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Shortcomings of the EU state aid model from peripheral perspective: the case of Estonian Air

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The problems with national airlines in small peripheral member states indicate that the effects of strict competition policy and state aid rules of the European Union (EU) may not be equally useful for all member states and their citizens. Measures that are considered efficient from the perspective of one EU member state may not necessarily improve the welfare at the EU level and vice versa. While common competition policy rules are often justified by referring to the core values of European integration and the Single Market, the values themselves prioritize different aspects of the ideals of free market, European solidarity, and institutional stability. Curiously, as a result, the EU practical regulations are often imposing significant costs on a local peripheral consumer while even unable of meeting the proclaimed European values. By using the case study of the Estonian national flag carrier Estonian Air the current study focuses on the question whether the EU state aid regulation is simultaneously rational and sufficiently flexible to take into account the joint values of the European single market and specific needs of peripheral member states.

Keywords: competition law; Estonian Air; European Union; state aid

1. Introduction

The state aid rules of the European Union (EU) are designed to ensure undistorted economic competition in the Single Market. In principle, state aid is prohibited in the EU. Only few exceptions are justified by referring to common economic and social interests but peripheral location has never been among them. However, the interpretation of the exceptions and common interests has not always been unambiguous in the member states. This serves as a source of dilemmas and challenges especially for the governments of the peripheral EU member states and for the numerous companies owned by them.

In practice, complicated situations seem to arise especially when the risky airline sector is coupled with public ownership and poor business conditions of the periphery. Currently,

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several investigations have been opened by the European Commission to assess the legality and economic reasonability of state aid granted by some EU member states. Among others, investigations have also been opened to assess whether state aid granted to the Estonian national flag carrier airline Estonian Air is in line with the state aid rules of the EU.

At first sight, the case of Estonian Air presents a typical example of a situation where an EU member state faces a probable need to recover the aid provided from the state's resources to the company owned by itself. In the aviation sector similar investigations have recently been conducted by the European Commission regarding national aviation companies like Cyprus Airways, airBaltic, Adria Airways, SAS, LOT, Air Malta, and Czech Airlines. In addition, the case of state aid provided to Estonian Air also exemplifies a complicated situation where strategic interests, business needs, and political motives of an EU member state are opposed to the limits of EU legal regulation to reflect the economic diversity of the union in real terms. Hence, apart from being 'just another' of those cases with state aid to ailing airlines the case of Estonian Air also highlights the trade-off between unfair competition through state aid and the relevance for a small peripheral member state to maintain necessary and stable airline connections.

The starting point for the European Commission is that state aid distorts economic competition and therefore it should be banned as widely and automatically as possible. In such circumstances the government of an EU member state providing state aid is a priori presumed to be guilty and the recovery of the aid is seen as the appropriate solution. The strict position of the Commission has often been justified with the need to compensate for the tendency of national governments to rescue their flag carriers at any cost as part of their national pride and as a symbol of success of a national government (Nulsch, 2014, p. 5).

It must be admitted that the question has obviously wider implications beyond airline companies, as peripheral states have disadvantages also in others sectors. Nevertheless, both the economic effects and social considerations of an EU member state should be taken into account since often the reason for state aid is that peripheral companies face unequal competitive situation arising from the locational disadvantage or there is a social need for certain services in a member state.

Consequently, a question emerges if the current EU state aid rules are lacking flexibility in practice and therefore would be appropriate only in a limited number of cases. Moreover, the related debate reaches a more fundamental depths of European integration dynamic, focusing on the question of how much real autonomy is left to national governments responsible for designing and executing their national policies in a rigid policy environment where any such measures implemented in a member state has a strong potential to be ruled out due to causing distortions at the EU level.

In this light, by using the case study of the Estonian national flag carrier Estonian Air the current study focuses on the question whether the EU state aid regulation is simultaneously rational and sufficiently flexible to take into account the joint values of the European single market and specific needs of peripheral member states. The study will also focus on core reasons behind the contradictory interests of the European Commission and national governments of peripheral member states and offer options for state aid reforms in the upcoming years.

2. Framework of the state aid regulation model

2.1. General prohibition of state aid

The general prohibition of state aid in the primary law of the EU (Official Journal, 2012, Article 107) can be linked to the concepts of economic liberalism, neoliberalism, utilitarianism, and the derogation model. According to the liberal and neoliberal approach, the resources should be allocated through self-regulating market mechanisms and the government interference in the

operation of free markets should be minimized. It is believed that in the long term this will provide the highest level of welfare (Harvey, 2005, pp. 3–4). Liberal foundations are clearly present in the four freedoms, providing the ideological basis for the free movement of people, goods, services, and capital in the EU internal market. Hereby the motivation is mainly functional – to achieve optimal allocation of resources, higher standard of living and higher income, and last but not least, a more peaceful society. The possible harm from state aid can be related to the risk of creating static inefficiency in production due to encouraging production by inefficient firms (Spector, 2009, p. 176).

