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RESPONSE TO COMMISSION'S CONSULTATION DOCUMENT ON STATE AID FOR INNOVATION

In its Consultation Document on State Aid for Innovation, the Commission sets out the principles it proposes to employ to govern how state aid for innovation should be controlled. Principally, the Consultation Document explores the idea that the simplification of EC state aid rules would not be assisted by the development of a new and separate framework for state aid for innovation. Therefore the Commission intends to address the issue of state aid and innovation within the context of the existing rules and frameworks, with a focus on two "innovation-related activities", namely: (i) activities that support risk-taking and experimentation; and (ii) activities which improve the general business environment for innovation. The Consultation Document explores in what circumstances these two types of activities might qualify for state aid and, to this end, poses a number of detailed questions (many of which ask for empirical evidence) on the propositions it makes.

Lawrence Graham LLP has a number of comments on the issues considered in the Consultation Document. Rather than answering specific questions, we set out below our views on the themes that emerge from the proposals. Many of these themes were highlighted by the various speakers at the Commission's Colloquium on State Aid for Innovation, held in Brussels on 17 November 2005. The recurrence of some of these themes during that Colloquium indicates strongly that the proposals set out in the Consultation Document may well need to be re-examined before implementation.

1. Approach to authorising State Aid for Innovation

As stated above, the Consultation Document clarifies that the Commission does not propose to introduce an innovation-specific framework. Rather, state aid for innovation is to be tackled through the current rules (and possibly, to some extent, included within the new "super-Block Exemption"). Nor, indeed, does the Commission choose to define "innovation" per se, although it does define "technological innovation" in line with the Oslo Manual (footnote 4 of the Consultation Document). However, through its focus on technological innovation, the Commission makes it clear that innovation in the services sectors is excluded from its current proposals.

Lawrence Graham LLP would make the following points on this approach. First, it is clear that, without a definition of "innovation", it would be impossible to develop an innovation-specific framework. In other words, by choosing not to define "innovation", the Commission rules out the possibility of doing anything other than focusing on specific activities that slot into the current rules and frameworks. We agree that a loose definition of "innovation" would be obstructive, rather than helpful. But, as discussions at the Colloquium recognised, innovation may have different meanings in different sectors or circumstances depending for example, on lead times or development cycles. Therefore, to the extent that rules on state aid for innovation are to be integrated into existing sectoral guidance or rules, we suggest that for those sectors at least, some definition of "innovation" is attempted. This would also help to address the problem raised by Commissioner Kroes at the Colloquium, of where to draw the line between innovation and commercialisation, which can vary dramatically between sectors. Indeed, it could be argued that the Consultation Document is unhelpful in this regard, as the definition of "technological innovation" refers to the "implementation/ commercialisation of a product with improved performance characteristics". Thus innovation is equated with commercialisation, indicating that it is impossible to draw a line between them.

A further point can be made on the decision to exclude innovation in services from the scope of the proposals. To the extent that services are at the market face (i.e. the commercialisation stage of development), it is logical to exclude them, as state aids this close to the market would be far more likely to have a distortive effect. However, it is not clear that the Consultation Document is consistent in this regard. The proposals regarding state aid for innovation intermediaries aim to subsidise the purchase of services to assist innovative entities. This could be read in two ways, each of which is inconsistent with the exclusion of innovation in services from the proposals:-

§ services are not at the market face, in that they are part of the development phase of innovation and as vital to that process as, say, the development of a prototype (which phase may now, under the proposals, benefit from state aid; or

§ these services are being provided to a market but nonetheless they may still be considered as eligible for aid (indirectly, as the innovative entities purchasing the services pass on the benefit of the state aid to the service providers).

Turning next to the Commission's proposed methodology for evaluating state aid for innovation, the Consultation Document lays down a clear three-step process. The first step is to identify a "well-defined market failure". This starting point reflects the Commission's intention to adopt an economic approach to state aid. This is commendable. However, a global view suggests that such an assessment may be difficult to make. One of the overarching aims of the Commission's reform of state aid is the desire for the EU to increase its competitive position in the global market. This is recognised in the Lisbon Agenda. To a greater or lesser extent, depending on the sector, innovation is a global issue. So, does a lack of innovation in a sector mean that there is a global market failure? In other words, if we use tried and tested economic tools to define the market, and discover that the market is worldwide, does a lack of innovation within the EU part of that market mean that the market must have failed globally? This analysis will clearly breakdown if, for example, in the USA there is evidence of innovation in that market.

A similar point can be made in relation to the second step in the Commission's proposed methodology: the aid has to target the identified market failure. Again, if the market is global (or at least, wider than the EU/EEA), will the aid only be given to target that failure to the extent that it affects businesses in the EU? If so, can this easily be done?

A further point that can be made in relation to the methodology was raised at the Colloquium. The Consultation Document states that "the aid measure must have an incentive effect". However, it will be very difficult to establish whether the innovation that the aid is intended to incentivise would have happened even in the absence of the aid. In other words, how can it be shown that the aid motivated the idea and did not simply reward it?

