UNIVERSITY of York

This is a repository copy of *Aiding the State : Administrative Capacity and Creative Compliance with European State Aid Rules in New Member States*.

White Rose Research Online URL for this paper:
https://eprints.whiterose.ac.uk/162686/

Version: Accepted Version

Article:

Lindstrom, Nicole orcid.org/0000-0003-2042-2465 (2020) Aiding the State : Administrative Capacity and Creative Compliance with European State Aid Rules in New Member States. Journal of European Public Policy. 1791935. ISSN 1466-4429

https://doi.org/10.1080/13501763.2020.1791935

Reuse
Items deposited in White Rose Research Online are protected by copyright, with all rights reserved unless indicated otherwise. They may be downloaded and/or printed for private study, or other acts as permitted by national copyright laws. The publisher or other rights holders may allow further reproduction and re-use of the full text version. This is indicated by the licence information on the White Rose Research Online record for the item.

Takedown
If you consider content in White Rose Research Online to be in breach of UK law, please notify us by emailing eprints@whiterose.ac.uk including the URL of the record and the reason for the withdrawal request.

White Rose
university consortium
Universities of Leeds, Sheffield & York

eprints@whiterose.ac.uk
https://eprints.whiterose.ac.uk/

Aiding the State: Administrative Capacity and Creative Compliance with European State Aid Rules in New Member States

Nicole Lindstrom

Abstract

The article advances a new explanation of the role of administrative capacity in compliance with European Union (EU) rules. I argue that strong administrative capacity fosters not only compliance but creative compliance where capable civil servants aid determined governments in following formal EU rules while challenging their substance. I develop this argument by comparing two new member states that increased levels of state aid post-crisis but on different types: 'neoliberal' Estonia reporting proportionally more on 'bad' vertical aid than 'illiberal' Hungary. Drawing on original empirical data, I explain that Hungary has engaged in more creative compliance due to more cohesive ideological commitment to state intervention (a will) and stronger administrative capacity to achieve objectives while minimizing EU scrutiny and sanction (a way). Creative compliance with single market rules presents another challenge to the EU's ability to enforce uniform rules to ensure a 'level playing field' within the single market.

Key words: Administrative Capacity; Compliance; EU State Aid Policy; New EU Member States; Comparative Political Economy

Introduction

Given so much of the academic literature on new EU member states of Central and East European (CEE) focuses on democratic backsliding (Bozóki and Hegedűs 2018; Cianetti et al.

2019; Kelemen 2020), are we are also witnessing an erosion in adherence to core rules underlying the single market? In the wake of the devastating 2008 financial crisis, many CEE leaders promised to make their national economies more self-sufficient by sheltering domestic industries from the pressures of transnational market integration, aims that could, in principle, conflict with European state aid rules. Hungarian Prime Minister Viktor Orbán articulated the strongest 'illiberal' political economic alternative to open competitive markets, yet moves towards state intervention is visible to varying degrees and types across (and beyond) CEE (Johnson and Barnes 2015; Appel and Orenstein 2018; Bohle and Greskovits 2019; Toplišek 2020). Unlike democratic backsliding, however, where EU institutions face political constraints in enforcing compliance with core liberal democratic principles, state aid regulation falls under the EU's exclusive competence and gives the European Commission more autonomy to monitor and enforce rules. In this article, I consider whether state aid compliance in CEE has decreased post-crisis and what accounts for variation in compliance in terms both levels and types of state aid across CEE states.

What constitutes (non-)compliance with EU state aid rules? Since state aid rules first appeared in the 1957 Treaty of Rome, the Commission has been tasked, as part of its broader competition portfolio, with prohibiting 'bad' vertical government interventions that give an undue advantage to one firm over competitors within the European single market. State aid regulations have gradually evolved, however, to allow more scope for member states to distribute, with less Commission scrutiny, 'good' horizontal state aid, such as investment in research and development, deemed to enhance national (and European) competitiveness as a whole (Blauberger 2009b). The assumption underlying the EU's regulation of both 'good' and 'bad'

state aid is that markets allocate resources more efficiently than states and state aid expenditure should thus be minimized. To measure formal compliance with European state aid rules, I thus consider variation in both *levels* and *types* of state aid. Analyzing Commission state aid data, I find that state aid expenditure as a percentage of total GDP has steadily increased in CEE since 2004 and, by 2018, was three times higher than in the EU-15. But CEE states vary both in the amount and kind of aid granted. Not only do some CEE governments spend more on state aid than others; they vary in the proportion of aid spent on 'good' horizontal objectives versus 'bad' vertical interventions.

I develop an in-depth comparison of two states, Hungary and Estonia, that have increased levels of state aid since 2008 but differ in type: Hungary reporting a higher proportion of horizontal aid and Estonia more vertical. This result is unexpected given that Estonia, as a paradigmatic 'neoliberal' state, has traditionally provided minimal aid to industry, vertical *or* horizontal (Bohle and Greskovits 2012). Meanwhile, Orbán has pledged to transform Hungary from an 'embedded neoliberal' state, supporting (FDI-based) industrial development largely through horizontal measures, to an 'illiberal' state that discriminates in favor of (national) insiders, a pledge more in line with vertical aid. To explain this counterintuitive observation, I go beyond reported compliance/non-compliance indicators to examine the process of compliance in the two states. Drawing on European Commission state aid data and personal interviews with European Commission, Estonian and Hungarian state aid officials, I argue that this outcome can be explained by different degrees of willingness and ability to comply creatively (Batory 2016). Hungarian governing elites are more unified in their ideological commitment to intervene

directly on behalf of firms and industries (a will) and can draw on stronger administrative capacity to achieve these objectives while minimizing EU scrutiny and sanction (a way).

