

## Local Government International Bureau (UK)

### State aid & innovation – response to Commission consultation

November 2005

- i) The Local Government International Bureau works with the Local Government Association (LGA) who represent nearly 500 local authorities in England and Wales, who in turn represent over 50 million people. LGIB works in conjunction with the LGA to support local authorities on European and international matters.
- ii) This position has been produced based on discussions and consultations with a wide range of stakeholders, including local authorities. A full response with the political support of the Local Government Association will be sent to the Commission in due course.

#### Overall approach

1. We very much welcome the Commission's initiative to revise the state aid regime relating to the award of public monies to companies in support of innovation. The UK Local Government Act 2000 granted local councils new 'well-being' powers to promote the economic, social and environmental well-being of their area. A flexible, predictable, transparent, and effective state aid regime to promote innovation is an important element in this process and helps to contribute directly to regional development.
2. We welcome the practical approach outlined by the Commission to integrate new rules on innovation as a strand to run through the existing body of rules, rather than seeking a specific definition of 'innovation' and a separate state aid regime for innovation framework<sup>1</sup>. This integrated approach respects the need to simplify and streamline the EU state aid regime as a whole.
3. In a similar vein, we also welcome the consolidated approach adopted under the proposed new Competitiveness and Innovation Programme (CIP) which joins previously separate innovation initiatives into a single programme.
4. We support the market failure approach in all fields of state aid policy, and appreciate that the use of public funds is not at all effective in markets where sufficient support is available from the private sector. However, any reported market failure in innovation capital must be justified by independent economic analysis. Merely asserting market failure should not be taken as sufficient justification to allow the award of aid.
5. When reviewing existing guidelines to better embed innovation aims, we feel it is also important to recall the global context in which the EU state aid regime operates. With the US and Japan investing significantly more in innovation than the EU, and with China and India predicted to overtake the EU in innovation related

<sup>1</sup> The consultation document proposes that new rules regarding innovation will be integrated into a new R&D framework, and also into the risk capital guidelines, environmental guidelines, and the general block exemption (avoiding the need to notify awards of aid to the Commission).

spending by 2010, it is important that the new rules for innovation aid are as flexible and generous as possible whilst still respecting the Treaty and avoiding significant distortions of competition. Existing state aid rules are weak in this area as they treat the EU as a separate entity in isolation from the global context.

### **Eligibility issues**

6. There has been much discussion about the extent to which state aid for innovation should be allowed to support larger companies (those with more than 250 employees etc). We support the focus on SMEs and recognise that they would normally find it more difficult to secure financial support for innovation than larger companies.
7. Nevertheless, given the global context in which the EU's state aid regime operates, aid to larger companies for innovation may be appropriate in a limited number of circumstances (in the face of losing an innovative larger company from the EU altogether, for example, as has already happened in several cases). Any aid to larger companies should be strictly controlled, considered on a case by case basis, and be subject to notification to the Commission.
8. In this light, we would therefore suggest that the SME definition on its own is too blunt an instrument to define eligibility. Subsidiaries, or single business units of larger companies fall beneath this threshold for example, and also find it difficult to secure capital.
9. If innovation aid is to be focused where it is most likely to benefit competitiveness, then other factors may need to be considered by individual Member States alongside, or instead of, the SME definition: factors such as the amount of aid awarded; the extent of market failure in that particular sector or Member State; the company's turnover; the amount of existing spend on RnD within the company; the likelihood of success; their track record in project management; the transferability of the innovation etc.
10. An approach along these lines has already been demonstrated successfully in the recently adopted state aid rules relating to support for services of general economic interest. Even though the main intention was to exempt aid to SMEs operating SGEIs from the need for notification, aid thresholds and a turnover criterion were used rather than the SME definition itself. This allows aid to be targeted in a more refined manner.

### **Risk capital and start-up aid**

11. We welcome the Commission's commitment (section 6 of draft Regional Aid Guidelines) to allow new forms of enterprise aid to start-ups in assisted areas, along the lines of the UK's recently approved Enterprise Capital Fund, or the more established SFI programme (Selective Finance for Investment in England). There is a huge equity gap in the UK and other Member States, and the lack of finance for SMEs is a well-established and well-evidenced barrier to regional competitiveness. The Commission's more open approach in this area should help future schemes of this type to be approved across the EU.
12. We would emphasise the need to involve all levels of governance and all partners in the design and delivery of such aid schemes. This will help to ensure that they have their intended effect, and are well understood, promoted, and adopted at the regional and local level. This has not always been the case to date.

### **Aid for research and development (R&D)**

13. Reform is also required as regards the intervention rates available to the different 'phases' of research currently defined in the guidelines for state aid to R&D. A

distinction is currently made between 'fundamental research', 'industrial research' and the 'pre-competitive development' phases. The distinction between the latter two phases is artificial and no longer reflects modern research practices. The 'industrial research' and 'pre-competitive development' phases should therefore be merged, and an appropriate single intervention rate allowed.

14. In addition, the rules around aid for R&D should be widened to allow greater support for prototype design, demonstration projects, and feasibility study work. Even though these measures may be seen as 'nearer to market' than fundamental research (and therefore more likely to distort competition), they should be supported where innovative potential can clearly be demonstrated, and where gains in regional competitiveness outweigh the concerns over distortions of competition.