The European Commission, when analysing negative distortive effects of state aid, has been in the position that a full market is both achievable and creates the most beneficial competition situation for consumers (European Commission, 2011, 2013a). Yet, these studies tend to pay insufficient attention to the fact that a usual market environment consists of several additional variables which may not allow the creation of a fully equal competition situation. These variables are often amplified by supranational legal harmonization removing the traditional protection models.

Thus, competition rules at the EU level which prohibit state aid are expected to ensure maximum positive outcome for the EU as a whole. Since exceptions from common regulation give rise to costs, they should rather be avoided to maximize common positive outcome for the union (Rosamond, 2000, pp. 51–52). With regard to state aid regulation at the EU level, a fundamental question arises whether state aid creates favourable competitive advantages for particular companies only or if it has also the potential to enhance competition and stimulate the economy in general. Hereby arises also a wider question if subsidizing companies in difficulties is an optimal policy (Nulsch, 2014). In theory, state aid is considered as a useful tool for attracting firms to peripheral and poor regions and for reducing geographical inequalities. This latter aspect is important for the Central and Eastern European countries as well as for the Southern European ones. Nevertheless, while the main justification for state aid is to enhance efficiency in order to optimize total welfare, this may look differently from national capitals and union wide perspective (Nulsch, 2014, p. 7). Measures which are considered efficient from the perspective of an EU member state, might not necessarily improve welfare at the EU supranational level and vice versa.

As stipulated in the derogation model of integration, state aid is prohibited to preserve and develop the single market. Along these lines, state aid should be regulated using the ‘one size fits all’ approach based on formal criteria and any measures qualified as state aid should be pursued to the full. In the EU legislation, alongside the general prohibition of state aid also exceptions are specified which justify state aid granted by the common interest objectives under specific conditions (Official Journal, 2012, pp. 45–46). This approach follows the competition model, which considers state aid control as the possibility to promote good functioning of the market by addressing market failures through state aid (Crocioni, 2006, pp. 91–92). The competition model moves away from the formal application of EU regulations and provides ground for systematic assessment of positive and negative effects of state aid. This approach is also reflected in the view which suggests it only be focused on meaningful distortions and that the European Commission should not put procedural obstacles in the way of necessary and urgent rescue measures and merely address negative spill-over effects to the EU member states (Crocioni, 2006, p. 93). Likewise, the argument of ‘strategic trade’ has been used by the European Commission to justify strict approach towards state aid. In this approach national governments might use state aid to gain extra advantages in a fully functional market. In this case one could see how governments compete with each other and state aid is simply an option in their arsenal (Crocioni & Newton, 2007, p. 153).

2.2. Evaluation of the effectiveness and rationality of state aid

The evaluation of the effectiveness and rationality of giving state aid and rescuing state-owned companies depends on the measured categories and the definition of success. The economic aspects of cost-efficiency and profitability are often contested with political popularity based on social services maintained by the government. Here the interests and definitions of success by the European Commission and national governments tend to contradict each other. The Market Economy Investor Principle formulated by the European Commission which states that ‘government is allowed to invest only under comparable conditions to a private sector investor’ contradicts clearly the main function of the state: to deliver services and goods to taxpayers for their own money according their collective democratic decisions. Following this logic, for example, Nulsch (2014) has proposed that the survival of a company should be taken as a central variable. Still, one needs also to acknowledge that the main output should be crucial, as should be the availability of goods and services with best possible prices for consumers.

The discussion on the motivation and key values expected from state aid regulation at the EU level has also been explained by the model of Europeanization, as an additional condition of the domestic political process and a smokescreen for domestic reforms, as the macro-process and an independent variable producing policy changes (Radaelli, 1997). As argued by Spector (2009, pp. 178–181), state aid control might be desirable for three reasons: national public authorities might be unable to resist lobbying pressure, subsidy awards provided by national politicians might have a wasteful effect or the negative externalities on neighbouring countries cannot be internalized. For example, when a government has already started rescuing a company, in order to avoid political losses the only politically rational way is to accomplish it at any cost (Nulsch, 2014, p. 5). The fact that the national governments are not setting limits for themselves makes also understandable the very strict position of the European Commission. Nulsch also stipulates that by accepting the supranational enforcement system, EU member states recognize the inability to resist national lobbies.

