SCOTTISH COUNCIL FOR DEVELOPMENT AND INDUSTRY

RESPONSE TO THE EUROPEAN COMMISSION'S CONSULTATION PAPER: STATE AID ACTION PLAN
"Less and better targeted state aid: a roadmap for state aid reform 2005-2009"

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 review of state aid policy at this time. SCDI has, over many years, promoted and supported the opportunities afforded to our members through UK membership of the European Union. With regard to EC Competition policy, and in particular state aid, SCDI continues to support a 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. Therefore, SCDI supports many of the objectives outlined in the Action Plan: creating a more flexible, straightforward and transparent state aid regime, ensuring Member States and their regions can tackle regional disparities and address market failures, and that businesses in Scotland can operate on a level playing field with their European counterparts.

In summary:

- "SCDI argues that there is 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"
- "SCDI supports UK Government proposals for a more flexible state aid framework enabling Member States to provide the minimum necessary payments to tackle market failures and achieve social, environmental and economic objectives in the wider public interest"
- "SCDI suggests the state aid rules have been unnecessarily complex and burdensome, often leading to an inconsistent approach between Member States and a narrow interpretation by aid administrators…[]…Supporting more horizontal aid measures under block exemptions (such as risk capital, innovation, R&D, environment) would be the most effective way of permitting controlled aid levels whilst reducing the delay and burden created through legal uncertainty"

Background to the consultation

The European Commission DG – Competition, issued its consultation document on state aid reform on 7 June. In its Action Plan the Commission sets out the guiding principals for a comprehensive reform of state aid rules and procedures over the next five years: the objective is to make state aid policy clearer, simpler and easier to understand, therefore encouraging Member States to contribute to a renewed focus on the 2000 European Council Lisbon Strategy - *to make Europe the most dynamic and competitive knowledge-based economy in the world by 2010* - whilst streamlining and standardising state aid policy in an enlarged European Union. Setting out their objectives in the Action Plan, the Commission presents a reform package based on the following key themes:

- Less and better targeted state aid;
- A refined economic approach;
- More efficient procedures, better enforcement, higher predictability and enhanced transparency;
- Shared responsibility between the Commission and Member States

Together with the annexed roadmap, the Action Plan sets out the Commission's timetable and priorities for a reformed state aid regime. These include increasing incentives to businesses to invest in innovation and R&D; improving the business climate and stimulating entrepreneurship; investing in Human Capital; improving the quality of Services of General Economic Interest; simplifying and consolidating the block exemption regulations – which allow aid which is compatible with the state aid articles in the EC Treaty; updating and developing regional policy; encouraging environmental protection and sustainable development; and setting up modern transport, energy and ICT infrastructures.

Although the Commission retains sole competence for state aid policy and responsibility is largely reserved at Member State level, the consultation document is a unique opportunity for those with vested interests in local and regional economic development to influence the Commission's thinking on the reform of a small but nonetheless important component of the wider Lisbon Strategy.

SCDI Response:

1. SCDI welcomes the Commission's consultation on its intention to review state aid rules and procedures at this time; to improve the predictability and scope of a cumbersome and often unclear set of rules governing Member States' support to business. The review of state aid policy - in line with a renewed impetus on the Lisbon Strategy for sustainable growth, jobs and cohesion - is a move which SCDI supports, in as much as it should create a more flexible, efficient and equitable state aid regime.

2. In this regard, SCDI argues that there is 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. SCDI supports UK Government proposals for a more flexible state aid framework enabling Member States to provide the minimum necessary payments to tackle market failures and achieve social, environmental and economic objectives in the wider public interest; clearly in line with the objectives of the Lisbon Strategy. SCDI supports the UK Government view that where this approach retains the fundamentals of competitive, market–based delivery payment of the minimum necessary to encourage certain outcomes - which the market would not otherwise deliver – it should be compatible with the articles on state aid in the EC Treaty.

