory measures in favour of competitors".

[4] There is hardly any literature regarding the rules on rescue and restructuring aid despite the distortive effect that this may have on competition. See, in this respect, P. Anestis, S. Mavroghenis, S. Drakakakis: Rescue and Restructuring Aid - A Brief Assessment of the Principal Provisions of the Guidelines, in: European State Aid Law Quarterly, Vol. 3, No. 1, 2004, p. 27 ff.; E. Valle, K. van de Casteele: Revision of the Rescue and Restructuring Guidelines: A Crackdown?, in: European State Aid Law Quarterly, Vol. 3, No. 1, 2004, p. 9 ff.; P. Nicolaides, M. Kekelekis: An Assessment of EC State Aid Policy on Rescue and Restructuring of Companies in Difficulty, forthcoming in European State Aid Law Quarterly, 2004.

[5] Other economists have also criticised the weak economic logic of the guidelines. See, for example, D. Harbord, G. Yarrow: State Aids, Restructuring and Privatisation, in: European Economy, 1999, No. 3, pp. 89 - 130; L.-H. Röller, C. von Hirschhausen: State Aid, Restructuring and Privatisation in the New German *Länder*, in: European Economy, 1999, No. 3, pp. 132 – 160; L.-H. Röller, C. von Hirschhausen: State Aid, Industrial Restructuring and Privatisation in the New German *Länder*: Competition Policy with Case Studies of the Shipbuilding and Synthetic Fibres Industries, Discussion Paper 13, July 1996, Social Science Research Centre Berlin.

Naturally, one need not accept the rationale advocated by the guidelines themselves. One may choose to argue instead that the government should not intervene to reverse the result of the market. An economist may also ask whether rescue or restructuring aid corrects any market failure. If not, then state aid should not be allowed. In this paper, we accept the objectives specified in the guidelines and adopt instead a more narrow criterion – that of internal consistency – with which to evaluate the guidelines.

The guidelines in paragraphs 3 and 28 provide three reasons or justifications for which rescue or restructuring aid may be allowed. One of those reasons is the "beneficial role" of SMEs. It is immediately obvious that support of SMEs is not just distinct but likely to be contrary to the third aim of the justification of the guidelines which is the prevention of the emergence of oligopoly or monopoly. This is the first inconsistency. Note, however, that while paragraph 3 refers to the role of SMEs, paragraph 28 is silent on this issue.

An SME or a company that according to the guidelines has "negligible" market share is unlikely to be a company with productive capacity of such magnitude that its demise would significantly affect market structure. If the purpose of rescuing companies is to prevent their surviving competitors from dominating the market, then SMEs would not need to be rescued. If the exit of a company from a market has such an impact on market structure, it seems reasonable to expect that the share of the failed company should be at least 25-30%. There is hardly an SME with such a high market share.

Perhaps the drafters of the guidelines had in mind regional markets where an SME can be a significant employer without being a large player in the European market. Although we acknowledge that this is indeed a possibility, nowhere do the guidelines ask for an assessment of the regional impact of such an SME. More importantly, if that were the implicit objective of the guidelines, it would still be unnecessary to expand their scope to include all SMEs. It would be sufficient to restrict aid to companies with significant regional impact.

There is also the question why SMEs should deserve to be rescued at all. Since according to the European Commission itself, more than 99% of all EU enterprises are SMEs, the aim of preserving SMEs is meaningless because it covers virtually the whole European economy.[6] By contrast, the regulation on aid to SMEs justifies the exemption of this kind of aid on the grounds that SMEs have difficulty accessing investment capital.[7] But if the European economy is made up of SMEs, the closure of some SMEs will not at all change the character of the economy, nor will it diminish their "beneficial role". So to put it crudely, on the one hand, the guidelines aim to preserve small companies and, on the other, they aim to preserve large companies.

The guidelines also permit aid schemes for SMEs. Since a scheme is approved by the Commission only once, individual awards need not be notified to the Commission for any further authorisation. Since the guidelines do not define precise aid intensity ceilings or eligible costs and given that the assessment of restructuring plans depends on the integrity of the analysis carried out by the Commission, the fact that member states do not have to notify individual awards of aid also implies that it is impossible to know whether they limit aid to where it is necessary or to the minimum amount. The only limit is an overall ceiling per recipient company of €10 million. In essence this means that member states can help 99% of the companies in their territories once every ten years with amounts of up to €10 million.