2.3. State aid as an instrument of positive integration

The state aid regulation at the EU policy level has mostly been following the logic of negative integration, however, state aid could also be an instrument of positive integration by defining the common European interest, which serves as a guideline for the EU member states in coordinating national actions and targeting spending (Blauberger, 2008, p. 5). Particularly in the light of the modernization of the EU state aid rules in the last decade, as for example, the European Commission has also developed its own vision of ‘compatible’ state aid policy the movement towards positive integration is clearly visible (Blauberger, 2008, p. 23). As argued by Blauberger, this way ‘the Commission might run the risk of undermining the negative integration it has achieved so far’ (2008, p. 23).

In a wider context, the question is whether European integration should be considered as the ‘highest value’ *per se* for what the interests of small peripheral countries might potentially be sacrificed, or the aim of integration should be to improve the realization of national interests in the framework of common policies. As regards state aid, the interests of the EU as a whole have been considered primary against national interests. The supranational ‘value’ at the EU level can thus be related to the maintenance of such a competitive environment that does not allow exceptions and that is unambiguous to all economic agents. However, even if liberal market conditions and fair competition is expected to have positive corrective impact at the EU level, they may also lead to negative consequences at the local level.

The third influential set of motivation related to state aid consists of institutional and neo-institutional factors. In the neo-institutional reasoning, administrative and legal motives are dominant

over economics and politics and small administrative solutions guide bigger political choices, not *vice versa*. The decision-making is dominated by institutional habits, procedures, norms, and compromises that prefer expectable, rational, continuing, regulated, and less risky choices. In the bargaining situations the existing policy-driving institutions tend to use policy areas for the improvement of their positions and not for actual policy goals (Veebel, 2012, p. 29).

To summarize, while originally inspired by the utilitarian and liberal values of free trade and undistorted competition, the EU state aid regulation has been influenced by the general process of Europeanization and the growing neo-institutional tendencies in the EU institutions. In practice, the competing motivations and goals make it more complicated to meet simultaneously the needs of member states in the core and periphery and to fulfil the aims of common European values.

3. The EU state aid rules and their economics

3.1. *The core principles*

The core principles of the EU state aid rules have not changed since 1950s (Botta & Schwellnus, 2014, p. 336). However, over 60 years of European integration, these rules have often been clarified both in the case-law of the Court of Justice of the EU and in the guidelines and recommendations of the European Commission. There are numerous historical circumstances which have shaped the state aid rules in general and the national airlines in particular to acquire such a strict and unified format. At the same time, accession of new member states has meant that the state aid economic effects and changes have become resilient and they also need reflection in legal terms. Finally, the appearance of low cost carriers has had its influence to state aid rules and one should not neglect that the nature of airline management in the EU has significantly changed after the deregulation of the market.

The EU member states have delegated the enforcement of state aid policy to the European Commission and the Commission's autonomy has strengthened over time. Interference of supra-national bodies has been justified with the threat of 'cross border negative spill-over effect' (Crocioni & Newton, 2007, p. 148). Before the current ongoing reform (the EU State Aid Modernization) programme, the state aid rules contained around 39 separate guidelines and communications. During the reforms, the number of guidelines is expected to decrease and the transparency of the rules is expected to be improved (European Commission, 2014a). This means that the EU state aid policy is moving away from the derogation model and towards the competition model suggesting that the European Commission should be involved only in cases of significant distortions.

With regard to the relevant legal norms, regulation is quite clear. As stated in the Treaty on the Functioning of the European Union (TFEU),

any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market. (Official Journal, 2012, Article 102)

The scope of state aid measures is ranging from rescue loans and restructuring aid, loans at favourable terms, guarantees, and tax exemptions, to the debt write-offs, infrastructure provisions, services provided at less than market costs and other measures (Kekelekis, 2011).

In order an aid to classify as state aid all of the following criteria need to be met:

- (1) The support is granted by state or through state resources.
- (2) The aid gives a selective advantage to certain undertakings or the production of certain goods (European Commission, 2014a).

- (3) The aid has the potential to distort competition. Hereby, the assessment is based on criteria whether aid has strengthened the position of the aid recipient or not.
- (4) The aid has the potential to affect trade between the EU member states (Pesaresi, Sinnaeve, Guigue-Koeppe, Wiemann, & Radulescu, 2012).

3.2. Market failures and state aid exceptions

To address market failures, under certain circumstances state aid is considered compatible with the EU state aid rules. The exceptions include the existing approved schemes, the ‘general block exemption regulation’ (GBER), the ‘de minimis regulation’ and the application of the ‘one time, last time’ principle (European Commission, 2014a).

The first group of exceptions includes the existing approved schemes such as non-discriminatory state aid which has a social character or is granted to individual consumers, and the aid to make good the damage caused by natural disasters or exceptional occurrences (Official Journal, 2012, Article 107). Additionally, state aid might be accepted if the purpose of the aid is to promote the economic development of areas of abnormally low standard of living or where there is serious underemployment. The same applies to the state aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of an EU member state (Official Journal, 2012).

