# EAGCP Commentary on European Community Rescue & Restructuring Aid Guidelines*

***06 February 2008***

**Bruce Lyons** (ESRC Centre for Competition Policy, University of East Anglia, Norwich): *Coordinator*

**John Van Reenen** (ESRC Centre for Economic Performance, London School of Economics)

**Frank Verboven** (University of Leuven)

**Xavier Vives** (IESE Business School, Barcelona)

* *This commentary should be read in the context of the 'Community Guidelines on State Aid for Rescue and Restructuring Firms in Difficulty' (2004/C 244/02, OJ, 1.10.2004), hereafter referred to as the R&R guidelines. It is intended to provide an analysis of the competition context of R&R aid with a view to improving the Guidelines when they are due for revision in 2009.*

# EAGCP Commentary on Rescue & Restructuring Aid Guidelines

R&R Aid provides state financial assistance to an individual firm which 'is unable, whether through its own resources or with the funds it is able to obtain from its owner/shareholders or creditors, to stem losses which without outside intervention by public authorities will almost certainly condemn it to go out of business in the short or medium term'.[1]

Parts I and II of this report set out the economic context in which the Guidelines on R&R Aid must sit. What is the role of exit/bankruptcy in the competitive process? Can we identify biases that lead to too much exit too soon? Part III examines some of the main arguments used to justify R&R aid, and Part IV provides advice on revisions to the Guidelines.

## I Competition, Exit and Productivity Growth

*The economic role of loss-making*

It is helpful to distinguish factors that affect all firms in an industry from those which affect specific firms. R&R aid is directed at individual firms, so it is firm-specific factors that are most important in this context. Nevertheless, it will often be the case that an industry-wide factor affects firms differentially, perhaps because of their particular market niche, quality or nimbleness in response.

There are many reasons why a once-profitable firm may become loss-making, but they generally fall under two headings: increase in relative costs; or loss of demand. If a firm fails to reduce its costs in line with its rivals or sees its costs grow out of line, it will eventually find itself unprofitable and in financial distress. The inability to sell for a price in excess of costs is the essential market signal that the firm's resources would be better used elsewhere (or that an inefficient senior management team should be replaced).[2] Similarly, if a particular firm's product range loses its customer appeal relative to that of its rivals, it may become unprofitable. This is an essential market mechanism by which customer preferences drive the pattern of production. Firms must adapt to changing tastes or it is right that they should fail. State subsidies reduce incentive for firms to respond speedily to the essential market signal that is provided by the prospect of financial distress.

[1] Paragraph 9 of current Guidelines; OJ 1.10.2004.

[2] When a firm operates in several product or geographic markets, a loss incurred in one may potentially contaminate the performance of another business within the same legal entity. If a firm operating in reasonably profitable market A is also incurring a loss in market B of such a magnitude that the combined position is loss-making (e.g. a firm with a stable domestic business may have been unable to control its costs when investing heavily overseas), the appropriate response is either to sell (to a better or more appropriate management team) or to close business B. If a sale can be made at a non-negative price or if the business can be closed with asset sales in excess of liabilities, there should be no contamination and no substantial problem for business A. If this is not the case, the perfectly good business A could be left with a burdensome debt. However, this situation should spur a negotiated re-financing as creditors have an interest in supporting business A if it has a positive on-going value and there is no benefit to creditors from unduly hampering it.

In the case of an industry-wide downturn in demand (or increase in costs relative to customer willingness to pay), and in the presence of some degree of economies of scale, a shrinking market will support fewer firms in the long run. The speed and order of exit depends on relative efficiencies and scale (e.g. inefficient firms exit first and if two firms have the same costs the larger one will reduce its size first).[3] This natural order can be distorted by financial subsidies which could allow either an inefficient business to survive the competitive (evolutionary) war of attrition at the expense of a more efficient one, or a larger firm to maintain its scale at the expense of a smaller one.[4]

We conclude that **loss making is the essential market signal that resources are better used elsewhere**.

*Competitive externalities*

Thus, loss-making and exit are an essential part of the competitive process. Actual R&R aid *directly* intervenes in this by delaying the exit of firms receiving the subsidy. Post-aid, this results in a higher market share for the subsidised firm at the expense of its unsubsidised rivals. This has an impact on productivity and the distribution of employment. In most cases, the consequence for rivals is that they will see their output and employment fall. One possible exception is when the failure of one firm results in a loss of consumer confidence in the market as a whole. A particular example might arise with a bank failure, which panics customers of other banks into withdrawing deposits and so create a generalised liquidity crisis.[5]

The future prospect of R&R aid also has important *indirect* effects on the incentives faced by firms across the market. First, inefficient firms who anticipate a financial safety net will take greater risks, which will in turn precipitate more such crises. Second, efficient rivals which do not anticipate having to call on R&R aid can expect to face a more reckless inefficient rival whose demise will be slowed down by an injection of state aid. Consequently, the efficient firm might invest more conservatively. This anticipation effect shifts market shares from more efficient to less efficient firms even before any financial crisis.