This article makes a novel contribution to understanding compliance with EU economic rules by turning conventional wisdom in the literature that strong administrative capacity leads to higher rates of compliance on its head. I show that skilled civil servants can facilitate the appearance of rule-conforming behavior that may run counter to the EU's intended policy goal. Put another way, national administrators play an instrumental role in the kind of 'ingenious disobedience' described by Moran (2002: 400, quoted in Batory 2016: 689) that 'ignores the spirit of regulation if it happens to get in the way' of government objectives. Use of creative compliance in state aid suggests something less than full formal and practical conformity with EU rules in CEE post-accession (Zhelyazkova et al. 2017). But it also challenges claims that high rates of formal compliance in CEE obscure 'a world of dead letters' in practical implementation (Falkner, et al. 2008). Indeed, to extend the metaphor, it shows how EU rules can be very much 'alive' in the hands of determined leaders and capable national administrators. In sum, while even the most stridently Eurosceptic 'illiberal' member states are compelled to comply with EU rules, the ability of some states to comply more creatively poses a challenge to the EU's ability to apply uniform rules to ensure a 'level playing field' within the European single market.

Conceptualizing 'creative compliance'

The literature on CEE compliance with European rules and norms post-enlargement presents a puzzle: how to reconcile no demonstrated 'Eastern problem' (Sedelmeier 2008) in formal compliance with policy rules set out in the *acquis* with increasing backsliding on democracy and

rule of law in many CEE states? Batory (2016) offers a nuanced account of 'creative compliance' in cases where a government's 'illiberal' objectives conflict with core EU political rules and norms. She illuminates how the Commission, lacking necessary autonomy to force governments to reverse an illiberal course, turns to core policy areas in which it can deploy stronger enforcement tools, such as single market rules. For example, if a government seeks to extend partisan control over the media by changing tax policy to reward allies and punish critics, the Commission can appeal to EU competition rules to argue the government is engaging in prohibited anti-competitive behavior. Batory shows how governments respond by making minor adjustments to comply with EU rules while still fulfilling their original objective. While acts of 'creative compliance' might also prove politically expedient for the Commission, Batory (2016: 696) suggests that this lack of meaningful enforcement can ultimately contribute to legitimating such moves domestically while, at the same time, delegitimatizing the Commission's authority to uphold core EU principles (see also Kelemen 2020).

Batory (2016) details specific incidents of rule of law crises where governments engage in creative compliance by obeying the letter of single market rules but ignoring the spirit of liberal democratic norms. Could governments also be obeying the letter of the law but ignoring its spirit when it comes to core principles underlying the single market? Many existing studies of CEE compliance with the *acquis* find no evidence of an 'Eastern problem' post-accession. On the contrary, they suggest CEE states often demonstrate equal or higher rates of compliance than EU-15, both in terms of formally transposing EU directives into national law and practically implementing the rules (Toshkov 2010; Zhelyazkova, et al. 2017; Börzel and Sedelmeier 2017). These findings defy general predictions that new member states, no longer subject to strict EU

conditionality, would exploit the EU's weakening sanctioning capacity and/or succumb to pressure from domestic veto players once membership was secured (Goetz 2005). Some scholars attribute higher than expected CEE compliance rates to highly specialized administrative and legislative capacities developed during EU accession (Hille and Knille 2006; Börzel and Sedelmeier 2017). Others focus on the continued credibility of external incentives in *aquis* compliance where, unlike democratic backsliding, the Commission and European Court of Justice have a necessary degree of autonomy and authority to sanction states for non-compliance (Schimmelfennig and Sedelemeier 2020).

While these studies demonstrate broad patterns of high rates of compliance in CEE, others seek to account for variation in rates of compliance across member states and policy areas. One key factor is administrative capacity. During the EU accession process, the EU engaged in 'direct-institutional building' to ensure that prospective member states had the necessary levels of professional expertise to enforce and implement EU rules and regulations (Bruszt and Vukov 2017: 665). Yet CEE states exhibit different levels of administrative capacity pre- and post-accession (Meyer-Sahling 2011; Kostadinova and Neshkova 2018), which is argued to affect the degree to which member states practically implement EU rules (Zhelyazkova et al. 2017). Other scholars have focused on varieties of capitalism as a determining factor in rates of post-accession compliance. Ademmer (2017), for example, identifies two main clusters of CEE states, a liberal market economy cluster comprising the Baltic States and Slovakia, and a coordinated market economy cluster comprising Hungary, Poland, Czech Republic and Slovenia. She argues that patterns of (non-) compliance in the first cluster can be better explained by government

ideologies and administrative capacity and the inter-play of preferences of various state and non-state actors in the second where rule contestation is more widespread.

European state aid policy provides an ideal but understudied case in which to examine the applicability of existing frameworks to understanding patterns of compliance. Falling under the EU's exclusive competence, the Commission enjoys considerable autonomy for enforce state aid rules. At the same time, state aid has the potential to become domestically contentious as it formally constrains governments from subsidizing economic actors as it chooses. Existing literature on compliance with European state aid rules in CEE support the general findings of the post-accession compliance literature: not only is there no demonstrated 'Eastern problem' in state aid compliance but new EU member states appear to abide by European state aid rules more faithfully than their EU-15 counterparts (Blauberger 2009a; Hölscher et al. 2017). Botta and Schwellnus (2015) attribute reductions in total state aid in the immediate period before accession to the direct effect of EU conditionality, whereby member states scrambled to meet all conditions to secure EU membership, including reducing the total amount of aid to industry. Investigating compliance three years after the 2004 enlargement, Blauberger (2009a) finds no increase in non-compliance with state aid rules. He argues that regular Commission control after accession more than compensated for the loss of the sticks and carrots of EU conditionality (Blauberger 2009a: 1040). Moreover, national state aid administrative authorities, built up during the EU accession process to monitor state aid compliance, worked to determine the admissibility of different types of state aid.

