

SCOTTISH COUNCIL FOR DEVELOPMENT AND INDUSTRY

RESPONSE TO THE EUROPEAN COMMISSION'S CONSULTATION

PAPER: STATE AID FOR INNOVATION

The Scottish Council for Development and Industry (SCDI) is an independent membership network, which strengthens Scotland's competitiveness by influencing Government policies to encourage sustainable economic prosperity. It is a broad-based economic development organisation, with membership drawn from Scottish business, trades unions, public agencies, educational institutions, non-governmental organisations, local authorities, and the voluntary sector.

SCDI welcomes the European Commission's (EC) consultation on the development of rules and guidance providing Member States with additional scope for supporting innovation. As with our response to the Commission's consultation on its Action Plan for wider state aid reform, SCDI continues to support a clear, flexible state aid regime which allows Member States and their regions to develop assistance and promotion mechanisms, tackling market failures whilst not adversely affecting the operation of the European Single Market.

In summary, our main points are as follows:

- There is a need for further public sector support to stimulate and increase the levels of innovation and R&D undertaken by Scottish businesses, and that eligible expenditure qualification of this support should be widened to include a greater range of innovative activities, such as adding value through design and innovation.
- SCDI believes that large companies should also be able to benefit from state aid for innovation where market failure occurs...[]...often the scale and levels of activity that large companies undertake in this respect carry significant risks but also rewards that can create wider benefits for the EU as a whole.
- SCDI believes that, in keeping with a flexible approach, scope for non-technological innovation, particularly in the services sector, should be included as eligible for state aid for innovation, where market failure can be demonstrated.
- SCDI supports the rules on state aid for innovation including regional bonuses helping to maintain a level playing field between firms in different regions, ensuring equality of opportunity for growth and competitiveness.
- SCDI notes the five-year start-up time criteria for innovation support will apply to many companies, however, in some cases, particularly the life sciences and pharmaceutical sectors, many companies will take longer to develop self-sustaining businesses, for example, due to the imposition of government regulations requiring clinical trials. SCDI supports the Scottish Government's suggestion to look at the possibility of sector specific rules in these cases.

Background to the consultation

A renewed focus on the Lisbon Strategy - *to make Europe the most dynamic and competitive knowledge-based economy in the world by 2010* - originally launched by the European Council in March 2000, and re-launched in 2005, drives the current European Union reform process. In attempting to re-energise the flagging strategy by focusing on encouraging growth and job creation, the European Commission is seeking to streamline and simplify the current plethora of regulations and procedures, providing a more encouraging environment to accelerate EU economic growth.

As a small, but important, part of this wider procedural reform process, the European Commission - DG Competition, recently produced its State Aid Action Plan, “Less and better targeted state aid: a roadmap for state aid reform 2005-2009” - a consultation on the Commission’s intentions to refine, simplify and consolidate state aid policy. Stemming from the wider intentions espoused in the Action Plan, the Commission has now put forward suggestions for developing the state aid rules to assist in encouraging innovation. As a key determinant of competitiveness in global markets, commercial innovation is seen as a key cornerstone of the Lisbon Strategy. In the consultation the Commission identifies the main market failures that may hinder optimal levels of innovation and considers how state aid could play a role in providing added incentive to encourage innovative activity where market failure hinders the process. On this basis, the Commission proposes to authorise aid for two types of innovation related activities:

- activities that support risk-taking and experimentation to help bridge the gap between research and the market; and
- activities which improve the general business environment

The consultation goes on to present six potential measures to support innovation via state aid:

- support for the creation and growth of innovative start-ups (through tax exemptions and subsidies)
- additional flexibility for state aid to risk capital
- expanding the current state aid rules for R&D and authorising state aid for SMEs engaged in innovative activities (such as commercial-usable prototypes, technological demonstration or feasibility studies)
- subsidies for SMEs to buy services from innovative intermediaries
- subsidies for SMEs to recruit highly qualified researchers and engineers and to benefit from exchange of personnel with universities and large companies.
- supporting the development of poles of excellence through collaboration, clustering and projects of common European interest.

SCDI Response:

1. SCDI welcomes the Commission's state aid proposals aimed at assisting the stimulation of innovation in the European economy. SCDI also welcomes the early application of the refined economic approach to state aid - outlined in the Commission's previous consultation on its State Aid Action Plan. In response to that particular consultation, SCDI argued that there was a balance to be struck between the aspirations of competition policy in achieving a level playing field across Europe, whilst providing the flexibility to allow Member States and their regions to grow their companies, tackle regional disparities and address market failures. Therefore, whilst SCDI acknowledges that a favourable macroeconomic climate and the preservation and growth of market competition are fundamental if businesses are to regard innovation as a cost-effective way to achieve competitive advantage, we welcome the Commission's recognition of the need for state interventions where market failures hinder this process.