3. SCDI was disappointed that the Commission did not follow through with its earlier suggestions for a standardisation of state aid policy in its significant impact test proposals: LASA (Lesser Amounts of State Aid) and LET (Lesser Effects of Trade). However, the Commission's intention to adopt a more refined economic approach - to support Member States in targeting aid towards the types of interventions where markets do not provide natural solutions - is to be welcomed, provided this does not place an undue burden on regional overheads by adding another 'bureaucratic hurdle'. SCDI supports UK Government reasoning that moves to a more 'economic-based' assessment of the impact of market augmentation measures should be complemented by a drive within the Commission to speed up the approval of such cases, as well as exempting more aid measures from the notification requirement where the potential distortion on competition is minimal (i.e. through block exemptions).

4. SCDI encourages the Commission's intention to increase the transparency and enforcement of the state aid rules in partnership with Member States. As widely recognised, Member States have differing traditions of intervention and adherence to the state aid rules; SCDI does not wish to see Scotland or rest of the UK put at a competitive disadvantage in this regard. The Commission's latest State aid Scoreboard (Spring 2005) reflects huge disparities in this regard that can have serious implications for Scottish firms. In 2003, the UK provided some €4.2 billion in state aid compared with €16 billion in Germany, €9 billion in France and €7billion in Italy. The Scoreboard also demonstrates that of the €9.7 billion of aid (in cases for which the aid amount is known) declared illegal by the Commission and due to be recovered since 2000, only €6.7 billion had been recovered by the end of 2004. It is also noted that four Member States (Germany, Spain, Italy and France) account for more than 90% of the pending recovery cases.

5. Therefore, whilst SCDI supports moves toward increased transparency we also have some reservations over proposals for the intended use of national competition authorities to decentralise certain elements of supervision. Certainly, any measures that simplify and increase the speed of assessment, as well as levelling the playing field, are to be welcomed. However, SCDI has some concern on how this would work in practice with so many varied national bodies attempting to exercise equitable judgment in such a complex and legally ambiguous area. The danger is that the Commission ends up overseeing yet another tier of bureaucracy. SCDI believes the inclusion of more types of aid in the block exemptions should be the Commission's main focus – providing increased legal certainty and transparency for all Member States.

II.1 Targeting Innovation and R&D to strengthen the knowledge society

6. Research, development and innovation provide the foundations for improvements in productivity and for sustainable global competitiveness. Significant inroads have been made in recent years in Scotland, particularly in terms of the percentage of UK expenditure by Scottish businesses on R&D. However, low levels of R&D investment continue to be a problem; business research and development as a share of GDP in Scotland continues to be lower than our competitors, with the EU average 50% higher than in Scotland *(OECD Main Science and Technology indicators and Regional Trends, 1997-2002)*. Latest figures show business enterprise expenditure on R&D in Scotland at 0.59% of GDP.

7. These figures demonstrate that there a significant need for further public sector support to stimulate and increase the levels of innovation and R&D undertaken by Scottish businesses. Lack of business initiative to innovate and undertake research and development activities has many contributory factors, from the lack of access to finance and risk capital; poor relationship structures between academic institutions and the business community; the regulatory environment; geographical location and infrastructure requirements. To date the state aid rules concerning R&D have been seen as broadly effective for developing Scottish programmes such as SMART, SPUR and R&D plus. However, SCDI would wish to see a broader approach to the definition of innovation and application of R&D activity and welcomes the review of the existing frameworks and guidelines to provide Member States with increased clarity and broader scope when encouraging private sector investment in R&D.

8. SCDI also 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. Such activity is made more difficult by a lack of contact between universities and businesses. 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. SCDI therefore welcomes the Commission's recognition that the state aid rules could be made clearer and more flexible towards such interactions – particularly concerning technology transfer with industry.

9. SCDI believes the focus for all revisions that touch on R&D and innovation should be on providing a complementary, unambiguous and transparent set of guidelines, further increasing the scope to stimulate innovation and investment in R&D, resulting in quality commercial products and services created in Scotland.

II.2 Creating a better business climate and stimulating entrepreneurship.