The existing literature on CEE compliance with European state aid rules appears consistent with the larger picture of post-accession compliance in CEE: while many CEE leaders are defiantly challenging European liberal democratic rules and norms they are quietly adhering to single market rules due to strong external enforcement and domestic administrative capacity built up during the accession process. In the following analysis I examine whether results from the immediate post-accession period still hold when state aid has become more politicized post-crisis due to more widespread demands for governments to protect economic actors from the adverse effects of competitive transnational market integration. Moreover, while existing literature on state aid compliance presents a homogenous account of CEE vis-à-vis the EU-15, few studies analyze different levels of state aid compliance across CEE states. Combining insights from the existing literature on administrative capacity and varieties of capitalism as key determinants of *aquis* compliance, I consider differences in both the will of governments to defy the substance of European state aid rules across coordinated and liberal market CEE political economies and the way with respect to national state aid authorities serving as 'local guardians' of EU rules.

Compliance with European State Aid Rules in CEE

The 2005 State Aid Action Plan, with the headline 'less and better targeted aid', made the most far reaching changes to European state aid policy since state aid regulations were revitalized in the 1980s with the passage of the Single Market Act (European Commission 2005). The Plan's reference to 'less' aid reflected continuity in the overarching aim that the market, rather than the state, should allocate resources since markets are assumed to do this more efficiently. 'Better targeted' signified an acknowledgment, however, that the market often fails to provide enough investment in many areas crucial to smart, sustainable and inclusive growth, such as research and

development, training, or infrastructure in underdeveloped regions. The Commission expanded the so-called 'General Block Exemption Regulation' (GBER) to exempt aid designed to address these horizontal goals from prior notification and Commission approval, effectively giving member states more autonomy to distribute 'good' types of state aid. The Plan also exempted smaller amounts of aid from prior notification and approval, under the *de minimis* rule, on the grounds that it is expected to have negligible impact on competition. EU state aid policy since 2005 can be understood more broadly as 'liberal developmentalism' (Bruszt and Vukov 2017: 671): concerned primarily with applying rules equally to ensure an open and competitive single market, but with an awareness that states may intervene to extend the range of the domestic (and regional) beneficiaries of transnational market integration.

It was not coincidental that the Action Plan coincided with the 2004 eastward enlargement. Prior to enlargement, applicant states were encouraged to establish their own state aid monitoring authorities, in addition to transposing all EU state aid legislation into national law. But these national monitoring authorities had no legal authority. After EU accession, the Commission assumed responsibility for ensuring that the CEEs followed European state aid rules. Monitoring ten new member states expanded the Commission's state aid unit's caseload considerably. But the GBER, by exempting a large proportion of state aid from ex-ante approval, effectively reduced the Commission's administrative burden. It also devolved more responsibility for enforcement to national state aid authorities who assumed responsibility for advising their governments on which aid is GBER compliant, keeping national public registers of individual aid awards to ensure transparency, and evaluating GBER aid schemes ex-post. 'Vertical' aid, however, continued to require prior notification and approval. Assessing whether notified aid

was permissible had long been left to Commission officials specializing in European competition law. But as criteria became more technically rigorous, such as the introduction of the Market Economy Investor Principle (MEIP), the Commission added economists capable of judging admissibility and national governments responded in kind by adding economists to their state aid units (Wigger and Buch-Hansen 2010).

The 2008 global financial crisis put the Commission's ability to enforce state aid rules to the test due to the scale of many governments rescue plans for their banking sectors and the speed in which they rolled them out. The solution was to evoke a clause in the treaties allowing aid 'to remedy a serious disturbance in the economy' and quickly process applications, sometimes approving millions in aid to the banking sector in just 24 hours (Davies 2013: 52). In 2013 the Council passed a 'Modernization Regulation' introducing important changes to state aid rules. It extended the GBER to exempt more categories of state aid, such as innovation, broadband infrastructure, and culture and heritage conservation. It also integrated state aid into the Commission's new European Semester recommendations on economic, employment and fiscal policies, to 'improve the quality of public spending by discouraging aid that does not bring real added-value and distorts competition' (Commission 2012). Finally, it focused the Commission's priorities on investigating cases with the biggest impact on the single market. After taking over as head of DG Competition in 2014, Commissioner Margrethe Vestager put this change in practice by pursuing highly visible cases, such as ordering Apple to pay $14.5 billion in back taxes to Ireland.

To investigate compliance with state aid rules in CEE since the financial crisis, I start with the most widely used measure: state aid as a percentage of gross domestic product (GDP). The Commission has published this indicator annually as part of the State Aid Scoreboard since the 1980s. If we compare state aid a percentage of GDP between 'old' and 'new' member states, we can observe a striking difference since the 2008 financial crisis (see Figure 1 in the online appendix). The median in new CEE states has steadily increased since 2000, rising to over one per cent of GDP in 2014 and remaining at that level to 2017. EU-15 states, meanwhile, remained at or considerably below 0.5 per cent over this same period. In 2017, the median amount of state aid as a percentage of GDP in CEE states (1.26) was nearly three times higher than in EU-15 states (0.44).