2. Innovation - the successful exploitation of new ideas - is imperative for the growth and sustainability of successful businesses as they move up the value chain in a competitive global market place; creating quality jobs; better products and services for consumers, as well as the development of environmentally friendly processes. Having 75 years of economic development experience, SCDI is fully aware of the concerns around productivity performance and growth, and the linkage between business investment in R&D and innovation. The Commission's own Key Figures on Science Technology and Innovation (2005) show that the EU invests about a third less in research than the US, whilst the most recent Innovation Scoreboard figures again show an EU/US innovation gap that has remained relatively unchanged over the past five years. Developments in technology, trade and production patterns now also lend weight to emerging countries such as China and India, which are fast becoming world-class centres of research and innovation. The stark reality for Scottish and European companies is the increasing location of large companies' R&D expenditure in these emerging countries is benefiting from lower wage costs, less restrictive labour conditions and increasingly competitive research, innovation and high-tech product markets, aided by a growing number of highly skilled workers. SCDI is therefore keen to see the Commission using the state aid rules to help enlarge Member States' scope to provide support schemes to develop research and innovation activity where market failure may be hindering this process.

3. As touched on in the previous point, Scottish business growth and productivity levels - significantly lower than on the continent - have been a long-standing concern for SCDI. As one of a number of indicators of businesses' growth and competitiveness, and as we have outlined in our most recent submissions to the European Commission and the Scottish Parliament, EU average expenditure on business research and development, as a percentage of GDP, is almost twice as high as that in Scotland, with the OECD average at a similar level. Indeed, the OECD's *Main Science and Technology Indicators and Regional Trends* data exposes the gulf with Scotland, with the Swedes spending as much as a five times higher share of GDP on R&D. It is of little surprise, therefore, that the 2004 Community Innovation Survey cited Sweden and Finland as Europe's top innovators. These successful innovators anticipate customer needs by continually adding value to their products and services, effectively applying and commercialising innovative activity in all areas

of their business processes. As such, SCDI believes that there is a need for further public sector support to stimulate and increase the levels of innovation and R&D undertaken by Scottish businesses, and that eligible expenditure qualification of this support should be widened to include a wider range of activities, such as adding value through design and innovation.

4. It is, therefore, true that innovation is not simply about developing high-tech products. Whilst, traditionally, R&D has been associated with technological research, many Scottish companies are in sectors where the greatest returns come from research into their customer base and needs. There is now a greater acceptance of the multi-faceted nature and complexity of what it means to innovate, with increasing emphasis on the importance of non-R&D innovation. At a global level, it is widely considered that the advances by the US and Japanese are often down to more than just matters of technological innovation. SCDI agrees with the view that, whilst research is a major factor for innovation, in today's highly competitive global environment the focus is often not on the technological aspects of new product development, but on more innovative ways to improve position in the market, from new business and delivery models to brand and design marketing. For businesses, innovation is a crucial way to create competitive advantage and superior customer value. This means that the definition of innovation is difficult to pin down – it can and does cover many areas, from the technological to the organisational and presentational; from processes to products. Therefore, SCDI believes that, in keeping with the flexible approach towards this subject area, non-technological innovation, particularly in the services sector, should be eligible for state aid for innovation, where market failure can be demonstrated.

Consultation Questions:

Principles governing the control of state aid for innovation

- *Do you think that it is appropriate not to create a separate Framework for Innovation and that the new possibilities for state aid target selected innovation activities?*

5. In keeping with the Commission's ambitions to refine state aid policy; creating more user-friendly and less cumbersome rules, and thus allowing for standardisation of government assistance schemes at Member State level, SCDI agrees with the proposal to integrate rules concerning innovation. Introducing guidance for innovation support to existing guidelines, such as R&D, environment, risk capital and SMEs would also be in keeping with moves to better target aid measures to specific types of market failure. The key is to strike a balance between a coherent and unambiguous set of rules - fostering ease of use - whilst maintaining the flexibility to react to market failures that will inevitably vary in their impact as barriers to innovation. The danger to mitigate is the creation of rigid and badly designed EC rules that lead to constraints and ambiguity and at Member State and regional level and that do not produce the desired results for the intended beneficiaries.