We conclude that **actual and prospective R&R aid has far-reaching adverse effects on business behaviour beyond the narrow confines of the local aid decision**.

In order to provide some context for the positive effects of exit, next we summarise some evidence on the productivity effects of exit.

[3] See: Ghemawat and Nalebuff (1985) 'Exit' *RAND Journal of Economics*; Fudenberg and Tirole (1986) 'A theory of exit in duopoly' *Econometrica*; Whinston (1986) 'Exit with multiplant firms' *RAND Journal of Economics*; Ghemawat and Nalebuff (1990) 'The evolution of declining industries' *Quarterly Journal of Economics*; Murto (2004) 'Exit in duopoly under uncertainty' *RAND Journal of Economics*.

[4] Exit can also be delayed by the formation of 'crisis cartels' in which illegally colluding firms attempt to raise or maintain price to delay or avoid the appropriate market adjustment. Article 81 rightly prohibits such cartels.

[5] However, in these unusual and special cases, policies other than state aid usually provide a better solution as they are less of a 'reward' for the failing firm (e.g. deposit insurance).

*Productivity growth and exit*

In recent years, there have been major advances in our understanding of the sources of productivity growth. The availability of large scale micro-databases has enabled researchers to show that much of aggregate productivity growth results from moving market share from less productive to more productive establishments, rather than from improvements in the productivity of incumbent establishments.[6] Thus, exit (at the firm or establishment level) is a major source of productivity growth. This provides empirical support for Schumpeter's famous argument that the emergence of new products and processes, whose success destroys the old, is 'the essential fact of capitalism'.[7] He called this the 'process of creative destruction'.

Focusing on the entry and exit process, the key difference between US and EU appears to be that although entry rates are similar, both post entry growth of efficient firms and exit of unproductive firms are slower in the EU than the US. Bartelsman et al[8] find a similar degree of entry in the EU and US, but show that more efficient US establishments are able to grow much more quickly than more efficient EU establishments. This suggests that there are barriers to growth and decline in Europe that are much stronger than in America. Part of this could be due to greater resistance in Member States against creative destruction as an essential feature of progress, with consequences for the overall level of productivity.[9]

We conclude that **intervention in the exit process compromises the driving force for productivity growth in Europe.**

## II The Role of Financial Markets

Having developed the role of exit in the competitive process, we next examine whether a justification for R&R aid can be found in the failings of financial markets. Some such issues are dependent on the details of different national liquidation and

[6] Much of the early work was on the USA and is summarised in Foster, Haltiwanger and Krizan (2000) 'Aggregate productivity growth: lessons from microeconomic evidence'. Disney, Haskel and Heden (2003) 'Restructuring and productivity growth in UK manufacturing' *The Economic Journal*, July Vol.113, provides evidence from the UK. They find that 'external' restructuring (exit, entry and market share change), as distinct from 'internal' restructuring (improvements by incumbents), accounts for 50% establishment labour productivity growth and 80-90% total factor productivity growth. Much of this comes from multi-establishment firms closing poorly performing plants and opening high-performing new ones. Additionally, external competition is an important determinant of internal restructuring. Bartelsman, Haltiwanger and Scarpetta (2004) 'Microeconomic evidence of creative destruction in industrial and developing countries', *Discussion Paper* 1374, *IZA*, Bonn, examine comparable data for 24 countries, including European (Estonia, Finland, France, Latvia, Netherlands Portugal, Slovenia, UK and West Germany) and North and South American firms.

[7] Schumpeter (1942) *Capitalism, Socialism and Democracy*.

[8] Bartelsman, Scarpetta and Schivardi (2005) 'Comparative levels of firm demographics and survival' *Industrial and Corporate Change*.