Disaggregating CEE into individual member states can help identify intra-regional variations in state aid expenditure. Figure 2 in the online appendix shows that member states consistently spending higher than average amounts of state aid since 2004 include Hungary, Czech Republic, Poland and Slovenia, which broadly corresponds with expectations that coordinated market economies would demonstrate lower levels of compliance (Ademmer 2017). Liberal market Estonia and Lithuania, on the other hand, have consistently spent lower than average amounts of aid, although this percentage has steadily increased since 2013. Latvia is an outlier in spending a much higher percentage of state aid on average, and as shown below, registering one of the lowest percentages of 'good' horizontal aid. Given that Latvia pursued an even more liberal strategy post-crisis, this anomaly requires further research to provide a more forensic accounting of the aid Latvia reported to the Commission over this period.

Turning to the Commission's objective of encouraging 'better targeted' aid, I examine the median share of block-exempted measures as a percentage of total aid over time. Figure 3 in the online appendix shows that since the 2004 enlargement and launch of the 2005 State Aid Action Plan, the percentage of aid that governments across the EU-28 declare as block exempt has increased. Moreover, CEE states declared significantly more aid block exempt than EU-15 states in the period between the 2004 enlargement and 2015. The expansion of GBER in 2013, which included many more areas of aid, further increased the percentage of block-exempted aid across the EU-28. By 2017, nearly 50 per cent of all aid across the EU-28 was covered by GBER. In sum, EU-15 states appear to be achieving both objectives set out in the 2005 State Aid Action Plan: spending less state aid *and* targeting it better. CEE states, on the other hand, are not spending 'less' but what they do spend is being classified as 'better targeted.' If we examine differences in the share of block-exempted measures as a percent of total aid across CEE states, we can observe notable variations, however. As of 2017, four CEE states declared less than half their aid as block exempt: Romania, Bulgaria, Czech Republic, Latvia and Estonia. At the other end of the continuum, Lithuania, Hungary and Poland reported more than two-thirds of their aid as block-exempt (see Table 4 in the online appendix). The type of aid reported presents a less clear pattern in terms of clustering around varieties of capitalism than levels of aid spent.

These differences could be interpreted in several ways. A higher percentage of block-exempted aid could indicate that governments simply avoid vertical interventions. But the issue of reporting raises another, less straightforward issue: who determines that aid qualifies as block exempt? At present, the Commission delegates to member states the task of classifying and reporting different types of state aid. The expanding list of GBER exclusions, moreover,

provides state aid authorities more scope to classify aid as falling within ‘good’ horizontal objectives. Doing so has the added benefit of avoiding what can often be a lengthy process of receiving *ex-ante* Commission approval. The logic is not conspiratorial so much as rational in that national state aid offices have an interest in advising aid-granting authorities (whether local, regional, or central governments) how proposed aid could feasibly be classified as block exempt, including the size of aid payments (in light of the *di minimis* rule) as well as its purported objectives. Blauberger (2009b: 735) anticipates such a scenario suggesting ‘the less precise the Commission’s rules on admissible state aid, the easier it becomes for member states to justify distortive aid on that basis’ (see also Cini 2001). In other words, expanding the criteria for permissible aid makes it easier for member states to make ‘bad’ aid ‘good’. In the following section, I consider factors that might account for why two states, neoliberal Estonia and ‘illiberal’ Hungary, increased levels of state aid post-crisis but differ in reported type of aid.

State aid compliance in Estonia and Hungary

I start by providing a brief comparison of the role of state aid in Estonia and Hungary’s different development paths. Since the 1990s, Hungary provided generous incentives, including subsidies and tax relief, to shelter some firms deemed strategically important from the adverse effects of market competition, and to attract valuable transnational foreign direct investment (Medve-Bálint 2014). Between 1992 and 1998, state aid comprised five and six percent of Hungary’s GDP, far higher than any other CEE (or EU-15) state over that period (Duman and Kurekova 2012: 1219). This approach was consistent across regimes. For example, in 1994 the left-leaning Horn government launched the ‘Dirty Dozen’ consolidation package to prevent the collapse of manufacturing firms it deemed crucial for employment and exports. In 2000, the right leaning

Orbán government introduced the ‘Szechenyi plan’ designed to develop SMEs through a range of measures including preferential credit to domestic companies, which amounted to 3.5 percent of Hungarian GDP. When left-leaning coalitions took power in 2002, they continued the scheme, renaming it ‘Smart Hungary,’ which included Joint Research Center schemes offering R&D capacities to multinational corporations including Nokia and Volkswagen (Duman and Kurekova 2012: 1222).

Estonia, in contrast, was reluctant to shelter domestic enterprises from the impact of transition. Between gaining independence from the Soviet Union in 1991 and entering EU accession negotiations in 1998, Estonia provided virtually no subsidies to domestic firms, in addition to eliminating all tariffs (Bohle and Greskovits 2012: 33). Bohle and Greskovits (2012: 101-103) suggest that Estonia’s minimalist industrial policy can be explained by a combination of its Soviet legacy, where uncompetitive heavy industries were located in majority Russian-speaking areas where displaced workers were effectively disenfranchised due to strict citizenship laws, and ideology, where successive Estonian governments believed that exposing its economy to competitive pressures presented the best way of catching up with the West. In the 2000s, Estonia led the so-called ‘second generation’ of neoliberal reforms by introducing a radical flat corporate tax rate designed to attract and retain FDI (Appel and Orenstein 2018: 98). The influx of Western capital during these ‘boom’ years made financial instruments like government-backed loans as a prevalent state aid tool in many states. Yet in general Estonia stayed on its neoliberal policy path, eventually joining the euro in 2011 despite facing one of the most dramatic economic downturns in the immediate wake of the 2008 financial crisis (Lindstrom 2015).