Lawrence Graham LLP does not suggest, in making these points, that ex-ante rules for state aid for innovation cannot successfully be devised or function. On the contrary, an increase in the clarity surrounding when state aid is permissible, before it is granted, is welcome and would certainly reduce the burden of notification and the delay in waiting for a decision. However, further clarity around these issues would be useful if the proposals are to increase certainty rather than reduce it.

2. Form Versus Substance

Whilst the Commission's stated aim is to adopt an economic approach to assessing aid (and therefore to look at the substance of a particular case), certain aspects of the Consultation Document appear to place a greater emphasis on form. Many of these issues were identified at the Colloquium. In particular, form appears to be more important than substance in the following respects:-

§ SMEs – at numerous points the Consultation Document appears to assume that SMEs suffer more from market failures than large companies, and that aid to SMEs will by definition be less distortive than aid to large companies. Yet it cannot be assumed that this will always hold true, for a number of reasons. For example, the innovation arm of a large company may be as small as an SME, but the company itself may be much bigger. Such a case will not qualify for the lighter treatment metered out to SMEs. Certain market failures may by definition affect all players, not just SMEs – for example, lack of information is not resolved simply by having a larger number of employees. In some instances, large companies may be worse off than SMEs – for example, internal bureaucracy in a large company may constrain the innovative process, whereas in a small start-up whose sole role is to innovate will not face such difficulties. More important than size is sector – the analysis of state aids should focus on sectoral conditions which are more likely to determine the incentives to innovate than the size of the entity concerned is. Equally, in relation to creating an innovation-friendly business environment, the size of the entity should not be determinative. For example, large companies may benefit as much as SMEs from the loan of personnel.

§ Form of the aid – the Consultation Document states that "the incentive effects of an aid measure may be influenced by its form". Lawrence Graham LLP does not believe that this is – or should be – the case. If an entity truly intends to innovate and is hampered only by a lack of finance, then the form in which that finance is provided should be of little or no consequence.

§ Definition of "innovative start-ups" – supporting the creation and growth of innovative start-ups is one of the forms of supporting risk-taking and experimentation described in the Consultation Document. However, the proposed means of providing such support seem very formalistic. A start-up must have less than five years of existence and must be an SME. We have already considered some of the issues regarding SMEs. As to the need for less than five years of existence, again, this ignores different sectoral considerations. In some industries, five years might be seen as a mature business. In others, five years would be insufficient time to have got the product anywhere near commercialisation. Similarly, the condition that R&D expenses should represent at least 15% of the beneficiary's overall expenditure does not seem to have any empirical foundation. A more fundamental issue is this: why should start-ups necessarily per se need state aid? It is not clear that start-ups necessarily face particular market failures. Unwillingness to invest in new ideas or business propositions may equally affect established businesses.

3. Aims of the Proposals

The Consultation Document identifies six main aims of the proposals, three in relation to supporting risk-taking and experimentation (supporting innovative start-ups; risk capital; and R&D) and three in relation to creating a supportive business environment for innovation (encouraging innovation intermediaries; encouraging training and mobility; and poles of excellence). In relation to the latter, whilst there is certainly a great deal of merit in the concept, it may be that in practice some of the proposals raise as many issues as they resolve. For example:-

§ In relation to encouraging innovation intermediaries, the Commission suggests that SMEs could receive a kind of "innovation services voucher" to buy services. Yet it may be that the administration of this idea is too complicated. Would this be an efficient way to procure such services? Indeed, if the services we paid for with public money, would the SMEs have to go through a formal procurement process (as the budget of €200,000 is over the threshold at which services must be procured in accordance with the procurement directives)? Is the Commission intending to audit the accounts of each SME who receives such a voucher, to ensure that the money is spent for the purposes for which it was given?

§ The Commission proposes to define "innovation intermediaries" on the basis of the services they provide. Will the Commission hold a register of such entities? Will it expect SMEs to notify the Commission of the entities from which they are buying services (thus creating a greater burden rather than reducing it)?

§ In relation to encouraging mobility, will the Commission be prepared to support the costs of mobility into and out of the EU, to the extent that this promoted an innovation-friendly environment within the EU, even if it also benefited innovation in the non-EU countries to which the personnel were sent or from which they came?

§ The proposals supporting the development of poles of excellence assume that innovation may (at least in some cases) best be achieved by collaboration. However, as was recognised at the Colloquium, this may not always be the case, as entities working alone may be just as successful. Even where poles of excellence are a success, global experience shows that this is more usually the case where they have grown up organically. State aid cannot itself achieve such organic growth, although it may help to foster a spirit of innovation which in turn may lead to organic growth. One issue that the Consultation Document fails to recognise is that collaboration, even at the innovation stage, may be harmful to competition. For example, where innovators working together wish to keep a new product from getting to market, so as to bolster sales of their existing products, this may be facilitated by their collaboration in a cluster. The line between anti-competitive collusion and pro-competitive innovative clustering may be loosely drawn.

Should the Commission have any comments or queries on Lawrence Graham LLP's response, please contact Anthony Woolich (anthony.woolich@lawgram.com) or Rosemary Choueka (rosemary.choueka@lawgram.com).