10. Whilst sound macroeconomic policies are imperative to the objectives of growth, reducing the administrative burden on business, through simplifying and improving the quality of legislation and improving the wider business environment is also of key importance, particularly for SCDI members. Entrepreneurial attitudes within businesses are largely dependent on the external influences that impact on a management team's decision to grow, or not. One of the main issues SCDI members consistently highlight is the 'goldplating' of regulation - or a more stringent standard applied within legislation.

11. SCDI suggests the state aid rules have been unnecessarily complex and burdensome, often leading to an inconsistent approach between Member States and a narrow interpretation by aid administrators. The end result of this quasi-legal uncertainty can be a risk averse culture within public authorities to supporting innovative project proposals with unnecessary delays whilst seeking legal certainty from the Commission. Supporting more horizontal aid measures under block exemptions (such as risk capital, innovation, R&D, environment) would be the most effective way of permitting controlled aid levels whilst reducing the delay and burden created through legal uncertainty.

12. SCDI supports the proposed review of the Communication on Risk Capital, in particular increasing the flexibility to reflect evidence-based market failure and the emerging equity gaps further up the investment scale. Indeed, the UK Government's 2003 consultation exercise, "Bridging the Finance Gap" noted that, "available evidence suggests that the equity gap is most often a constraint for businesses seeking up to £2 million of growth capital, and especially those seeking less than £1 million". 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.

II.3 Investing in Human Capital

13. SCDI notes the Commission's intention to simplify and consolidate the block exemptions on training and employment. Skilled, trained and adaptable workforces are the foundations of a competitive economy, and a cornerstone of the Lisbon Strategy. SCDI supports the exemption of this aid from prior notification, to allow Member States to provide the right incentives for employers to engage more workers, particularly those who have difficulty to access and remain in the labour market.

II.4 High quality Services of General Economic Interest

14. SCDI recognises the beneficial impact effective and high quality Services of General Economic Interest (SGEI) have in ensuring social and territorial cohesion, the provision of education, training and culture, and as an exercise in effective citizenship. Essentially, an SGEI is a service which the market does not provide, or does not provide adequately, in the opinion of the State and is desired in the wider public interest. Though the terminology is not commonly used in Scotland, SCDI notes the recent provision of the Commission's three texts providing guidance on the thresholds and conditions for exemption of certain aid from notification, as well as a framework for notifying larger SGEIs. Whilst noting the approach contained in the guidance, SCDI fully supports the principle of subsidiarity in allowing Member States a wide margin of discretion in determining their own SGEIs, whilst

demonstrating the provision of clear public service obligations to perform activities in the public interest.

II.5 Better prioritisation through simplification and consolidation

15. As expressed throughout this response, SCDI supports the Commission's intention to subsume the current exemptions - from the obligation to notify - into one general block exemption. As noted, the Commission's focus and resource should be on larger, more distortive aids and levelling the playing field for all Member States. Exempting more categories of aid from the obligation to notify, in line with the objectives of the Lisbon Strategy, will significantly improve Member States' abilities to develop timely and flexible aid schemes, as well as free-up the Commission's resource to pursue aid with real and damaging effects on competition and trade.

16. SCDI also notes the Commission's intention to review the de minimis threshold (currently, amounts below €100,000 to a single enterprise, over a rolling three-year period, are not deemed to distort intra-Community competition and trade). Any revision of this regulation and the threshold should take into account inflationary rises and administrative burden that recording and monitoring these payments can have. SCDI suggests one alternative might be to leave the threshold as it is but change the capture and monitoring period to one year, instead of three. Finally, SCDI supports the inclusion of this regulation in the transport sector and would urge the Commission to introduce this facility at the earliest opportunity.

II.6 A focused Regional aid policy

17. SCDI welcomes the recent enlargement of the European Union and recognises the economic and financial challenges this will have, particularly in relation to the overall objective of 'less and better targeted aid'. However, the implications for Scotland in the Commission's proposed reform of the Guidelines on National Regional Aid (hereafter the RAG) outlined in their 2004 consultation, caused some concern regarding the reduction in scope (48% population coverage to 8%) for Scottish schemes developed under the guidelines, such as the Scottish Executive's Regional Selective Assistance scheme and Highlands & Islands Enterprise's Initial Investment and Job Creation scheme. This was expressed in SCDI's response to the UK Government's consultation in the same year.