When Estonia and Hungary entered EU accession negotiations in the late 1990s, they were each required to transpose European state aid rules into relevant domestic legislation, develop the necessary legal and administrative competence to monitor state aid at the national level, and demonstrate a credible enforcement record (Birnstiel and Heinrich 2011: 48). Applicant states were thus faced with the challenge of developing the administrative capacity to enforce European state aid rules while remaining outside the single market and formal EU governance structures (Cremona 2003). Applicant states were free to choose where to place their state units. In Hungary, a State Aid Monitoring Office (SAMO) was established as part of the Ministry of Finance in 1995 to monitor aid granted by the Hungarian authorities prior to accession as required by the EEA (Hargita and Filep 2004). Hungary, unlike the Czech Republic and Poland, separated state aid monitoring from its newly created competition authority. A Hungarian official involved in this decision suggested that Horn decided to place SAMO within the finance ministry to 'keep it close to the budget' (personal interview, 21 March 2017). Estonia also placed its state aid authority within the Ministry of Finance. According to an Estonia state aid official present from its creation: 'Before 1995, we didn't know such a thing as "state aid" existed. We expected it would only require someone a day a month to comply' (personal interview, 23 May 2018). In sum, Hungary and Estonia both created separate state aid monitoring authorities and placed them in the Ministry of Finance. But keeping them 'close to the budget' arguably meant different things in the two cases based on their different development paths: Hungarian state aid monitoring authorities overseeing a higher level and wider scope of government state aid and Estonian authorities tasked with monitoring very little.

Upon each state entering the EU in 2004, responsibility for enforcing state aid rules was transferred to the European Commission. But just as CEE transferred authority over state aid compliance to the EU level, much of the administrative burden for overseeing state aid was shifted to the national level with passage of the 2005 State Aid Action Plan. Hungary and Estonia's administration of state aid evolved differently. Hungary shifted SAMO to the Ministry of National Development in 2006 under the left leaning Gyurcsány government. Soon after Orbán won his second term in office in 2014 he moved the state aid authority to the Prime Minister's Office as part of a ministerial restructuring and added lawyers and economists to the unit. In 2014 Orbán also declared in a now infamous speech to Hungarian-speaking leaders in Romania, evoking the examples of Russia and China as economic models to emulate: 'I don't think that our European Union membership precludes us from a building an illiberal new state on national foundations' (Mahony 2014). If this illiberal new state would, like Russia and China, involve more direct state intervention in industry, including greater state ownership, SAMO took on additional responsibility for ensuring that any such moves would be made within EU rules.

In Estonia, Jüri Ratas's Centre Party, a centre-left party historically most popular among Russian-speaking citizens, came to power in 2016, marking a change from almost uninterrupted centre-right rule since Estonia gained independence in 1991. The Ratas government made a commitment to increasing state expenditure across the board, marking a significant departure from over two decades of conservative fiscal policy. Under his tenure the Estonian national budget went into deficit after years of surplus. In addition to implementing more progressive taxes and pension benefits, the Ratas government has also increased state investment in the economy (Malberg 2017). The shift towards a more actively interventionist strategy did not

translate, like in Hungary, to increased investment in Estonia’s state aid monitoring unit, however, which is comprised (at the time of writing) by two full-time advisors sharing a cubicle in the Ministry of Finance. The two Estonian state aid officials noted that the change of government increased their workload in terms of answering more queries from government ministries about the admissibility of different types of state aid but did not lead to investment in more staff (personal interview, 23 May 2018).

State aid units in the two states not only differ in size and their location within national administrations; state aid officials I interviewed in the two states view their roles differently. Estonian officials described their role as providing government officials with necessary information when requested and complying with EU monitoring requirements. ‘We report anything suspicious to the Commission,’ one official remarked, ‘just to be safe. Estonians want to obey the rules’ (personal interview, 23 May 2018). Hungarian state aid officials, in contrast, defined their role more as an ‘advocate of aid granters’ (personal interview, 21 March 2017). That is, they take a more proactive stance in advising the government on which types of aid fall under block exemptions and, in cases of vertical aid, prepare notifications to the Commission that anticipate possible objections and build a solid economic and legal case for the aid being compatible with EU rules. An interview with a European Commission state aid official confirmed that the Hungarian lawyers and economists at SAMO fulfill this role well, remarking, ‘The Hungarian state aid authority is one of the best in the EU. The way in which they report state aid, and respond to our queries, is watertight in legal and economic terms’ (personal interview, 22 June 2017).

Investigating non-compliance in Estonia and Hungary

A final means of assessing rates of compliance across CEE member states is examining outcomes of Commission investigations of state aid. Such investigations are relatively rare. In 2017, for example, the Commission conducted 22 investigations in total across all EU-28 states. The Commission opens investigations when a state sends a 'notification' of its intent to provide a sizeable amount of 'vertical' aid in support of a firm or industry, or when it receives a complaint from a competitor about state aid giving a firm an undue advantage. Comparing the number of state aid investigations in Hungary and Estonia from 2010 to 2018, I observe an interesting pattern: the Commission conducted six investigations in Hungary and four in Estonia during this period, despite Hungary distributing a far higher amount of state aid as a percentage of its GDP. Moreover, the Commission issued negative decisions in each of the four Estonian cases but half the Hungarian cases. The following section examines these investigations, focusing in on two similar state aid cases involving state aid to energy firms with two different outcomes: a case involving Hungarian state investment into expanding a nuclear power plant (SA. 38494), which the Commission ruled was compatible with state aid rules, and Estonian state aid investment into the construction of two new oil-shale power plants (SA. 30531), which the Commission deemed legally incompatible.