#### **Aid for business infrastructure**

15. We recognise that ICT infrastructures such as broadband are critical for business development and therefore regional competitiveness. Under the state aid rules, such infrastructures should be treated in a manner consistent with other critical infrastructures, such as transport and energy, and not subject to delays in approval, or unnecessarily rigid rules, as is sometimes currently the case.

#### **Aid for innovation 'intermediaries'**

16. We support a wide definition of the term 'technology intermediary' as any public or private organisation supporting innovative SMEs and entrepreneurs.
17. We particularly acknowledge the role that local authorities can play as an intermediary by facilitating links and networking between universities, industry, local communities and other partners within the regions.
18. In a bid to progress towards the Lisbon goals, local government particularly recognises the value in supporting business incubation facilities such as innovation centres, often run in conjunction with enterprise parks or science parks. Public support for such facilities helps to boost the competitiveness of local economies whilst having a near-negligible effect on competition at the EU level.
19. However, such facilities typically involve a proportion of private capital which has unfortunately led to their development being hampered by the state aid rules. The state aid regime as a whole must therefore be reformed so that public-private partnerships are allowed to receive state aid when offering business incubation facilities or other 'intermediary' functions for the benefit of SMEs. Support for such intermediaries must ensure however that the overriding objective is to promote regional development, rather than operate on a purely commercial basis.
20. We therefore urge the Commission to develop not only more flexible rules relating to SMEs themselves, but also to ensure that those largely public bodies which act as intermediaries to promote innovation are also able to be supported.

#### **University activities**

21. In a similar vein, a more flexible approach to university activities, including support for university 'spin-out' companies, is also pressing.
22. More flexibility should also be shown to facilitate the transfer of research staff from universities to SMEs.

#### **Clustering & 'poles of excellence'**

23. The consultation document makes a number of proposals as regards supporting clusters and 'poles of excellence'. In general, our experience is that the most successful clusters develop in an 'organic' fashion often centring around one or

two larger 'anchor' companies from the same sector. The main factors influencing the initial location decisions of individual companies, and the subsequent success of the cluster as a whole, appear to be: the availability of a skilled workforce, proximity to transport links, potential synergies with other local companies and suppliers in the same sector, availability of ICT infrastructure etc, rather than the award of a, relatively small, public grant.

24. It is therefore important to recognise that support for such 'poles of excellence' in themselves may not achieve the desired gains in competitiveness, and may not add any value, unless funds address market failures relating to the factors outlined above. Support for already successful clusters to turn them into 'poles of excellence' may indeed exacerbate regional disparities. We would therefore call on the Commission to assess if the goals of creating poles of excellence and addressing market failures in innovation capital are mutually compatible.

### **Innovation aid versus the regional aid regime**

25. Whilst we support bonuses for innovation aid measures in the assisted areas, the rationale behind such bonuses should be made clearer. The bonus or 'top up' system for assisted areas is normally appropriate for redistributive measures such as investment aid or employment aid, whereas market failures in the provision of innovation or risk capital tend to be sectoral, or national, rather than sub-regional. Market failures may therefore not correspond well to the assisted areas map.
26. If innovation aid is seen as one of the tools to help achieve cohesion objectives, then the Commission should more squarely acknowledge the cohesion benefits innovation aid can offer to assisted areas. Such bonuses must not distract us however from the overarching goal of targeting market failure wherever it occurs.
27. In addition, to help achieve the Lisbon goals, aid should only be awarded to sectors which will contribute to a growth in competitiveness. Just as operating aid to failing companies is justified only in a very limited number of cases, aid to failing sectors must help them to transform and not merely act as a sectoral operating subsidy.

### **The general block exemption**

28. One of the main reforms proposed in the State Aids Action Plan is the creation of a general or 'super' block exemption bringing together SME, training, and employment block exemptions, along with regional aid, environmental and R&D guidelines, into a single consolidated block exemption.
29. This simplification is a positive step; allowing the Commission to focus its efforts on the more distortive aids, and relieving public bodies from the need to notify several forms of aid.
30. It is of course particularly important that the proposed general block exemption, as well as facilitating aid for innovation, is sufficiently wide-ranging and flexible enough to allow the full range of aids which are compatible with the Treaty. New limitations should not be unwittingly introduced, through the process of consolidation. In this light, the general exemption, when drafted, should be 'proofed' against what the rules currently allow.
31. Efforts must also be made to ensure that the general exemption is not implemented unevenly in different Member States, as some EU countries have a long history of granting illegal state aid and a lack of enforcement.

### **Regional innovation plans**

32. Finally, we support regional innovation plans but remind ourselves that many regions in the UK will embed this into a wider 'regional economic strategy' rather than addressing innovation directly under a separate plan. This approach may cause

innovation to take a lower priority when compared to other issues around sustainable development such as housing, transport or economic regeneration.

### **Conclusion**

33. These are our initial thoughts and reactions to some of the issues raised in the Commission's consultation document. As an organisation we continue to work with and consult with a wide range of partners both within the UK and across the EU.
34. On behalf of local authorities we represent, we will continue our work through the Committee of the Regions and the European Parliament amongst others and look forward to an ongoing dialogue with the Commission on these important topics.

### **Contact**

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