- *Do you think that the problems presented in the Annex and the market failures identified by the Commission as hampering the innovation process are accurate? If so why? If not, why?*

6. Clearly, insufficient innovative activity has many causes that will often vary across sectors, thus necessitating a flexible approach to tackling the problems and incentivising innovative activity. SCDI agrees with much of the Commission's analysis of the market failures, citing the structural differences within the EU economies that hinder the mobility of people and slow the transfer of innovative business models and ideas across EU countries, to the failures within the financial markets and unfavourable risk/return criteria of short-sighted investors. SCDI agrees that many of the sources of these issues stem from innovation as a public good and externalities the market does not reward, particularly acute for environmental technologies. Along with these problems, one area of continuing concern for SCDI members is the complexity often inherent in government assistance schemes that, in some cases, can add to the disincentive to innovate. These structural and regulatory problems will need a coordinated and region specific approach across all levels of government if we are to incentivise innovation in the face of market failures, particularly for our SMEs.

- *The measures described in this Communication provide ex-ante criteria on the basis of which state aid for innovation would be approved. Do you think that such an approach is adequate?*

7. SCDI agrees with the UK Government and the Commission's approach to less and better targeted state aid, aimed at tackling market failures where the payment of a minimum necessary approach is followed. The achievement of a level playing field for Scottish companies is crucial in this respect and whilst SCDI wishes to see a flexible and streamlined state aid system, recognising the limits of a purely rules-based approach, we also support the Commission's assessment and control role of state aid in the EU.

- *Stakeholders are invited to provide empirical evidence about the appropriateness of authorising state aid to large companies, in particular in connection with the objective of developing clusters around poles of excellence in the EU. Do you think that the Commission should develop ex-ante rules allowing state aid for innovation to benefit large companies, or that such type of aid always be subject to a case-by-case stricter analysis on the basis of a notification to the Commission? As far as support for innovation (or other state aid) is concerned, would it be appropriate to distinguish between different categories of large companies? If so, on the basis of which criteria? And for which purpose?*

8. Whilst it is true that large companies will tend to invest a higher proportion of their turnover in innovation activity than smaller companies, to generate new or improved goods and services and remain competitive, SCDI believes that large companies should also be able to benefit from state aid where market failure occurs. SCDI accepts that, in the main, the focus should be on SMEs, where market failures are more likely to exist, however, large company support should not be automatically precluded as often the scale and levels of activity that large companies undertake in

this respect carry significant risks but also rewards that can create wider benefits for the EU as a whole.

- *Stakeholders are invited to provide empirical evidence about the appropriateness of authorising state aid to non-technological innovation, notably in services sectors.*

9. Whilst the consultation paper proposes that the Commission would like to use the description of technological innovation (as defined in the Oslo Manual, page 9) to cover supportable activity (mainly because this is easier to define and measure), SCDI highlights views expressed in the European Commission's Communication, 'Innovation policy: updating the Union's approach in the context of the Lisbon strategy'. The Communication comments that whilst research is a major factor for innovation in today's highly competitive global environment, the focus is often not on the technological aspects of new product development, but on more innovative ways to improve position in the market. In this regard, there are various forms of innovation: from technological to organisational and presentational. Therefore, SCDI believes that scope for non-technological innovation, particularly in the services sector, should be included as eligible for state aid for innovation where market failures can be identified.

- *Should the rules on state aid for innovation include regional bonuses for cohesion purposes? Should they differ according to the geographical situation of the region, irrespective of cohesion issues?*

10. As with our response to the Action Plan, SCDI continues to believe that the geographical re-shaping of the EU after enlargement further emphasises peripherality issues for the compass rim regions such as Scotland and that this brings about a set of issues which have not been adequately researched or assessed by the European Commission as it reforms both the Regional Policy and the RAG. For Scotland, in particular our Highlands and Islands, the key issue is maintaining the flexibility within the state aid framework to be able to respond to geographical disparities as they see fit, ensuring that EU legislation does not actually preclude freedom to act on regional problems in Scotland. Therefore, SCDI supports the rules on state aid for innovation including regional bonuses - helping to maintain a level playing field between firms in different regions; ensuring equality of opportunity for growth and competitiveness.