In 2010, the Estonian government notified the European Commission of its intention to grant state support of up to 1.5 billion euros over 20 years to the state-owned energy company Eesti Energia to operate two new oil-shale fueled power plants (a hydrocarbon widely available in Estonia) to increase its national electricity generating capacity. The Commission opened an investigation in 2011, the first state aid investigation of Estonia since it became an EU member

in 2004. After a short, three-month investigation in 2011, the Commission ruled that the proposed grant was not in line with state aid regulations since the Estonian government failed to produce an open tender to all energy producers. Estonia did not contest the ruling and rescinded the notification. As the energy case was pending, the Estonian government was involved in a more high-profile state aid case: its effort to rescue and restructure Estonia Air, which was Estonia's first rescue and restructuring plan since gaining independence in 1991. The government bought the airline in 2010 to prevent it from going bankrupt and subsequently used capital injection and other forms of state aid to keep it afloat. The Estonia Air case generated significant media attention in Estonia since travelers feared a dramatic reduction in direct flights and an increase in fares without a nationally based airline. In 2015 the Commission ruled that state aid to Estonia Air was illegal and forced the government to recover the aid spent with interest. Unable to pay back the aid, Estonia Air subsequently declared bankruptcy and ceased operations. A new airline, Nordica, immediately took over operations from Estonia air.

According to the two Estonian state aid administrators, the Eesti Energia and Air Estonia Air cases had an unexpected effect: state aid attracted increased attention, both within government and the wider public (personal interview, 23 May 2018). In other words, even if the cases resulted in negative decisions from the Commission, it had generated increased debate about whether and how government *should* come to the aid of domestic industries. In 2019, Ratas formed a new government controversially including the far-right Conservative People's Party of Estonia (EKRE). The new EKRE Minister of Rural Affairs pledged to give local producers preference in the sale or lease of state-owned land. A Commission investigation was already underway over the government leasing land to an Estonian livestock company, AS Tartu Agro, at

below market rates. In January 2020, the Commission decided it was incompatible with state aid rules and required the Estonian government to recover around 1.2 million euros in illegal aid to the Estonian firm (European Commission 2020). Nevertheless, the EKRE minister pressed on, while the Minister of Public Administration, from the Centre Party, warned that 'giving preference to a specific business owner may damage the functioning of competition on the Common market' (ERR 2020).

In Hungary, the Paks II nuclear power plant case appears far less admissible than the Estonian shale plans. In 2014, the Hungarian government notified the Commission of its intention to form a new joint-stock company to construct two new nuclear reactors funded by a 10-million-euro loan from the Russian government and 2.5 million euros from the Hungarian budget to be owned and operated as part of a subsidiary of the Hungarian power company MVM. The government argued the aid would enhance energy security. It also provided extensive evidence that the plan met the MEIP test, or, in other words, that the government's investment in Paks II would be acceptable to a private investor operating under normal market economy conditions. The Commission opened a formal investigation of the aid in 2015. When asked about Paks II, a Hungarian state aid official described how the state aid team 'took the Hinkley Point case and followed the same logic' (personal interview, 21 March 2017). The Hinkley Point case involved construction of a new nuclear reactor in southwest England with £19.6 billion funding from French and Chinese energy firms, in addition to UK government funding and guarantees. The Commission cleared the Hinkley Point project in 2014, reasoning that the UK was entitled to choose its energy mix and the development of nuclear energy is a valid public interest objective. The European Court of Justice upheld the decision in 2018 after Austria and Luxembourg filed

objections to the Commission's ruling. In addition to Paks II, the Commission also ruled admissible the funding of technology companies through a government Research and Technological Innovation Fund in 2014, as well as a direct grant and corporate tax allowance to Audi in 2016. This latter case lends support to claims that despite Orbán's rhetoric about building an illiberal state on '*national* foundations,' transnational firms are large beneficiaries of Hungarian state aid (see Bohle and Greskovits 2019: 1075-77).

The Orbán government has received only three negative decisions at time of writing. Each involved the government levying progressive taxes on high turnover companies, namely advertisers, commercial food companies and tobacco distributors. In the advertising tax case, the German-based RTL group argued that the government's progressive tax discriminated against large commercial broadcasters (which, in the case of RTL, had been critical of the Orbán regime). The Commission's ruling included recovery, which required firms that benefited from lower tax rates to return the illegal advantage received. A Hungarian state aid official said about the case: 'I warned the government that the Commission was very likely to rule this illegal.' When asked why the government pursued the tax regardless, she replied simply: 'politics' (personal interview, 21 March 2017). The Orbán government fought the Commission's ruling, arguing that progressive corporate tax initiatives do not constitute state aid in the first place. The government ultimately passed several amendments to the advertising tax law to bring it more in line with EU state aid rules. However, to date, the government has recovered zero aid from the smaller commercial broadcasters who benefited from the lower advertising tax rates.