The second inconsistency is that while the guidelines justify rescue and restructuring aid on the need to minimise the "net effect of redundancies resulting from the firm going out of business" because "combined with the effects on its suppliers, [they] would exacerbate local, regional or national employment problems", paradoxically, the guidelines do not require public authorities to submit any assessment of the local, regional or national impact. They only require, in an annex, a "market survey". But this survey is used to determine the extent of the compensatory measures that will have to be taken by the beneficiary company. It does not calculate the local or regional impact of closure.

In this context, there is another problem. If the aim of the guidelines is to avert the negative local or regional impact of potential bankruptcy, why then do they ask companies to close down capacity? Of course, reduction of some capacity must have a

[6] See European Commission , DG Enterprise: Report on SMEs (2002), accessed at: http://europa.eu.int/comm/enterprise/enterprise_policy/analysis/doc/execsum_2002_en.pdf.

[7] Commission Regulation (EC) No. 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises, OJ 2001 L 10/33.

lesser impact on the local economy than closure of the whole firm. But it also means that the remedies provided for by the guidelines necessarily exacerbate some of the local problems that aid intends to ameliorate.

The third inconsistency concerns the plan that is eventually approved by the Commission. To understand the third inconsistency it is necessary first to highlight a puzzling aspect of these guidelines. The main criterion by which any proposed restructuring aid is evaluated is whether the recipient firm will return to viability. If the firm is able to cover all its expenses, then its owners should also be able to obtain a reasonable return on their investments. This is because those expenses also include return on capital invested. But if every company that receives restructuring aid has more than a fair chance to become profitable, why then do private investors need any state aid at all?

The answer must be that state aid makes the investment more attractive to private investors. It reduces the size of the restructuring costs that is to be borne by those investors and, therefore, it artificially raises the rate of return of whatever money they put into the company. If this is indeed the case, then the guidelines should lay down a different limit on the amount of state aid that should be authorised. This alternative limit should be the minimum amount of aid that would be sufficient to persuade investors to inject new capital in the company.

This is indeed congruent with the overall philosophy of state aid policy in the EC. As the European Court of Justice has repeatedly ruled, state aid is allowed for the purpose of inducing firms to do something they would not otherwise do under free market conditions and provided that what firms are asked to do falls within the range of policy objectives allowed by the EC Treaty.[8]

Should the guidelines be revised to permit only such minimum amounts of aid? Not necessarily, because even a smaller amount of aid may not be worth the value of the local or regional negative effects that it obviates. To put it simply, even if private investors would put in, say, €10 million of their own money, it may not be worth spending one million euro of public money to save one job.

In fact, the guidelines require that aid finances only what is strictly necessary for the restructuring. But what is strictly necessary is not something which is exogenously given. It is determined by the extent of the envisaged restructuring.

For example, assume that a firm with 300 employees faces problems because its operating costs are too high in relation to the demand for its product and, consequently, its output level (say, it has too many workers). To correct this problem it comes up with three different plans, as follows:

Plan 1: reduce workforce to 200

(probability of success: 60%; rate of return on capital invested: 10%; expected rate of return: 0.6 x 10% = 6%).

Plan 2: reduce workforce to 100 and invest in new equipment that operates at lower cost

(probability of success: 70%; rate of return on capital invested: 15%; expected rate of return: 0.7 x 15% = 10.5%).

Plan 3: reduce workforce to 50 and invest in new equipment to shift production to new niche product for which demand is stronger

(probability of success: 50%; rate of return on capital invested: 25%; expected rate of return: 0.5 x 25% = 12.5%).

Any one of these three plans would be compatible with the guidelines. They all address the underlying problem (surplus of workers), but they propose different solutions. Since they result in different rates of profitability, shareholders would have a strong motive to present the plan with the highest expected rate of return, which is plan 3.[9] But which one should the Commission approve? The one with the highest probability of success, the one with the highest rate of return (that it is also the riskiest), the one that preserves employment and minimises the impact on the local economy or the one that retains as much as possible of the original capacity of the firm (so that it can be a counter-force to oligopolistic tendencies)? Whereas a private investor would be interested in the highest possible return, for public authorities there may be several and conflicting policy objectives.

It is obvious now that the cause of the third inconsistency is that the plan that is eventually approved is not necessarily the one which minimises

[8] Case C-730/79, *Philip Morris v Commission*, ECCR 1980 2671, paras. 16-17.

[9] Our calculations regarding these plans are based on the assumption that investors and public authorities are risk neutral. That is, their concern is expected return and they have neither love nor aversion of risk.