[9] An example of this is the retail sector. This industry has been one of the driving forces of the US "productivity miracle" since 1995, the acceleration in productivity growth that has not been experienced in Europe (see Bloom, Sadun and Van Reenen, 2007, *NBER Working Paper* No. 13085). Foster, Haltiwanger and Krizon (2006) "Market selection, reallocation and restructuring in the retail sector" *Review of Economics and Statistics* show that aggregate productivity growth in US retail is almost entirely driven by the closure of inefficient stores and the opening up of more efficient stores.

reorganisation laws (i.e. bankruptcy law).[10] We do not offer a commentary on such national idiosyncrasies, other than to suggest that it would be unwise to build EU policy around such features. Instead, we highlight some general threads of analysis.

The starting point is that firms should shut down when they can no longer make an economic profit. A Type 1 error arises if an efficient firm is pushed into bankruptcy too soon. A Type 2 error arises if an inefficient firm continues in business too long. Collectively, these two types of error are known as filtering failures. Additionally, there can be inefficiencies if a firm continues to invest in inefficient projects (or fails to invest in efficient ones), including if it adopts an investment strategy that is too risky. It is important not to focus on only the Type 1 error as to do so only increases the other sources of error. Good policy requires a balanced approach.

*Bankruptcy bias*

The following characteristics are common to most systems. Investment and bankruptcy decisions can be influenced by the existence of different priorities for creditors (e.g. suppliers, banks, bond holders, shareholders) and agency issues between creditors and managers. In the event of bankruptcy, there is usually a strict priority of creditors, with a status quo of higher priority creditors being paid in full before the next priority level until assets are exhausted (this is known as the 'absolute priority rule'). Limited liability means that shareholders can lose their entire investment in a firm but creditors cannot claim against a shareholder's private assets. The supervisory system for managers usually aligns their incentives most closely with shareholders. Because limited liability restricts the consequences for equity holders in the event of very bad outcomes, it encourages managers to take more risks (i.e. managers do not take creditor losses fully into account). There is a justification for each of these features but this is not the place to develop them. Instead, we highlight some of the consequential biases in relation to exit and reorganisation.

If high priority creditors perceive that the firm is in decline though with a reasonable chance of recovery, they may still try to push the firm into bankruptcy so that they can be paid off with certainty (i.e. they do not take low priority creditors fully into account). However, there are strong incentives working in the opposite direction. Managers may start taking ever increasing risks as bankruptcy looms because by this time shareholders can only retrieve their investment if a positive long shot works out. Furthermore, firms in difficulty can sometimes borrow by giving the lender first creditor priority status to the disadvantage of other creditors. Overall, the fact that firms often enter bankruptcy with far higher liabilities than assets suggests that the balance of these biases may be to keep failing firms going longer than is efficient.

---

[10] For example: 'In France, bankruptcy officials appointed to decide whether firms in bankruptcy will be liquidated or reorganised have "safeguarding the business" and saving jobs as their primary objectives. However, in the UK and Germany, bankruptcy procedures are more pro-creditor than in the US or France and reorganisation is less likely to occur"; Michelle White (2005) 'Bankruptcy Law' draft chapter for the *Handbook of Law and Economics* edited by Polinsky and Shavell. Also, in the US, senior managers have the right to file for bankruptcy reorganisation under Chapter 11 as an alternative to Chapter 7 bankruptcy liquidation. See also White (1989) 'The corporate bankruptcy decision' *Journal of Economic Perspectives* and White (2007) 'Economics of corporate and personal bankruptcy law' entry in *New Palgrave Dictionary*.

*Reorganisation bias*

When there is an opportunity for reorganisation, this is clearly attractive to both managers and shareholders. The former keep their jobs for longer and the latter can normally negotiate away from the absolute priority rule by offering creditors a partial payment that might still be more acceptable (e.g. quicker or more certain) than the alternative of liquidation. Such reorganisation possibilities tend to exacerbate the above biases and the expectation of state subsidies would further reinforce a bias that keeps failing firms in operation too long.[11]

Other theories do suggest forces that may work in the opposite direction. For example, reorganisation requires the consent of numerous creditors with differing priorities, so it is possible that there could be a coordination failure between dispersed creditors with diverging interests. The main issue here is to allow sufficient time and create sufficient incentive for creditors to agree. This should be only a very short term problem and so relate only to rescue not restructuring aid. The prospect of the latter would only reduce the cost of delayed agreement – so making disagreement more likely. Another argument is that creditors and financial markets do not have all the information that managers have as to the continuing viability of a firm. However, it is extremely unlikely that a ministry deciding on state subsidies will have better information and so make a better funding decision. Financial markets and creditors have a strong financial incentive to acquire and interpret information accurately.