In general, EU member states can put the measure into effect only following the respective approval of the Commission (European Commission, 2013a). However, under certain conditions which are defined as GBER state aid measures are exempted from the requirement of prior notification. The aim of the GBER is ‘to bring benefits to the society’ that would outweigh the potential distortions of competition in the EU single market (Rose, Bailey, Macnab, Bellamy, & Child, 2013, p. 408). The main areas of GBER cover regional development, research and education, employment and training, and support to entrepreneurship.

The exemption to mandatory prior notification also applies to the *de minimis* aid not exceeding €200,000 to a single undertaking over a three-year fiscal period. State aid can also be permitted in exceptional cases for rescuing and restructuring non-financial undertakings and only once following the ‘one time, last time’ principle. This principle states that rescue and restructuring aid should be allowed to be received only once within 10 years (European Commission, 2013a). The exception is allowed, should the restructuring aid follow the granting of rescue aid as part of a single restructuring operation (European Commission, 2014b). Hereby, the concept of ‘temporary restructuring support’ in the form of limited liquidity assistance granted to the small and medium-sized enterprises and to smaller state-owned undertakings has been introduced in the guidelines for 2014–2020 (European Commission, 2014b).

The decision whether aid qualifies as state aid and follows the EU state aid regulation is particularly complicated in the field of services of general economic interest (SGEI) which play an important role in ensuring social and economic cohesion and sustainable development in the EU (European Commission, 2011, p. 3). The specific nature of these services is related to the fact that they would not be supplied in the market or that they would be supplied in a lower quality or scope if the financial compensation would not be provided by public authorities. This type of services may require public intervention and public compensation. The SGEI cover large commercial services which are provided to the entire population at affordable conditions (e.g. postal service, public transportation, energy supply) but also a broad range of health and social services which are usually provided by the state, regions, and municipalities, but could also be supplied by private operators (Pesaresi et al., 2012, p. 1).

Besides the horizontal state aid legislation at the EU level, sector-specific vertical regulation is applied to certain sectors such as agriculture, energy sector, financial sector, and transportation

(European Commission, 2014c). The new state aid guidelines for 2014–2020 set out new conditions under which EU member states and local authorities can grant state aid to airports and airlines in the EU. These guidelines allow, for example, public authorities to support investment into airport infrastructure and equipment and create more flexible criteria for granting start-up aid for routes from the remote regions. First, there must be a credible restructuring plan capable of restoring the long-term viability of the company without further public support. Second, the company must make its own contribution to avoid the entire burden falling on taxpayers. Third, measures should be introduced to mitigate the distortions of competition created by the aid (European Commission, 2014d). Therefore, the existence of a viable restructuring plan is particularly important.

3.3. *Recovery cases*

If none of the above introduced exceptions does not match actual circumstances and the negative decision about state aid has been taken by the Commission, it will open a ‘recovery case’ to enforce the member state involved to recover the aid that has already been paid. If the member state does not comply with the decision in due time the Commission may refer it to the European Court of Justice. In practice, the recovery of illegal aid has caused serious challenges and has often not succeeded. According to the Study on the Enforcement of State Aid Law at National Level (Jestaedt, Derenne, & Ottervanger, 2006), the recovery of illegal state aid by EU member states has faced a number of obstacles such as lack of clarity as to the identity of the national body responsible for issuing recovery decision, of the beneficiary required to repay the aid and as to the exact amount of the aid to be repaid; the absence of a predetermined procedure to recover aid, and so on.

The difficulties of EU member states in recovering illegal state aid could here intriguingly raise the question if the recovery case is too formal and impractical to meet actual local economic circumstances and needs. Assuming that state aid is granted to a state-owned company to overcome urgent financial difficulties, the recovery of the aid – in a situation where company has already used it and is, under changed circumstances, also not able to obtain additional funds on the credit market – would inevitably put financial pressure on the company, and in the worst case scenario, force it to go bankrupt. In that case it will not be possible to restore the initial market conditions as one of the companies has disappeared from the market. More intriguingly, in case the initial competitive conditions were not efficient the rationale of the restoration of the initial situation becomes even more questionable. The recovery of illegal state aid is particularly crucial in the case of the state-owned companies with a public service mission. Here the state is responsible for the efficient recovery of state aid provided by itself to the company in financial difficulties, which is also partially or fully owned by the state.

Thus, as the current section indicated, despite there being numerous ways for exceptions and legitimizing already delivered state aid, none of these options are directly related to the special needs of peripheral states. This can largely be imputed to historical reasons. As the original ideas and first steps of competition policy and state aid date back to EC Treaty in 1958, including merely the founding six members all closely linked to each other in the heart of Europe, special cases for peripheral needs did not rise. With each subsequent enlargement, geographical distances and economic differences have grown and in 2015 the state aid reform agenda should consist also special provisions and options for peripheral, small, and often less well-off members.