Table 1
Recent Cases of Rescue and Restructuring
(amounts in million euro)

Company		Revenue	Employees	Market share	Amount of aid	Reference	Aid/staff
Brittany Ferries	UK	197		45/50% of specific route, 7.5% of all channel traffic	11	OJ L 12 15/01/2002	
Fairchild Dornier	D		3600		94	IP/02/889; OJ C 239 2002	0.026
AMBAU Stahl	D	8	139	2.5% (DE - Wind energy sector); 0.089% Metal & Chemical Industry	1.28	OJ L 103 24/4/2003	0.009
ILKA MAFA	D	7	45		14.4	OJ L 296 30/10/2002	0.320
Koninklijke Schelde Groep	NL	226.7	1000		4	OJ L 14 21/01/2003	0.004
Dopp Stadt	D		305	3%	39.2	OJ L 108 30/04/2003	0.129
Gotha Technik	D	24.3		20% (EU)	1.6	OJ L 314 18/11/2002	
Hoch- und Ingeneurbau	D	4.7	72		0.892	OJ L 307 08/11/2002	0.012
Mesacon Messelektronik	D	1.9	20		0.9	OJ L 134 22/05/2002	0.045
KataLeuna	D		89		25.3	OJ L 245 14/09/2001	0.284
KHK Verbindetechnik GmbH	D	2.4	27		0.491	OJ L 31 01/02/2002	0.018
Philip Holzman	D	1100	5000	3rd largest in market	191.7	OJ L 248 18/09/2001	0.038
Babcox Wilcox	S	264.5	1100		830	OJ L 67 03/03/2002	0.755
ACHCN	F		692		261	OJ L 47 19/2/2002	0.377
Instituto Poligrafico e Zecca dello Stato	I	453	3130		500	OJ L 126 13/05/2002	0.160
Elpro AG	D	46	400	1%	36	OJ L 229 09/09/2000	0.090
Wildauer Kurbelwelle	D	19	293		22.5	OJ L 287 14/11/2001	0.077
Schiffsanlagenbau Barth	D		81		7.42	IP/00/1243	0.092
SNIACE	S	34.5	600		7.3	OJ L 108 30/04/2003	0.012
Saleco	I	131	821	1 of 2 Italian firms in market, products sold throughout EU	450	OJ L 227 07/09/2000	0.548
Graphischer Maschinenbau GmbH	D	63.6	99	61	2.268	OJ L 272 22/10/1999	0.023
Everts Erfurt	D		117	1.1% of EU condom market	4.65	OJ L 310 04/12/1999	0.040
Kranbau Eberswalde	D	34	160		30	OJ L 326 18/12/1999	0.188
Keller and Keller Meccanica	I		613		23	OJ L 63 12/03/1999	0.038
Société française de production	F	76	996		379	OJ L 205 22/07/1998	0.381
Nouvelle Filature Lainière de Roubaix	F	22	248	8% of French, 0.8% of EU	1.1	OJ L 145 10/09/1999	0.004
Aircraft Services Lemwerder	D	33	575		36.75	OJ L 306 11/11/1997	0.064
Air France	F	8300	64000		3000	OJ L 254 30/09/1994	0.047

Source: Commission Annual Competition Reports, 1994-2002.

any negative local effects or preserves the firm as an effective counter-force to competitors. This is because the firm naturally puts forth the most attractive plan as seen from the perspective of the shareholders. From the example outlined above, it is plan 3. It is also likely to be the one with the largest negative impact on the local economy (as more workers are laid off) and the one that will require the largest amount of aid.

If the Commission knew about the alternative plans and if its primary concern were employment it should approve plan 1. Although the rate of success of this plan is lower than that of plan 2, the expected number of jobs that would be saved would be 120 (= 0.6 x 200) against only 70 (= 0.7 x 100) of plan 2. Since only 100 workers would be laid off and no substantial new investment would be required, plan 1 could also be the cheapest for the public purse in terms of the required amount of state aid.

These examples also expose a related problem. Community and national authorities may have conflicting policy objectives and, therefore, may favour different plans. Normally, such conflicts should not exist, as the purpose of the Community guidelines on state aid is to clarify how aid is to be assessed. But the rescue and restructuring guidelines, despite their name, offer no guidance on this point.

Naturally, these examples do not constitute proof that in all cases of rescue and restructuring there were less costly options to be financed by taxpayers. They merely illustrate the complexity of the choices available during corporate restructuring and the inability of the current guidelines to force member states and beneficiary companies to opt for the plan that minimises social costs.