Overall, while there are theoretical arguments that can conceivably go either way, our conclusion is that **corporate finance and bankruptcy law do not create a fundamental bias that can justify R&R aid**.[12]

## III Arguments Used in Support of R&R Aid

Having established the deep weakness of attempted justifications for R&R aid on efficiency grounds, we turn to some of the main justifications that are offered by Member States. These include social (or 'equity') issues. In our analysis, we build on two themes we have been developing. First, there are indirect effects of aid. If a firm expects R&R aid in the event of it getting into financial difficulties, this weakens its incentives to avoid such difficulties in the first place (e.g. taking undue investment risks or conceding unrealistic wage claims). Second, for most economics-based justifications, there are other interventions that are typically better placed to solve the problem without unfortunate side-effects than is R&R aid.

*Local employment*

The closure of a large business can have a significant local impact, particularly on employment and with knock-on effects on other local businesses. This may properly be a justification for some form of aid to ease transition. However, it is unlikely that

[11] Writing about the US system, White (2007, p.5) concludes: 'many firms that reorganise under Chapter 11 end up requiring additional financial restructuring within a short period. This is consistent with the theoretical prediction that too many financially distressed firms reorganize'.

[12] We note that even if this was not the case for a particular Member State, the appropriate intervention would be to reform bankruptcy law, not to use R&R aid with all its distortionary effects on competition.

R&R Aid will be the best form of targeting such aid, not least because much of it may go to help creditors outside the region. Even taking only local issues into consideration, it will normally be far better to subsidise retraining, infrastructure and/or new investment in the region, and not to subsidise an ailing firm. Furthermore, we note that most R&R aid cases are not in deprived areas. There are twice as many rescue cases outside assisted areas as there are in them, and 50% more restructuring cases are not in assisted areas as are in them.[13] Note also that if the regional economy is bouyant, R&R aid adds to labour scarcity in other related sectors of the region,

*Danger of systemic failure*

In section I, we noted the possibility that there may be some exceptional cases, particularly in financial markets where consumer confidence is crucial, where the failure of one firm may have a negative externality on its rivals (i.e. in contrast to the usual positive externality). In markets where this argument has validity, there is usually a financial regulator (e.g. national central bank) which oversees the market. If the regulator fails in its supervisory role, there may be a case for carefully controlled R&R aid. We can think of no other significant set of markets where this argument is likely to be valid. Furthermore, this exceptional feature of banking markets is best addressed by other solutions that can avoid a crisis (e.g. mandatory deposit insurance), not R&R aid in the heat of a crisis.

*Reduction in the number of firms below the 'competitive' level*

It might be claimed that the exit of one firm may leave too few in the market to compete effectively. This argument confuses competition with competitive outcomes. If there is fierce competition, or if one firms is driven to innovate successfully, then a less efficient rival may have to exit. This is a sign of an efficient market. Article 82 is there to protect against situations of anti-competitive foreclosure (predation). In cases where there is no exclusionary behaviour by a dominant firm, competitive dynamics of the market are good for consumers and should not be discouraged by protecting rivals against the consequences of competition.

*Global competition when extra-EU rivals have access to subsidies*

If one country is subsidising a global competitor, the strategic trade policy literature suggests that there may be an incentive for counter-subsidies if that would shift profits to its 'national champion'. There are numerous caveats to this argument, but one relevant point in the context of R&R aid is that this aid is not administered when there is a possibility of shifting profits. On the contrary, the aid is given when there are losses so it becomes a strategic loss shifting argument, which cannot be beneficial.. Nevertheless, if it was thought that external subsidies were being used in a predatory manner, and would disappear in the event of exit by the European firm, there is a potential justification for intervention. However, that intervention would be much better targeted by bilateral negotiation or using anti-dumping and anti-subsidy external trade measures. These have much more attractive properties in that they can bring about a reduction or elimination of the extra-EU subsidy and they do not have a negative externality on other EU firms.

[13] London Economics (2004) 'Ex post evaluation of state aid' report for DG Enterprise, Table A3.1.

*SMEs*

Inasmuch as aid to an SME is less likely to affect cross-border trade, it is unlikely to have some of the harmful externalities described above. Nevertheless, it may delay the selection of the best from a group of SMEs fighting to grow and succeed in the market.[14] Slower exit also leaves less room for new entry. Since the current de minimis rule operates on an absolute size threshold, this would seem to be a roughly appropriate way to deal with the lower likelihood of harm. It is currently quite low, but great caution should be exercised before raising it because to do so might interfere further with the essential Schumpeterian process of competition.