4. **Common gains of the EU versus the special needs of peripheral member states: the case of Estonian Air**

In this section the case of Estonian Air will be analysed in order to assess whether the state aid regulation model of the EU is flexible enough to allow meeting both the different economic

needs of the peripheral member states and the common European values based on liberal and institutional ideals.

4.1. Background

The Estonian national flag carrier airline Estonian Air has faced financial difficulties since 2006 and reached a state of technical bankruptcy in July 2012. Financial support from the Estonian governments and rescue loans have been granted to the company several times during the period 2009–2014. In addition, the company has received interest rate cuts and other benefits such as the prolongation of the repayment period of the loan from six months to five years. The resources injected into the company by the Estonian governments have been remarkable, especially in light of the fact that there are only 600,000 taxpayers in Estonia and Estonian Air only flies to 14 destinations. To be specific, in 2009 7.3 million EUR and in 2010 19.9 million EUR were granted (formally as a loan) to Estonian Air by the state and the private shareholders. In 2011–2012, additional 30 million EUR were granted to Estonian Air by Estonian government. At the same time, the Estonian government has notified the European Commission about its intention to grant a rescue loan to Estonian Air in the amount of 8.3 million EUR only in December 2012. The initial rescue loan in the amount of 8.3 million EUR was disbursed by the Estonian government in three instalments: 0.793 million EUR in December 2012, 3 million EUR in January 2013, and 4.507 EUR in February 2013 (European Commission, 2013b, p. 15). However, the Estonian government informed the Commission only two months after 8.3 million EUR was granted that the government will increase the rescue loan by 28.7 million EUR, which includes 16.6 million EUR granted to the national airline in March 2013 and 12.1 million EUR to be provided to the company at a later stage (State European Commission, 2013b, p. 16). The Estonian government has later on explained that the total needs of Estonian Air at the rescue phase have been set at 37 million EUR that covers the sum of the initially notified loan of 8.3 million EUR plus the later notified loan in the amount of 28.7 million EUR (European Commission, 2013b, p. 6). In June 2013, Estonia notified the Commission about the intention to grant a rescue loan to Estonian Air in the amount of 40.7 million EUR (European Commission, 2014e).

Investigations were opened by the Commission in February 2013 and continued in February 2014, mainly focusing on the questions whether the five-year restructuring plan of Estonian Air is capable to ensure that the company will become viable without continued state support, whether the company is able to meet the challenges faced by the air transport sector over the next years and whether the ‘one time, last time’ principle has not been infringed. The latter question becomes crucial since the company has benefited from public interventions in several times (European Commission, 2014e). The situation was further complicated as in October 2014, during the ongoing investigation of the Commission, the Estonian private company Infortar announced about its interest in buying the majority of the shares of the Estonian Air should the Commission declare that the aid granted to Estonian Air is legal.

4.2. Was it state aid?

The Commission has confirmed in its opening decision in 2013 that the aid granted to Estonian Air classifies as state aid in the following aspects. Firstly, the capital injection was granted through state resources. Secondly, the aid benefited only the Estonian Air. As stated by the Commission, ‘The measure in question thus enabled Estonian Air to continue operating so that it would not have to face, as other competitors, the consequences normally deriving from its poor financial results’ (European Commission, 2013b, p. 8). Thirdly, according to the opening decision, ‘the measure affects trade and threatens to distort competition between Member States’ (European

Commission, 2013b, p. 8). The last argument is opposed to the initial view of the Estonian government which considered the measure as not distorting competition. It argued that:

relative to total European air traffic, the Estonian market is considered as extraordinarily small. In addition, on a number of routes served by Estonian Air, the airline is the only carrier offering a direct connection. On these routes the aid will not affect the competitors of the airline. (European Commission, 2013b, p. 7)

This situation marks clearly a conflict of interests. The reasoning of the Estonian government overlaps with the argumentation from previous sections which saw small and peripheral EU member states view the competition situation in the EU internal market to some extent differently from the institutions of the EU. Whereas such peripheral member states consider state aid as a tool for reducing geographical and economic inequalities, the institutions of the EU interpret it as the distortion of competition between member states. Still, in principle the Estonian government has not contested the decision by the European Commission that the measures classify as state aid (European Commission, 2013b, pp. 8–9). Hereby, the focus of the investigations of the Commission is on the question whether state aid granted to Estonian Air could qualify under the derogation concerning the development of certain economic activities provided that it does not impair trading conditions. Meanwhile, the Commission has pointed out that the state aid granted to Estonian Air qualifies as unlawful aid since the requirement of the prior notification has not been followed (European Commission, 2013b, p. 10).