Indeed, available data suggest that there is wide variation in the size of rescued and/or restructured companies and the amount of state aid which is granted to them. Table 1 gives references to cases from the past eight years for which information was available. The relevant data from those cases are summarised in Table 2.

These data reveal that rescue and restructuring aid is granted to both minuscule companies of less than 1% market share or employing just 20 persons and giant companies employing more than 60,000 persons. What is surprising is the variation in the amount of aid per employee of the beneficiary companies. It varies from about €4,000 to €755,000. Since the average annual salary in the EU is €24,000, one wonders whether it is worth paying 32 times more per job that is saved.

The Commission's own data show similar variation in the amounts of state aid per beneficiary firm. The latest issue of State Aid Scoreboard (Autumn 2003, pp. 15 f.) reveals that between 1990 and 2002 the Commission approved about 120 awards of aid.[10] The size of each award varied between €1 million and €20 billion. What is more interesting is that 60% of all EU awards were made by just four member states: Germany (35), France (20), Spain and Italy (15). Denmark, Greece, Ireland, Luxembourg, the Netherlands, Finland, Sweden and the UK each had "at most 2 cases of rescue and restructuring aid being awarded and in some cases none whatsoever." Are the firms in these countries immune from financial problems or are the governments of these countries less willing to bail out firms in financial difficulty?

This brings us to the question of how this kind of aid should be assessed. If the current guidelines do not limit aid to what is socially optimum, are there any alternative criteria that may be used?

Alternative Evaluation Criteria

If the inconsistencies identified above are to be eliminated and if the guidelines are to be placed on economically sound foundations, then the criteria used for approval of notified aid must be different and must relate to the proclaimed policy objectives of rescue and restructuring.[11] To repeat, these public policy objectives are not just to save companies. They are to minimise the negative impact on society from the demise of companies.

One may ask why should such analysis be performed for rescue and restructuring aid? This is not done for other kinds of aid. We think there is a simple justification for that analysis. Other kinds of aid aim to induce companies to do things such as train their employees, hire more workers, protect the environment or invest in backward regions. State aid has a direct and measurable impact on these aims, otherwise it is not granted. By contrast, there is no direct link between rescue and restructuring aid and avoidance of negative regional or economic effects from company failure.

[10] State Aid Scoreboard, op. cit., p. 15-16.

[11] See also the criteria in D. Harbord, G. Yarrow, op. cit.; and L.-H. Röller, C. von Hirschhausen, op. cit.

Table 2
Rescue and Restructuring Aid
(recent cases, 1994 - 2002)

Market shares (%) of beneficiary companies (where data were available)	Employees of beneficiary companies (where data were available)	Aid per employee (€ x 1000) of beneficiary companies[1] (where data were available)
0.8, 1, 1.1, 2.5, 3, 7.5, 8, 20, 45 (on an air route), 61 (third largest in EU)	20, 27, 45, 72, 81, 89, 99, 117, 139, 160, 248, 293, 305, 400, 575, 613, 600, 692, 821, 996, 1000, 1100, 3130, 3600, 5000, 64000	4, 4, 9, 12, 18, 23, 26, 38, 38, 40, 45, 47, 64, 77, 90, 92, 129, 160, 188, 284, 320, 377, 381, 548, 755

[1] Note that the average annual EU income at present is €24,000.
Source: Commission Annual Competition Reports, 1994-2002.

To establish a direct link between the impact of state aid and the impact of rescue and restructuring, any alternative assessment criteria must relate to the gains for society from government intervention through state aid, otherwise it is impossible to have any objective criterion by which to judge the adequacy of the state aid granted. It follows that rescue and restructuring aid should be granted only if the net gains to society outweigh the cost of the aid intervention.

The issue of course is how to measure those gains and costs. This is not an easy task. But our objective here is not to define a new method for calculating the impact of company failure and therefore the gains from avoiding that kind of failure. Rather, irrespective of how the economic impact of failure and the social gains from rescue and restructuring are measured, they should be compared with the cost of intervention.

To illustrate how an impact assessment may be carried out assume that the social cost of intervention is the amount of aid which is expended to rescue or restructure a company.[12] This means that the amount of aid must never exceed the social cost of closure of the company concerned.

For example, assume that the cost of a viable restructuring plan is 100 and that it is shared 60/40 between private investors and public authorities, respectively. If the company would return to profitability and if it implemented sufficient compensatory measures, this share would in principle be acceptable to the Commission as private funds exceed the amount of state aid. However, it does not follow that the Commission should authorise the granting of that aid. As long as the social cost of allowing the company to go bankrupt is below 40, aid cannot be justified.

