The European Commission's Draft Community Framework for State Aid for Research, Development and Innovation

Commentary by the Economic Advisory Group on Competition Policy

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1. On 20th April 2006 the European Commission published a Draft Community Framework for State Aid for Research and Development and Innovation. This is a welcome development, which represents a step towards the implementation of a more economic approach to state aid control, as advocated in the State Aid Action Plan of June 2005. As the Draft Framework emphasizes, for state aid control to contribute to an effective use of state aid in promoting innovation will require balancing the strengths and weaknesses of state aid in this area. There is an important complementarity between the efforts of member states to promote innovation and the scrutiny of such aid on the part of the Commission. This Commentary discusses the strengths and weaknesses of state aid for innovation in the light of this complementarity.

2. The Draft Framework refers approvingly to both the Lisbon agenda, which has called for an increase in both public and private R&D spending in the European Union, and the Commission's State Aid Action plan, which has called for "less and better targeted state aid". The document does not explicitly acknowledge the potential tension between these two approaches, but in our view it would be desirable for this to be openly addressed. To the extent that both public and private R & D spending in the EU have been lower than their optimal levels, this is not necessarily because state aid control has been too restrictive in the past. On the contrary, it is likely to be because firms and governments have failed to target some potentially productive opportunities for R & D spending, while directing resources to other less productive uses. A better targeting of overall state aid, assisted by a more economic approach to state aid control, is likely therefore to entail a reduction in some categories of state aid but an increase in others, of which aid to some kinds of R & D might well be an example. In any event the way to assist innovation in the EU is not merely to relax state aid control in this domain, keeping the efforts of member states unchanged. On the contrary, member states will need to increase the effectiveness of their efforts to support R & D, and increase the social productivity of the R & D projects that are funded, to ensure that an increase in R & D spending does not lead to a decline in the overall productivity of such spending. State aid control will be an essential complement to this process, otherwise state aid for R & D may not only be of declining productivity, but may increasingly distort competition in the process, especially if firms come to believe that they can ask for state support under the nominal heading of R & D for activities that in reality are aimed at restricting competition rather than undertaking efficient innovation. Thus effective state aid to R & D, and rigorous state aid control by the Commission, should be seen as complementary rather than antagonistic policies.

3. There are indeed good reasons for thinking that market failures, such as those set out in the Framework under the heading of public goods/knowledge spillovers, imperfect and asymmetric information and coordination failures, may lead to insufficient research and development in a modern economy. However, while market failures do indeed mean that there is probably less R & D than there should be, not all R & D is beneficial from the point of view of society. Some of it involves needless duplication, as when firms try to invent

substitute products or processes for those already invented by their rivals. Some of it is pursued solely or mainly for the purpose of excluding rivals from a market. Under certain conditions, therefore, an increase in R & D by some firms may reduce R & D spending by others, even leading to a decline in overall R & D spending in the industry concerned, or a reduction in the amount of innovation that is achieved as a result of that spending. It is important also to bear in mind that even under the best of conditions, many R & D projects fail, and firms that do not bear the costs of such failure (for instance because they are funded with public money) may not be sufficiently motivated to avoid gratuitously high failure rates. There is no reason to think that marginal R & D (that which would not be profitable in the absence of state aid) is more socially beneficial than less marginal R & D, and the opposite may be true. For this reason it is important that public support to R & D be based on a systematic identification of the conditions under which the activity in question is likely to be socially productive.

4. A *first* important condition for R & D to result in productive and socially useful innovation is the presence of complementary factors of production, such as skilled labour or certain kinds of technological infrastructure, in the regions where the projects take place. R& D projects that cannot hire the appropriate technical personnel, or that are hampered by the absence of means of communication, are a waste of money. Many of these complementary factors of production need public support, but in the form of investment in public goods rather than state aid to firms. Member states should not conclude from the favourable references to R & D in Commission documents that simply increasing state aid for such purposes will automatically result in effective innovation. If they wish to undertake state aid for the purposes of meeting the objectives of the Lisbon agenda, they will need to review carefully their policies in these complementary areas. Applications for the approval of state aid could also be required to demonstrate the availability of factors of production necessary for innovation, or at least significant progress towards improving such availability.