- *Are some types of aid more suited to specific innovation activities (ex: tax rebates, secured loans, repayable advances)?*

11. All of the above will be useful depending on the circumstances, and provided a wider range of expenditure qualifies for support. A good example of where support should be encouraged is in activities adding value through design and innovation that can significantly increase demand for goods and services. Indeed, early indications from the recent Cox Review: 'Enhancing the Role of Creativity in Driving the Productive Performance of SMEs in the UK', commissioned by the UK Treasury, suggest that there is role for the Government in using its spending power and tax relief measures to incentivise the use of design and innovation to improve productivity. We would recommend the Commission and UK authorities also

consider detailed analysis of the role that design can play in business growth and competitiveness from SCDI members, Farm7, an independent research and consultancy organisation www.farm7.com. Whatever the support measure, SCDI urges the Commission and UK public authorities to guard against the tendency towards excessive bureaucracy, which is unnecessary and costly. In many cases smaller, growing companies claiming these funds face a financial and administrative burden as they often have to employ consultants to tackle the complexities that arise if eligibility is not clearly defined - leading to delay. Simplified access to support and clarity of eligibility and decision making, as well as proactive marketing are needed if well-intentioned measures, designed to encourage innovative behaviour, are to achieve their desired objectives.

Supporting risk-taking and experimentation

- *Do you agree with the proposed criteria to define innovative start-ups, with the approach of not defining eligible costs, with the amounts of aid and cumulation rules? Do you think that different eligibility criteria should be established for high-tech sectors like biotech and pharmaceuticals which have long time-to-market and product development cycles?*
- *Beyond the proposed rules, empirical arguments are welcome that demonstrate the need for state aid: i) for start-ups independently of the innovativeness criterion, and ii) for innovative SMEs established for more than 5 years.*

12. The type of support that is provided to Scottish companies must be determined by the fact that Scotland has a higher than average proportion of small businesses that are highly fragmented into different industries. Therefore, SCDI generally welcomes the Commission's proposed flexible criteria: supporting the creation and growth of start-ups; risk capital; and support for experimentation and commercialisation. The focus on SMEs and the particular problems they can face, from finance to facilities and equipment and advisory services, is on the right lines. However, SCDI notes two aspects of the criteria that could raise potential problems for our members.

13. Firstly, the start-up criterion and current SME definition. SCDI Members have recently highlighted problems as regards shareholding and independence from large companies. With the tightening of the SME definition to include linked and partner enterprises, the current guidance is very complex and can require companies to seek legal advice on its interpretation. SCDI calls for greater clarity in this guidance to avoid costly delays created through uncertainty.

14. Secondly, SCDI notes the five-year start-up time criteria for innovation support will apply to many companies, however, in some cases, particularly the life sciences and pharmaceutical sectors, many companies will take longer to develop self-sustaining businesses, for example, due to the imposition of government regulations requiring clinical trials. In this regard, SCDI supports the Scottish Government's suggestion to look at the possibility sector specific rules in these cases.

- *Do you think that other types of state aid apart from those currently granted in respect of risk capital are required in order to help European SMEs grow beyond the start-up phase? If so, which ones?*
- *Do you think that these provisions would produce the expected effects in terms of encouraging SMEs to launch innovative products in the market? If not what changes should be made to these rules?*

15. SCDI notes the comments from our members that private investment funds focus on growing companies that have already launched innovative products and are likely to generate high rates of return on investment, leaving a lack of access to risk capital by many small companies at crucial stages in their development. This market failure, preventing the supply of equity meeting demand at an acceptable price, has major implications for business growth and development - particularly for start-ups and young, innovative SMEs.

16. As noted, the type of support that is provided to Scottish companies must be determined by the fact that Scotland has a higher than average proportion of small businesses that are highly fragmented into different industries. Therefore, the Commission's recognition of the problems with the efficient funding of firms with equity, particularly in the early business lifecycle phase and post-seed stages is welcome. As noted in our response to the Action Plan, SCDI supports the proposed measures put forward by the UK to increase the flexibility to reflect evidence-based market failure and the emerging equity gaps further up the investment scale

- *Is there evidence that these provisions should be extended to large companies? Do you think that notification should be required for measures granting substantial amounts of aid to individual firms or individual sectors? If yes, above what amount? What empirical evidence should then be requested by the Commission?*

17. As with our earlier response in this paper regarding large companies, SCDI believes that where it can be shown necessary, large companies should be eligible for assistance.

A supportive business environment for innovation

- *How would you regard specific support for innovation intermediaries which merge or develop joint venture to reach critical mass in a technological field of specialisation? Should investment aid be permitted in this context? If so, on what conditions? What other measures could be envisaged?*

18. SCDI supports the intention to provide increased clarity and scope for innovation intermediaries offering infrastructure and business services - such as business incubation services for innovative start-ups. SCDI echoes UK authorities' calls for a lighter touch to the regulation of these activities, which will often involve no state aid to the actual intermediary itself.