Admittedly, it is not for the Commission to tell member states how to spend their money wisely. This has indeed been stressed by Community courts in several competition cases.[13] However, the guidelines themselves stipulate that rescue and restructuring aid can be justified only if it prevents certain things which are detrimental to society. It is not unreasonable, therefore, to request member states to:

- confirm that indeed the aid they propose to grant can reduce some or all of the costs that society would bear if the potential beneficiary company went bankrupt;
- limit the aid to at most the amount of the social costs which are avoided by keeping the company alive.

So, there must be an upper limit to the amount of authorised aid and that limit should be the social costs of letting the company go bankrupt. In addition, this ceiling has to be adjusted by the cost that private investors avoid by keeping the company afloat. This is because the closure of a company is always costly to the owners.

Using the figures from the example above, if the estimated social costs of closure are 35, public authorities should offer no more than 35 in terms of aid. If the shareholders are willing to put in 65 of their own money it means they obtain an acceptable return on their investments. But this should not be the end of the story.

There may be costs that the shareholders do not have to incur when the company is restructured and made viable. Assume that these costs are 5. It follows that the maximum amount of aid that is granted must be only 30 and that the shareholders will have to put 70 of their own money into the company. It may be argued at this stage that the

[12] In an otherwise perfectly functioning economy transfers of public money are costless. Naturally, in imperfect economies this does not hold because public revenue is raised through distortionary taxes, its disbursement uses up valuable resources, companies also expend scarce resources to secure state aid and the aid itself may have opportunity costs in terms of the foregone output from those activities which are not aided.

[13] See, for example, Case C-320/91, *Paul Corbeau,* 1993 ECR I-02533; Case C-393/92, *Municipality of Almelo and Others v NV Energiebedrijf Ijsslmij*, 1994 ECR I-01477; Case C-158/94, *Commission v Italy, 1997 ECR I-05789*.

shareholders have done their calculations and they obtain a reasonable return only at 60 but they are willing to invest 65 because they gain 5 by not having to close down the company. This indeed is possible. But we think it should be up to the beneficiary company to argue the case and provide convincing evidence why 65 is the maximum that they are willing to invest.

Having taken into account both the social costs of closure and the private gains of avoiding closure, the state aid granting authority should then perform the following calculation. It should compare the total social costs of restructuring (i.e. CR) and the total social costs of allowing the company to go bankrupt (closure) (i.e. CC) and it should intervene only if the former is less than the latter; i.e.

CR < CC

=> net state aid (i.e. gross state aid minus the private benefits of avoiding closure) + social cost of restructuring (e.g. partial redundancies) < social costs of closure

This formula shows that restructuring also causes social costs other than the granting of state aid itself. These costs may be, for example, the re-training of workers laid off and are currently ignored in state aid procedures.

A question that arises in this context is how to prevent member states and companies from exaggerating the social costs of closure so as to get the Commission to approve a larger amount of state aid. Ascertaining true costs and true intentions is indeed one of the biggest problems in designing efficient state aid schemes. No one can know for sure the minimum amount of state aid that a company would accept in order to undertake a socially beneficial project, nor is it possible to determine ex ante whether a company that applies for aid under an approved aid scheme would have undertaken a project or invested in a deprived region or hired extra workers without state aid.[14]

Nonetheless, it seems to us that if the authorities take into account both the social costs of closure and the social costs of restructuring, it will be more difficult for companies to argue at the same time that both the social costs of closure and the costs of restructuring are very high. To see why this is likely to be so, we need to elaborate the equation derived above. We assume that the various components of the equation can be expressed in terms of the following factors:

- state aid = cost of new capital equipment (K) + redundancy payments to reduce the labour force (U1) + re-training of remaining workers (T)
- private benefits of avoiding closure = redundancy payments to the whole workforce (U2)
- social costs of restructuring = reduction of activity of suppliers + unemployment and re-training of laid-off workers (U3)
- social costs of closure = reduction of activity of suppliers + unemployment and re-training of the whole workforce (U4).

Public authorities should grant state aid only if $K + U1 + T - U2 + U3 < U4$

It would not be easy for the company to argue that it needs a large amount of aid to lay off many workers and at the same time that the social costs of restructuring are not high. The more workers it lays off, the higher the social costs of restructuring and, therefore, the higher the chances that the cost of restructuring will exceed the cost of closure. So, by taking into account the costs to society both of closure and of restructuring, there is an in-built safeguard against excessive demands for aid.