*"R&R Aid is fine because it has helped firms survive in identifiable cases"*[15]

This argument is clearly flawed. Even if it appears to work for the subsidised firm, this may be at the expense of others. Also, the firm may well have survived in the absence of aid, or even avoided the financial difficulty in the first place. Furthermore, the aid may have allowed an inefficient firm to survive at the expense of a more efficient potential entrant. Nevertheless, it is quite possible that there have been some cases where the aid has beneficially helped an efficient firm survive. However, such examples must be set against the almost certainly larger number of cases where the aid has been ill-targeted and caused more harm than good. There is no positive case for aid based on oversimplified precedent.

*A note on gainers and losers from 'equity' arguments*

The above arguments suggest that the least harmful arguments for R&R aid are based in equity arguments (e.g. local unemployment).[16] It must be appreciated, however, that this does not mean local workers are necessarily the greatest beneficiaries, as a financial injection (e.g. a grant, tax exemption or soft loan) most immediately benefits shareholders, who are unlikely to be located in a disadvantaged region. It also imposes costs on taxpayers whose money is being given away. Furthermore, there is a substantial deadweight loss in the form of distortions across the economy created by the tax system. Finally, there are political economy reasons (e.g. lobbying and political pressure according to where swing voters are located) which distort the allocation of aid such that it is not necessarily the most worthy firms/areas that are likely to received R&R aid – in the absence of tightly specified rules focusing on the

[14] Recall the evidence on productivity growth, discussed at the end of secton I, which shows that a difference between Europe and the USA is that successful American entrants grow more quickly than in Europe and unsuccessful entrants exit.

[15] Two reports by London Economics (2004 and 2005) for the Commission have examined the success or otherwise of recent R&R Aid cases. They find that only a third of the 71 cases they looked at (1995-2002) survived to 2003 with unchanged status, a third ceased trading and a third were acquired by other companies or changed their name. This is not a very impressive success rate. In terms of predictability, survival is more likely when a pre-aid market decline was followed by post-aid sector growth – financial factors were found to be poor predictors. In other words, growth (luck?) seems to be more important than aid.

[16] This is also the aid most consistent with the Treaty Art.87(3)(a): aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment.

economic justification for aid, it is the ones with the most powerful political lobby, and not the ones with the best economic justification, that will receive R&R aid.[17]

## IV Revisions to the Guidelines

The key elements of the existing guidelines should continue in place, in particular:

*Rescue aid* should be: restricted to the amount needed to keep the firm in business; for a maximum of 6 months; warranted on the grounds of social difficulties; have no adverse effects on the industrial situation in other Member States; reimbursed within 6 months; and "one time, last time" principle applied.

*Restructuring aid* should be: restricted to the amount needed to keep the firm in business; based on a clear and approved plan which is monitored and implemented in full; extremely tightly controlled, particularly with respect to firms that are not SMEs or firms in assisted regions; and "one time, last time" principle applied. State aid to cover the social costs of restructuring, and which does not involve financial assistance directly to the firm in difficulty, should be viewed favourably. We discuss 'compensatory measures' below.

However, certain aspects of the guidelines need clarifying and tightening.

### *Rescue versus restructuring aid*

The characteristics of rescue aid, in particular the six-month limit and requirement to repay loans, mean that it is less likely to impose substantial negative externalities than restructuring aid. The main issues we have relate to restructuring aid.

### *Essential need for a properly justified economic case*

An effective policy that does not damage the crucial role of exit in the competitive process must have the following characteristics:

1. Intervention must be based on an identifiable economic case explaining the equity (or, exceptionally, efficiency) justification for R&R aid. This should include a precise explanation of why general government policies (e.g. employment or regional) and private finance cannot remedy the problem that would be created by not pumping aid into the firm in financial difficulty. This requires a clearly defined counterfactual.
2. The economic case must not be speculative – the firm and State ministry must be able to identify and prove the inequity (or, exceptionally, inefficiency) in order to take an appropriate course of action. Proof should be based on solid, cogent and convincing evidence.

[17] A good review of the academic literature on some of the issues in this paragraph can be found in D. Spector, 2007, 'State aids: economic analysis and practice in the EU' (paper presented at IESE Barcelona conference on Fifty Years of the Treaty).

3. The Commission must then weigh the costs of intervention (some of which are identified earlier in this commentary) against the gains claimed by the State ministry. This must include an evaluation of the implications on other interested parties. Importantly, this should include the market's customers as well as the implications for competitor firms and the regions in which they produce.