18. SCDI is aware that the Commission has, after lengthy consultation with Member States, recently issued its draft guidelines for the forthcoming RAG, which will operate from 2007 to 2013. The reality is the new RAG, in limiting further the scope of state aids in the UK and EU, will place restrictions on Scotland and many other regions within the EU. 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 may have not been adequately researched or assessed by the European Commission as it reforms both the Regional Policy and the RAG.

19. In response to previous proposals, SCDI considered the deselection of areas through statistical effect as unfair and unwarranted in real economic terms. Therefore, SCDI welcomes what the draft has to say about statistical effect areas, such as Scotland's Highland and Islands - qualifying for 87(3)a) status until review in 2009. Furthermore, SCDI notes the addition of unemployment as an additional, identifying indicator for allocating and targeting

support at NUTS2 and NUTS3 levels in areas designated as 87(3)c). In our response to the 2004 proposals SCDI argued that GDP per head was too blunt a tool for targeting allocation across larger geographical areas (such as NUTS2). Therefore, SCDI welcomes the additional flexibility afforded to Member States in targeting localised regional disparities over smaller population areas using a wider basket of indicators, such as: employment or unemployment; local productivity or skills indicators.

20. Within the draft, SCDI also understands there is to be some additional flexible coverage afforded through a formula based on the differences in economic performance at national level and a safety net preventing Member States from losing more than 50% of current coverage. SCDI is glad to see revision of the Commission's original position on UK coverage, up from the previously proposed 9% to the currently estimated 23.5% and will be encouraging the Scottish Government to seek to ensure Scotland obtains an equitable share of allocation at UK level. Although in broad agreement with the aim of less and better targeted state aid, the Commission must be careful to retain aid intensities which provide realistic levels of support which is truly additional rather than merely an indicative gesture of support. In this regard, SCDI suggests a rise in the proposed aid intensities for 87(3)c) areas from the previously proposed 15% Gross Grant Equivalent to 20% Gross Grant Equivalent, whilst also maintaining regional 'top-ups' contained in many of the other state aid guidelines and block exemptions.

21. The addition of enterprise aid – to encourage small enterprise start-up costs over the first five years in assisted areas – is a welcome move that SCDI suggests could be included as part of the SME rules in the proposed block exemption.

22. Given the inevitable reduction in Regional aid coverage, the key issue for Scotland will be maintaining the flexibility within the entire state aid framework, allowing Scottish authorities to respond to geographical disparities as they see fit, ensuring that EU legislation does not actually preclude freedom to act on regional problems and market failures.

II.7 Encouraging an environmentally sustainable future

23. SCDI fully supports the intended review of Environmental Protection guidelines to better address the Lisbon and Sustainable Development Strategies, originally expressed at the Gothenburg European Council, in 2001. As environmental policy is a shared responsibility of Member States and the EU, SCDI would encourage the Commission to enable Member States to support and encourage proactive activities that not only control pollution but actually prevent it, thus countering the negative effects of economic growth.

24. SCDI acknowledges the UK Government view that the Commission's current approach to the guidelines does not take enough account of direct and indirect benefits of public support in achieving environmental goals, such as reduced emissions of greenhouse gases; better use of natural resources; increased recycling of waste; and reduced landfill. As a result, SCDI supports UK Government arguments for developing a minimum necessary payment approach in the guidelines, recognising the right of Member States to tackle market failures and achieve wider environmental objectives, whilst not unduly affecting competition and trade at an EU level.

II.8 Setting up modern transport, energy and information and communication technology infrastructures.

25. 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. Where investment in infrastructure is potentially caught by the state aid rules, particularly concerning Public Private Partnerships, 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.

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September 2005

Background to EU State aid rules and this consultation:

From EC Competition website:

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.