As the rules foresee, the aim of state aid with such comprehensive restructuring programmes must be limited to restoring the airline's health. State aid should also be self-contained in a sense of requiring no further help after implementation. Thus, the role of the government in managing the company must be limited to its ownership rights. There exist also capacity restraints making sure the aid does not give advantages in the EU internal market. As no anti-competitive behaviour is allowed the aid must also be transparent.

Comparing the case of Estonian Air to the Commission guidelines, even if its general logic points to a comprehensive restructuring programme, its details appear to violate several aspects of the guidelines. The most obvious potential violation concerns the 'one time last time' principle which requires the existence of a comprehensive plan and an implementation tactic concentrated in a short period of time.

Although according to the opening decision of the Commission the Estonian flag carrier has qualified as 'firm in difficulty' (European Commission, 2013b, pp. 7–8), what makes the approval of the state aid case difficult is the requirement that aid should be granted only after the Commission has approved the restructuring plan. As noted by the opening decision of the Commission, 16.6 million EUR (out of the total 28.7 million EUR constituting the new measure) were already disbursed to the company on 5 March 2013, before obtaining authorization. Since the Commission concluded that the new measure constitutes state aid, the amount of EUR 16.6 million has been granted to Estonian Air in breach of the standstill obligations laid down in Article 108(3) TFEU. Accordingly, the Commission considers at this stage that the EUR 16.6 million part of the new measure qualifies as unlawful State aid (European Commission, 2013b, p. 10).

4.3. Options for exceptions

Thus, in the case of Estonian Air it is rather evident that it was state aid and that it was allocated in ways which are directly prohibited and with an aim not supported by the Commission guidelines. As is clear from the facts, the Estonian government granted rescue aid to the Estonian Air in several separate instalments before it started thinking in terms of a proper restructuring plan appropriate in the particular case and meeting the formal state aid requirements. It could

perhaps be argued that the aid granted by the Estonian government before notifying the Commission was literally a *rescue* mission to save the company from bankruptcy and only after that the government could start putting together a restructuring plan. Yet, this could be difficult to prove considering the years it took for the government to come up with the restructuring plan. Nevertheless, probably the most difficult requirement to fulfil is the need for the Commission to be convinced that the plan enables Estonian Air to compete in the EU internal market on its own merits without recourse to further aid.

There exist also other possible grounds in the present case of making an exemption and legalizing the aid. For example, the aid could be deemed lawful had the Estonian Government given it to a recipient entrusted with a clearly defined public service mission, the compensation being strictly limited to the discharge of a public service and having chosen the beneficiary in a public tender. A yet wider ground for an exemption could be found from the Article 107(3) (a) TFEU which allows for aid to promote the economic development of areas where the standard of living is abnormally low or where serious underemployment exists. The living standard of Estonia has not yet exceeded the 75% of the EU average. This exemption deserves a more advanced analysis in the context of systemic economic inequalities between the core countries and the periphery of the EU which is conducted in the next section. However, it suffices here to note that hitherto it has not been serving as a ground for exceptional treatment of airlines of the peripheral states.

Another possible ground for exemption could be derived from the GBER that allows for certain types of aid where member states are not required to ask the Commission for approval. The GBER could be applied to the case of Estonian Air if the situation will be interpreted as one that brings along growth not only in the aviation sector but for the Estonian economy as a whole. Yet, it must be proved by the Estonian government that its activities have been targeted to the growth of the sector. The Commission has already argued in the opening decision that 'Estonia's concern on the impact on the national economy of the closure of Estonian Air as well other general considerations such as the lack of connectivity due to Estonia's peripheral geographical situation, are in principle not apt, on their own, to justify a derogation from the 'one time, last time' principle' (European Commission, 2013b, p. 6).

While in the case of Estonian Air there are not many arguments available to support the 'incentive effect' or 'innovation spill-over' as justifications, the arguments of avoiding market failure impact on social welfare and security or the need for compensation due to specific business environment could have more substance. In turn, the argument of economic prosperity is harder to justify as the actual cost has been remarkable in comparison to the offered service and its social impact.

Drawing on the above it has become clear that unless there exists a plan of restructuring the rules leave only limited space for helping state-owned companies in difficulties. This is also understandable as the aim of the regulation is to avoid national governments subsidizing their state-owned companies on a regular basis to gain market advantage. The criteria for legal state aid cannot be met on *ad hoc* basis and need long-term planning before launching actual aid.