Conclusions

While state aid as a percentage of GDP has increased across CEE since the 2008 financial crisis, CEE states differ in both levels and types of state aid. Through an in-depth comparison of Hungary and Estonia, I argue that both states, despite representing different varieties of capitalism, have increased the level of state aid, but Hungary has been more adept than Estonia at aiding industry while avoiding EU scrutiny and sanction due to superior administrative capacity. I make a novel contribution to our understanding of EU compliance by demonstrating how adept administrators are not only important to implementing EU rules; they play a crucial role in aiding governments in complying creatively when governmental ideological preferences conflict with the substance of core EU rules. I do not suggest, however, that civil servants engaged in creative compliance are transformed from 'local guardians' of EU treaties to local guardians of their governments. Instead I show how national administrators are important but hitherto understudied *agents* in navigating growing tensions between the uniform application of supranational free market rules and increased domestic politicization of the core incentives and obligations underlying the single market project.

My findings contribute to broader debates on the comparative political economy of the 'crisis of neoliberalism' in CEE and beyond. I highlight how challenges to the core competitive market principles underlying state aid come from both the right (Hungary) and left (Estonia). In both cases we can observe a challenge, following similarly devastating effects of the global financial crisis on their respective economies, to the neoliberal axiom that exposing economic actors to the competitive demands of transnational market competition is the most efficient means of catching up with the West. But my analysis highlights two other important and related factors affecting a government's ability to realize these preferences while avoiding Commission scrutiny and

sanction. Path dependency matters in that leaders of embedded neoliberal Hungary could draw on deeper experience with state aid, even if, as I argue, the choice to invest in administrative capacity after 2010 was crucial to Orbán's ability to comply creatively. Moreover, creative compliance is arguably easier when leaders enjoy a super-majority, as in the case of Hungary, than a broad coalition, as in Estonia, where governing parties hold less coherent preferences on state intervention. I bracket the question of what shapes government preferences on state aid in this article. One promising area for further research is assessing the variable impact of national and transnational industry pressure on forming government preferences and its direct and indirect effects on (creative) compliance.

A final question is whether evidence of creative compliance marks a deterioration in the EU's credibility. In other words, are EU incentives, positive or negative, not only proving insufficient in enforcing liberal democratic principles but also core single market rules? On the one hand, creative compliance with state aid rules is a far cry from non-compliance. Indeed, investing in the capacity to comply creatively suggests that governments seek to avoid EU sanction and, more indirectly, continue to receive EU rewards, including structural and cohesion funds. On the other hand, creative compliance can gradually erode the EU's legitimacy if enough states engage in the practice. One might argue that states have always engaged in creative compliance. What is arguably new is creative compliance accompanying increased politicization, whereby political leaders not only cut corners in the formal application of rules but challenge their substance. Creative compliance with single market rules can also work to undermine the EU's legitimacy domestically by leaving beneficiaries optimistic that they can continue to reap rewards without sanction and leave critics pessimistic that Brussels can do anything about it (see Krekó and

Enyedi 2018). As the EU now seeks to reconcile the principles of free market competition with the massive infusion of state aid to help industries devasted by Covid, the idea of applying uniform rules to ensure a 'level playing field' on which the single market project is based appears ever more challenging.

The online appendix for this article can be accessed at: [link to source]

Brief biographical note: Dr Nicole Lindstrom is a Senior Lecturer in the Department of Politics at the University of York, UK.

Address for correspondence: Department of Politics; University of York; Heslington, York YO24 1DE, UK. Email: nicole.lindstrom@york.ac.uk

Acknowledgments: I thank Alex Buck, Willem Koelewijn, and Eszter Palotai for their expert research assistance; state aid officials in Brussels, Budapest and Tallinn for their valuable insights; and Charlotte Burns, Neil Carter, Simona Davidescu, Timothy Sinclair and two anonymous reviewers for their very helpful comments and suggestions.

Works cited

Ademmer, E. (2018) 'Capitalist diversity and compliance: economic reforms in Central and Eastern Europe after EU accession' *Journal of European Public Policy* 25.5: 670-689.

Appel, H. and Orenstein, M. (2018) *From Triumph to Crisis: Neoliberal Economic Reform in Postcommunist Countries*, Cambridge: Cambridge University Press.

Batory, A. (2016) 'Defying the Commission: creative compliance and respect for the rule of law in the EU' *Public Administration* 94.3: 685-699.

Birnstiel, A. and Heinrich, H. (2011) 'Hungary', in E. Szyszczak (Ed.), *State Aid in the Accession States*. Cheltenham: Edward Elgar, 44-63.

Blauberger, M. (2009a) 'Compliance with rules of negative integration: European state aid control in the New Member States' *Journal of European Public Policy* 16.7: 1030-46.

Blauberger, M (2009b) 'Of "good" and "bad" subsidies: European state aid control through soft and hard law' *West European Politics* 32.4: 719-737.

Bohle, D., and Greskovits, B. (2012) *Capitalist Diversity on Europe's Periphery*, Ithaca, NY: Cornell University Press.

Bohle, D. and Greskovits, B. (2019) 'Politicizing embedded neoliberalism: continuity and change in Hungary's development model' *West European Politics* 42.5: 1069-1093.

Börzel, T. and Sedelmeier, U. (2017) 'Larger and more law abiding? The impact of enlargement on compliance in the European Union' *Journal of European Public Policy* 24.2: 197-215.

Botta, M. and Schwellnus, G. (2015) ‘Enforcing state aid rules in EU candidate countries: a qualitative comparative analysis of the direct and indirect effects of conditionality’ *Journal of European Public Policy* 22.3: 335-352.