In summary, to avoid the internal inconsistencies identified in the previous section it is necessary to define alternative methods for evaluating requests for rescue and restructuring aid. Such an alternative method is to relate state aid directly to the social costs of closure and restructuring – not just the private costs of restructuring. Moreover, the amount of state aid that is eventually granted should be adjusted downwards by the amount of costs that shareholders avoid by not having to close down the company.

With these arguments in mind we now turn to the draft new guidelines that were published by the Commission on 9 January 2004.

The Draft New Guidelines

The Commission has recently published draft new guidelines for the purpose of eliciting com-

[14] One of the comments we received on an earlier version of this paper suggested that public authorities should be requested to grant restructuring aid only through capital injections. If the recipient company eventually goes bankrupt, public money would be lost anyway. If, however, it succeeds, public authorities and ultimately taxpayers obtain some return. This is a good idea which, however, we have decided not to propose in this paper for two reasons. First, it would be contrary to Article 295 of the EC Treaty. Second, it would complicate matters because it would reduce the return to private shareholders and would discourage their participation.

ments, in order to satisfy the concerns expressed.[15] The new guidelines retain many of the provisions of the current guidelines. They retain the definition of undertakings in difficulty, the case of groups of companies, the principles that restructuring aid must be the minimum necessary, that it should be accompanied by a plan to restore the recipient firm to viability within a reasonable length of time, that it should not cause undue distortion of competition and that restructuring aid may not be granted more than once (at least, not more than once every ten-year period).

The main differences between the two sets of guidelines are as follows.

- *Urgency aid.* Rescue aid is replaced by "urgency aid". This is aid for at most six months and has to be repaid by the end of the six-month period, otherwise it will be counted in the overall amount of restructuring aid (in the current guidelines, rescue aid has to be repaid within twelve months).
- *Simplified procedures.* A major innovation of the new guidelines is that urgency aid is assessed through a simplified procedure and expedited assessment process. In addition, urgency aid is subject to the "one time, last time" principle.
- *Maximum amount of urgency aid.* The maximum amount of urgency aid is determined on the basis of a formula which is defined in an annex to the new guidelines.
- *SMEs.* No restructuring plan is required to be submitted in the case of SMEs.
- *Compensatory measures.* The compensatory measures may have to be as high as 100% of the beneficiary company's capacity if the beneficiary operates in a market with long-term structural problems. Also, the new guidelines have dropped the reference to "negligible" market share and do not further require compensatory measures by small enterprises.
- *Own contribution.* The money that has to be contributed by the shareholders of the beneficiary company must be at least 25% for small enterprises, 40% for medium-sized enterprises and 50% for large enterprises.

In addition, it is noteworthy that member states are requested to submit information on the economic impact of aid they propose to grant. These requirements appear in Annex II on urgency aid:

"3.1 Will the aid under the scheme be warranted on the grounds of serious social difficulties? Please justify.

3.3 Please explain why do you think that the aid is limited to the minimum necessary (i.e. is restricted to the amount needed to keep the firm in business for the period during which the aid is authorised or for urgent structural measures such as the immediate exit from a loss-making field of activity)."

And in Annex III on restructuring aid:

"5. Effects on employment.

Please provide an initial appraisal of the estimated impact on employment, at local, regional or national level, of the firm's possible disappearance, as well as of the predictable employment impact of any viability restoration and/or compensatory measures."

Conclusion

This paper has examined the current guidelines on rescue and restructuring from an economic point of view and identified a number of contradictions and defects. The main contradiction in the guidelines is that they justify rescue and restructuring aid on the grounds of minimising the negative impact of company failure on the local and regional economy, yet they allow aid to companies with insignificant such impact. The main defect of the guidelines is that they do not limit aid to the socially optimum amount.

A number of innovations incorporated in the Commission's draft new guidelines are mostly welcomed, such as the simplified procedures. However, they do not remove the contradictions and defects identified in this paper. They do not require member states to grant socially optimum amounts of aid. With regard to SMEs a restructuring plan is not even required.

The additional information provided for in the draft annexes II and III raise issues concerning the negative social impact of company closure and how it may be ameliorated by state aid. Certainly, they will force national authorities to justify state aid by taking into account the potential economic effects of their intervention. But there is no requirement for any systematic comparison of positive and negative economic effects of closure and of state aid.

[15] The draft new guidelines were published on 9 January 2004 and can be accessed on DG Competition's website at http://europa.eu.int/comm/competition/state_aid/others/difficulty/en.pdf.