5. A *second* important condition for effective state aid to R & D is that access to public support be available for new entrants and, more generally, for firms outside the favoured circle of those with an established track record and good contacts with public decision-makers. Indeed, the latter kinds of firm face many fewer obstacles to raising funds for research and development from private credit markets. Much empirical research has shown that innovation and growth have come in the past disproportionately from new entrants to established markets (and sometimes from firms that have created markets that previously did not exist); these are precisely the firms that are most likely to be hampered by market failures from undertaking adequate levels of R & D. Furthermore, for such innovative firms to be able to enter existing markets, it is important that incumbent firms not resort to state aid as a means either of delaying their own exit (if they are no longer able to operate profitably) or of making entry or expansion more difficult for their rivals. So increasing vigilance on the use of state aid to firms in difficulty will be important if the objectives of the Lisbon agenda are to be achieved. This implies also increasing vigilance on the use of aid that is nominally for R & D to ease firms' difficulties of operation.

6. A *third* important condition for state aid to R & D to be effective is that member states be willing not only to sponsor promising research projects but also to halt support for projects that are failing in their objectives. While private markets are sometimes unwilling to support projects that are socially desirable, there is much evidence that governments are frequently unwilling to withdraw support for projects that have ceased to show convincing evidence of effectiveness. If member states are to make good use of increased spending on R & D, they

will need to improve their retrospective analysis of projects that have been funded in the past (and be willing to stop funding for those than have not demonstrated their effectiveness). They should also give encouragement through their funding policies to aid schemes that have inbuilt explicit retrospective monitoring as well as automatic termination clauses in place as an integral part of their procedures.

7. A *fourth* important condition is that the criteria for funding should avoid inadvertently giving encouragement for projects that are likely to be of lower quality. For instance, the "matching clause" discussed on page 21 suggests that aid can be approved even if it would not otherwise meet the guidelines if "competitors located outside the European Union have received or are going to receive aid of an equivalent intensity for similar projects, programmes, research, development or technology". This has no economic rationale – the fact that competitors may have been aided for ineffective projects gives European governments no reason whatever to undertake such projects themselves. The clause is an encouragement to the would-be recipients of money for undeserving projects to scour the annals of worst practice in the rest of the world in order to import such practice into Europe. Other, less egregious instances of criteria with potentially unfortunate incentive effects include the implicit encouragement of projects that are not profitable (p. 28), or have low levels of appropriable cash flows (p. 29). While it is undoubtedly true that some projects may be socially worthwhile in spite of having low private profitability or low appropriable cash flows, the focus of encouragement should be on the identifiable positive externalities that make them socially worthwhile, rather than on the low profitability or cash flows per se.

8. The Framework at present contains elements of both a more restrictive and a less restrictive approach to the approval of state aid than has been the practice to date. The emphasis on the balancing test, considered by itself, appears to indicate a more restrictive approach to aid: it implies aid can no longer be approved simply because it addresses an objective of common interest, but must satisfy the Commission that it does so in an effective manner and without distortions of competition that outweigh the benefits. However, the proposed extension of the block exemption regulation beyond the aid to SMEs that is currently covered, coupled with a generally encouraging attitude towards the various benefits that may be claimed for aid to R & D, could easily result in a marked relaxation of state aid control. It creates at least a risk of opening the doors to aid measures (especially those aimed at large established firms) that would have been difficult to justify under the previous policy and whose benefits for innovation are open to significant doubt. The overall impact of the Framework will depend, therefore, on the detailed manner in which it is implemented, as well as on the willingness of Member States to accept that the Lisbon agenda requires complementary policies on their part. The Commission can play an important role in publicizing the details of these complementary policies and enabling a comparison of different approaches to support for R & D in different member states.

9. Overall, therefore, we welcome the focus of the Framework on an economic approach to state aid control, and its implementation of such an approach through the balancing procedure that identifies market failures that can be alleviated by state aids, providing that the costs in terms of any distortions of competition do not outweigh such benefits. However, we would place much more emphasis than is present in the framework on the need for member state governments to improve their own procedures for identifying and supporting socially productive R & D projects, and for creating the right conditions for such projects to succeed, particularly in terms of the supply of complementary factors of production such as skilled labour. An increase in the level of public spending on R & D will not lead to a real increase in

innovation if it comes about solely through a relaxation of the standards for approval of state aid. It will be helpful for the Commission to clarify that this is not what is intended by the extension of the block exemption regulation. On the contrary, rigorous scrutiny of state aids is an essential means of ensuring that increases in overall public spending on R & D, which may make a valuable contribution to the Lisbon agenda if carefully designed and implemented, are not instead simply dissipated in lower levels of effectiveness of the research and development that is undertaken by the beneficiaries. We note in conclusion that we are well aware of the dangers of public policies that aim at 'picking winners'. Let us stress therefore that we favour policies that are 'bottom-up' - that is, available to all potential firms that meet explicit social efficiency criteria. 'Rigorous scrutiny' should therefore be understood as finding social efficiency criteria that reduce the probability of 'picking losers'

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