Bozóki, A. and Hegedűs, D. (2018) ‘An externally constrained hybrid regime: Hungary in the European Union’ *Democratization* 25:7: 1173-1189.

Bruszt, L. and Vukov, V. (2017) ‘Making states for the single market: European integration and the reshaping of economic states in the Southern and Eastern peripheries of Europe’ *West European Politics* 40.4: 663-687.

Cianetti, L; Dawson, J. and Hanley, S. eds. (2019) *Rethinking 'Democratic Backsliding' in Central and Eastern Europe*, London: Routledge.

Cini, M. (2001) ‘The soft law approach: Commission rule-making in the EU’s state aid regime’ *Journal of European Public Policy* 8.2: 192-207.

Cremona, M. (2003) ‘State aid control: substance and procedure in the Europe Agreements and the Stabilisation and Association Agreements’ *European Law Journal* 9.3: 265-287.

Davies, W. (2013) ‘When is a market not a market? ‘Exemption,’ ‘externality’ and ‘exception’ in the case of European state aid rules’ *Theory, Culture & Society* 30.2: 32-59.

Duman, A. and Kureková, L. (2012) 'The role of the state in development of socio-economic models in Hungary and Slovakia: the case of industrial policy' *Journal of European Public Policy* 19.8: 1207-1228.

ERR (2020) 'Restrictions still not introduced on selling land to foreigners', 15 April. Available at: https://news.err.ee/1077633/restrictions-still-not-introduced-on-selling-land-to-foreigners.

European Commission (2005) 'Less and better targeted state aid: a roadmap for state aid reform 2005-2009 ('State Aid Action Plan')' COM(2005) 107. Brussels: Commission of the European Communities.

European Commission (2012) 'State aid: Commission launches major initiative to modernise state aid control'. Available at: https://europa.eu/rapid/press-release_IP-12-458_en.htm.

European Commission (2020) 'Press Release: State aid: Estonia to recover incompatible aid from agricultural company AS Tartu Agro'. Available at: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_118.

Falkner, G., Treib, O. and Holzleithner, E. (2008) *Compliance in the Enlarged European Union: Living Rights or Dead Letters?*, Aldershot: Ashgate.

Goetz, K. H. (2005) 'The New Member States and the EU', in S. Bulmer and C. Lequesne (Eds.), *Member States and the European Union*, Oxford: Oxford University Press, 254-80.

Hargita, E. and Filep, Z. (2004) 'State aid control in Hungary' *European State Aid Law Quarterly* 3.4: 6.

Hille, P. and Knill, C. (2006) 'It's the bureaucracy, stupid': the implementation of the Acquis Communautaire in the EU Candidate Countries, 1999-2003' *European Union Politics* 7.4: 531-52.

Hölscher, J; Nulsch, N. and Stephan, J. (2017). 'State aid in the CEEs' *Journal of Common Market Studies* 55.4: 779-797.

Johnson, J. and Barnes, A. (2015) 'Financial nationalism and its international enablers: the Hungarian experience' *Review of International Political Economy* 22.3: 535-69.

Kelemen, R. D. (2020) 'The European Union's authoritarian equilibrium' *Journal of European Public Policy* 27.3: 481-499.

Kostadinova, T. and Neshkova, M. (2020) 'Reforming post-communist bureaucracies: the effect of transitional justice' *Governance* 33: 305-321.

Krekó, P. and Enyedi, Z. (2018) ‘Explaining Eastern Europe: Orbán’s laboratory of illiberalism’ *Journal of Democracy* 3: 39-51.

Lindstrom, N. (2015) ‘Wither diversity of post-socialist welfare capitalist cultures? Crisis and change in Estonia and Slovenia’ *European Journal of Sociology* 56.1: 119-139.

Mahony, H. (2014) ‘Orbán wants to build ‘illiberal state’, *EU Observer*, 28 July. Available at: https://euobserver.com/political/125128.

Malmberg, K. (2007) ‘Economic policy leaning to the left’, *Estonian News*, 9 May. Available at: https://news.postimees.ee/4106559/economic-policy-leaning-to-the-left.

Medve-Bálint, G. (2014) ‘The role of the EU in shaping FDI flows to East Central Europe’ *Journal of Common Market Studies* 52.1: 35-51.

Meyer-Sahling, J. (2011) ‘The durability of EU civil service policy in Central and Eastern Europe after accession’ *Governance* 24.2: 231–260.

Moran, M. (2002). ‘Review article: understanding the regulatory state’ *British Journal of Political Science* 32.2: 391–413.

Schimmelfennig, F. and Sedelmeier, U. (2020) ‘The Europeanization of Eastern Europe: the external incentives model revisited’ *Journal of European Public Policy* 27(6): 814-833.

Sedelmeier, U. (2008) ‘After conditionality: post-accession compliance with EU law in East Central Europe’ *Journal of European Public Policy* 15.6: 806-825.

Toplišek, A. (2020) ‘The political economy of populist rule in post-crisis Europe: Hungary and Poland’ *New Political Economy* 25.3: 388-403.

Toskov, D. (2010) ‘Taking stock: a review of quantitative studies of transposition and implementation of EU Law’. Vienna: Institute for European Integration Research.

Wigger, A. and Buch-Hansen, H. (2010) ‘Revisiting 50 years of market-making: the neoliberal transformation of EC competition policy’ *Review of International Political Economy* 17.1: 20-44.

Zhelyazkova, A., Cansarp, K. and Schrama, R. (2017) ‘Notified and substantive compliance with EU law in enlarged Europe: evidence from four policy areas’ *Journal of European Public Policy* 24.2: 216-238.