5. Problems with current state aid framework

5.1. Policy conclusions

The EU competition policy and state aid regulation model tend to follow the ideals of common, universal, simple, and supreme regulation, aiming at guaranteeing the best possible competition conditions and the effective functioning of the EU single market both from economic and legal point of view. However, this approach seems to lack an understanding that the competition situation among the EU member states remains different in terms of geographical, historical, cultural,

and so on factors. This conclusion holds even despite the obvious success of economic and legal integration in removing barriers between member states and safeguarding the principle of four freedoms. Under these circumstances, the universal rules tend to support companies with stronger market position, logistical advantages, or better environmental conditions. In addition, the EU state aid rules, while carrying the ideals of utilitarian free market, tend in practice to be dominated by the principles of neo-institutional and legal universalization. Thus, flexibility and social impact in some member states has apparently not seldom been sacrificed for fast and simple applicability and common gains.

In principle, the state aid regulation is designed to prevent governmental subsidies to private companies that provide services which are not socially irreplaceable. Under functioning market conditions and normal access to financial resources, the regulation that concerns the recovery of aid is indeed applicable in practice and supports market competition, since in case of a negative judgement aid can be returned and competition restored without harming the provision of services. Thus, national governments are more eager to support fully or partially state-owned companies offering social or strategic services but unable to directly recover their running costs in a sustainable way, which represents also the case of Estonian Air. The aim of this type of state aid appears not to consist in getting competitive advantage among other market actors but to prevent bankruptcy and to thereby to safeguard the delivery of services. Under practical circumstances, the situation may be even more complicated as high social importance of national airlines in peripheral states can also cause a misuse of state aid by policy-makers to gain or keep political popularity before the elections. Additionally national government can be bound by 'path dependence' forcing them to continuous injection of funds to keep partially unsuccessful rescue mission alive and to save national airline at least from direct bankruptcy during their rule. Both these aspects appeared also in the case of Estonian Air, as the successful rescue of the national flag carrier was one of the central election promises of the acting minister of economic affairs and transportation in his pre-election campaign in 2013–2014.

In addition, as described above, the possibility to recover aid from financially troubled companies tends to be low and even if aid is recovered, the original market situation and supply of services is hard to restore. Intriguingly, from the perspective of the European Commission it is not rational, if not naïve, to expect that national governments are under these circumstances motivated to submit correct data on state aid and to be responsible for the efficient recovery of it from a company which it fully or partially owns, which is offering public or strategic service and having no funds for the recovery of aid. Since bankruptcy as an alternative would end up with additional costs for the government and may also harm the accessibility of services, governments are also motivated to find arguments for the delay of reimbursement or for the justification of the state aid granted. Still, from the perspective of the Commission, there is a pressure to follow the principles settled in its previous decisions and to apply the procedures that have been used previously, despite the fact that these principles and procedures have been often developed before the accession of the Central and Eastern European member states.

It has to be realized that what is at stake here for a small and peripheral member state, in this particular case also missing direct and easy alternative connections in terms of railway, shipping, or motorway, is connectivity needed both for security reasons and business options. Hereby, the case of Estonian Air can be considered in a broader context. In the regulatory room of the EU, the 'standard' way of granting aid to a national flag carrier would have presumed limited rescue aid, a clear-cut restructuring programme and the efficient implementation of the restructuring programme in cooperation with the Commission, including long-term advance planning and meeting all formal state aid rules. As long as it is another of those cases of compatibility or not with the common EU rules, the decision of the Commission is fully in its place. However, the discrepancy arises between the probable mismanagement of the aid injections by the Estonian

government and the possibilities that the EU single aviation market offers content-wise to a small peripheral country.

For the governments of small peripheral states, the question tends not to be about the profitability of a state-owned company in the sense of it acquiring a bigger share of the market by the help of state aid, but about its survival as a sort of public service provider that has to secure the connectivity and offer stable and sufficient number of direct business routes to the major cities in Europe and to those of the neighbouring region. In this sense, the question is rather about providing a minimum of public service, or even of the availability of a basic ‘infrastructure’ for an economy. It must be admitted that the market on its own would not probably finish off with the aviation in Tallinn and other similar capitals. Still, without state aid it would presumably only provide for the service of destinations with sufficient demand. The public service obligations (PSOs) would be an alternative to guarantee the existence of routes to crucial destinations. It is relatively widely used in the old EU member states. Yet, the Central and Eastern European countries have seen only a few cases covered (legitimized) by the PSO (European Commission, 2014b).

5.2. Suggested reform

The first suggestion the authors could offer as to the state aid regulation in the EU is that further efforts should be targeted to supporting systematically state-owned companies with social or strategic mission in peripheral and small member states. In contrast, the main idea underlying the EU competition policy presumes that the best competition environment will be created by the market. Thus, at first sight the given suggestion contradicts the essence of the state aid rules in the EU. However, there are other variables affecting the market such as geographical location, logistical options to conduct a business, population size and density, capitalization, and other factors. What the current rules seems to miss is an awareness of a systematic disadvantage that the peripheral countries suffer from. These divergent conditions have become more apparent and aggravated by the financial and economic crisis in 2008–2012 and especially through the imposed austerity measures (see Ploom, 2014). Thus, to support less advantageous market participants different standards are needed. The suggestion is also based on the rational argument that if there is a social need for certain services and the market cannot provide it in a stable and sustainable manner, there should be a legal way to allow it.