- *Is there evidence that the recruitment by SMEs of other types of highly skilled personnel should also be aided?*
- *Should the Commission adopt specific rules for cases where a researcher chooses not to return to his/her home university or where the university no longer intends to hire him/her back?*

19. People are at the centre of research and innovation activity. As such, there needs to be an increased focus on the training and attraction of qualified researchers, engineers and other skilled workers. As the UK authorities recognise, the solution to the problem goes beyond state aid. In order that business is not compromised by a lack of high quality labour, on-going investment in education and training will be needed and lifelong learning is crucial in improving productivity and supplying Scotland with a quality workforce. Along with this, a greater priority needs to be given to providing those in Further and Higher education with grounding in entrepreneurialism and greater information on business and risk. Whilst Scotland has its fair share of graduates and key policies to attract highly skilled economic migrants, the key is to provide the experience and economic opportunities here in Scotland. Therefore, whilst we need wider policies that focus on developing our home grown skills base, SCDI welcomes the proposals to allow state aid to be used to assist companies attracting highly skilled workers from inside and outside the EU.

- *What definition of cluster/clustering activities should be followed and what criteria should be used to distinguish clusters from the broader category of innovation intermediaries?*
- *Do you think that state aid should be allowed to promote European centres of excellence? If so, what type of State aid, for what reasons, and subject to what conditions? What other, possibly better, measures could be envisaged?*

20. The creation of regional research driven clusters is a good idea in principle, however, SCDI agrees with the UK and Scottish authorities' view that in most cases clusters will develop naturally around universities and other research intensive institutions. SCDI also agrees that support should focus on providing the best environment to encourage clustering and intermediary activity and foster greater collaboration between universities and businesses. As noted in our response to the Action Plan, SCDI wishes to see the Commission providing greater certainty and more flexibility in the state aid rules when concerning support of university and business research collaboration, as well as measures to increase the conversion of academic research into innovative, commercial products that boost competitiveness. Encouraging the clustering of these activities, to exploit the synergies gained from such close-proximity working is fundamental if we are to harness the potential benefits of such innovative activity. Finally, SCDI can see no reason not to support aid for the creation of innovation clusters around European Centres of Excellence.

- *What are your views more generally about the need for additional provisions for infrastructure that supports innovation (e.g. in the field of energy, transport etc.)?*

21. SCDI recognises that efficient transport, energy and communication infrastructure play a central role in increasing the competitiveness of Scottish businesses in the wider knowledge economy. High quality transport links and a supportive planning system are both fundamental to providing business with the best environment in which growth and innovation can occur. In particular, state aid can be helpful with interventions in the supply of broadband in rural areas or business incubation centres in poorer regions. SCDI encourages the Commission to consider the UK approach to such provision and produce clear guidance, accepting the principles of competitive market-based delivery and the important, wider benefits such investment obtains.

- *Do you think that large firms should be entitled to state aid, e.g. to establish research facilities in a European pole of excellence? Should the Commission try and develop specific criteria to control such state aid? What type of economic evidence should be requested to analyse the necessity of such state aid?*

22. Yes. Large companies should be entitled to support where market failure acts as a significant disincentive to innovate. SCDI supports both the Scottish and UK authorities' view that large companies should also be eligible for funding as intermediaries.

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Annex

Set out in Articles 87 and 88 of the EC Treaty, state aid is an integral part of European competition policy, prohibiting aid granted by Member States that has the potential to unduly distort intra-Community competition and trade. Article 87 of the EC Treaty prohibits, *‘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’*. With the Commission having *sole competence* in determining the presence of aid and approving it, the emphasis is very much on the Commission interpreting threats to competition and trade in the protection of the Single Market.

Aside from the general ban on state aid, the Treaty does allow certain forms of aid, which may be deemed *compatible* with the objectives of the Common Market. These include aid having a social character, to individual consumers; aid designed to promote economic development of areas regarded as particularly backward in relation to Community criteria; aid to promote important projects of common European interest; aid for the development of certain activities or areas; and aid to promote culture and heritage conservation. In practice these exceptions to the general ban on state aid provide the basis for the numerous guidelines, frameworks and exemptions the Commission uses to clarify its state aid policy.

These guidelines, frameworks and exemptions provide the criteria for allocating aid deemed to be justified because of the beneficial impact in overall EU terms. They can include aid for regional development purposes or aid promoting policies of common interest such as: R&D, small and medium-sized businesses; employment and training; protection of the environment, and rescue and restructuring of firms in difficulty. The Commission generally takes a favourable view of such schemes provided they do not distort competition to an extent contrary with the common interest.