*The counterfactual*

Two types of issue need addressing. First, what would happen to the firm's assets if no aid were granted? Second, what would be the social implications for the locality of any sudden loss of jobs?

- *Assets*: in cases where restructuring aid is meaningful (i.e. at least some part of the firm can profitably operate in the medium term) it is often the case that some of the bankrupt firm's assets will be purchased and used by another firm. For example, a factory may continue in operation under new ownership, or the new owner may buy only the brand name and transfer production elsewhere. Evidence should include failed attempts to sell the assets to other firms with a capacity to operate them efficiently.
- *Equity issues*: inasmuch as employment is expected to fall in a local area, it is necessary to identify re-employment and mobility prospects. All economic progress requires change, so the counterfactual should identify why this situation would be particularly inequitable. Evidence should include local unemployment rates, lack of success in local job creation and relative weakness of employment and regional policies.

*Burden of proof*

The firm in difficulty (in relation to the assets) and Member State (in relation to equity issues) are best placed to provide the information necessary to prove a counterfactual (against a status quo that the future of the firm should be left to competitive market forces). The Commission is best placed to 'market test' the impact of the aid, particularly on customers and other firms in the market (which may lose market share or even find themselves in difficulty). The Commission must be aware of the full political economy pressures that will inevitably be at work (e.g. customers may be pleased to have a subsidised input, horizontal rivals will have their own agenda and taxpayers may be poorly represented in the crisis).

*Compensatory measures*

'Compensatory' measures are intended to ameliorate distortions to competition resulting from a firm receiving aid. They include requirements such as divestitures, capacity reduction and production caps. They are set out in #38-42 of the current guidelines, but the underlying reasoning needs clarification, not least because they appear to be required as a means of 'compensating' rivals and not for helping consumers. From the latter perspective, it seems odd that the Commission should facilitate output restrictions and capacity reductions – activities which would rightly

be harshly treated as a hard-core cartel in any other circumstances! On the other hand, from the perspective of a more efficient rival, the absence of 'compensation' would substantially distort competition because of the simultaneous injection of aid. This ambiguity could lead to confusion and bad decisions. The tension with respect to compensatory measures comes from two conflicting pressures. First, for the pervasive reasons we set out in section I, restructuring aid distorts competition and inevitably has undesirable side effects – it would be optimal to accept the prohibition in Art.87(1) and address equity issues by other instruments (e.g. helping redundant workers directly rather than by subsidising shareholders). Second, if the reality is that some restructuring aid is to be allowed, then the rules should be written so as to minimise the damage – this is the role of compensatory measures.

The aim, then, is to limit the moral hazard problems and competitive externalities discussed in sections I and II. One way of achieving this is to place compensatory measures in the context of the counterfactual – R&R aid should be seen as facilitating a smooth transition to the market outcome (i.e. the counterfactual). This provides a level of incentive compatibility for the firm and Member State to reveal the true degree of distress. If the counterfactual is that few of the firm's assets would be reused in the market, then more aid may be allowed but only alongside strong 'compensatory' measures (including closure). On the other hand, if the counterfactual includes substantial re-use of assets under a different management team, then both aid and 'compensation' should be very limited as a healthy firm can survive.[18] This 'compensation' mechanism provides a disincentive for the firm to request, and the Member State to grant, inappropriately high levels of aid.

If the aid package includes an increase in the extent of state ownership (e.g. the restructuring may include an injection of capital in return for an equity stake), it should be a standard requirement that such stakes should be privatised within a short and tightly specified time limit and without a bias that would reward those associated with the original distress. More generally, 'compensation' may also be required from the Member State (see #46; e.g. opening up a regulated market to competition, or privatisation of a state owned enterprise). To the extent that these measures are sensible, of course, they should ideally be implemented independently of a financial crisis in a related firm. Nevertheless, political economy considerations may mean the benefits can be brought forward and wherever possible such measures should be encouraged.[19]

In conclusion, it is appropriate that compensatory measures should be seen as a punishment for the managers and owners of a firm in difficulty (and possibly also the Member State), because this provides a deterrent to firms sliding into difficulties or asking for, and Member States granting, R&R aid. The overarching aim of the revised Guidelines should be to minimise efficiency distortions and encourage the use of alternative measures to address equity issues.

[18] Of course, this assumes that R&R aid is justified in the first place.

[19] To the extent that such requirements are anticipated, they may influence a Member State to hold some regulatory 'hostages' to be used judiciously to throw into the pot when a national champion demands R&R Aid. Needless to say, such strategic behaviour should be strongly discouraged.