Secondly, further efforts should be dedicated to evaluating whether state aid could at all be recovered and the initial market situation be restored in real terms. The ideals of the European integration are hardly met should the one and only result of the application of the EU regulation be the piling of tensions between the national government and the European Commission. At present, the cooperation between national governments motivated primarily by their national political and economic interests and the Commission looking for a broader picture from the European perspective is already problematic. These interests, however, are prone to remain different also in the future. Therefore, the most rational solution would be to improve the European legal acts to meet better the needs of specific cases in peripheral member states.

Thirdly, as a practical step it would seem to be beneficial to increase the motivation and the competence of the officials of the Commission conducting the evaluation. Under certain circumstances, the assessment should be targeted to focus on the values for consumers and society as a whole rather than following institutionally comfortable and legally traditional approach. However, a similar suggestion would be due as far as national governments are concerned. It would be only rational for the national government or the company involved to foresee how the Commission would investigate and evaluate a particular case based on the state aid criteria, and thus by its appropriate actions to make it easier for the Commission to find a convincing

justification to approve a state aid programme. It is definitely a demanding, but not an impossible task to meet the EU state aid rules. Yet, it needs detailed planning and cooperation between the EU member state and the European Commission right from the beginning.

6. Conclusions

The problems with national airlines in small peripheral member states indicate that the effects of strict competition policy rules may not be equally useful for all member states and their citizens. Measures that are considered efficient from the perspective of one EU member state may not necessarily improve the welfare at the EU level and vice versa. While state aid rules and their general logic is often justified by referring to the core values of European integration and the Single Market, the values themselves prioritize different aspects of the ideals of free market, European solidarity, and institutional stability. Curiously, as a result, the EU practical regulations are often imposing significant costs on a local peripheral consumer, while even unable of meeting the proclaimed European values.

As the above analysis indicated, the present EU state aid rules are lacking sufficient flexibility in practice even if there are options for exceptions when special conditions are met. As the case of Estonian Air showed, time-pressure and mistakes in allocating the aid can create a situation where it is formally highly complicated to legalize the aid without creating a confusing precedent in terms of state aid practice on the EU level. The study also indicated that the bases of exceptions do not include the variables of peripheral location, limited area for functioning, low density of population, and complicated climate conditions that all play a role in causing low profitability of peripheral national airlines. Several studies (Friederiszick, Röller, & Verouden, 2006, p. 655; Nulsch, 2014, p. 5) confirm that the European Commission tends to follow too rigorously its strict, and in this sense also comfortable, legal traditions without being sufficiently open to the idea that state aid can also be a source of economic development and effectiveness. It is rather evident that in all cases instead of formal-legal categorization a deeper analysis of the market situation and the impact of state aid measures is needed.

The conclusions of the present study are even more important in the light of the new round of EU reforms aimed at enhancing its economic competitiveness, stabilizing indebted peripheral areas, and regaining of public support and legitimacy. Differentiation of competition policy regulations and state aid rules would be one source for extra growth for both peripheral member states and for the EU in general. What are the central points to be considered during the reforms? First, it would be reasonable from the European Commission to change its relatively dominating and standardized premise that state aid is negative and should be banned as widely as possible. Instead a more reciprocal cooperation with national governments (providing aid) would be beneficial to analyse the diverse situations and to achieve result where vital social services are delivered but competition situation is not harmed. In this regard, testing cross border market impact of state aid receivers is something to be developed further. This would help especially smaller companies in the periphery to be separated in state aid evaluations and treated differently from market-makers in core states.

Second, the Commission needs to admit that one of the functions of the state is to provide goods and services which are not offered by the private sector, even with subsidies if needed. In practice, joint analysis of the Commission and a national government should be aimed at establishing if state aid is the best or only way in particular circumstances of providing vital social services.

Third, gains of the single market should not come at the cost of peripheral economic stability and social security as it will also impact the legitimacy of the EU and its public support in general. The overall positive economic effect coming from a legal unification of state aid regulation is

understandable, but even when the summarized effect is positive, it is not tolerable nor responsive to the integration values that the benefits of core-located consumers come at the expense of peripheral consumers.

To conclude, there is a need of achieving a dynamic balance which combines simultaneously special clauses for peripheral states and the secures the functioning of the market. The situation in small peripheral states with low population density requires special attention also in terms of concrete stipulations in state aid rules to compensate the disadvantages caused by environmental and natural factors. At the same time, the rules and their application must be stringent enough also for the peripheral states to enable the elimination of the possible populist urges in subsidizing state-owned companies.

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