21 November 2005

EVCA's COMMENTS ON THE EUROPEAN COMMISSION CONSULTATION ON STATE AID FOR INNOVATION

The European Private Equity and Venture Capital Association (EVCA) welcomes the overall approach taken by the European Commission on the initial proposals to reform the rules governing state aid for innovation announced on 21 September 2005. These rules are to be included in the framework on state aid for R&D, the guidelines on risk capital, the environmental state aid guidelines and the block exemption regulations. *EVCA believes that this approach reflects better the reality of European businesses and that state aid will now be targeted towards small, innovative firms, which will encourage this sizeable section of the economy to develop their potential and which will contribute to improve the competitiveness of the European economy*.

The Commission has identified two innovation-related activities that state aid regulation could address:

A- *Supporting risk taking and experimentation*: The Commission has identified three areas which may be prone to market failures and where well-targeted aid may be necessary and efficient:

1. Supporting the creation and growth of innovative start-ups
2. Tackling the equity gap to increase risk capital in the EU
3. Technological experimentation and risks launching innovative products.

B- A supportive business environment for innovation:

1. Encouraging innovation intermediaries
2. Encouraging training and mobility
3. Supporting the development of poles of excellence through collaboration and clustering.

Supporting the creation and growth of innovative start-ups

EVCA is pleased to note that the diverse nature of SMEs has been reflected in this paper and particularly welcomes the concrete measure proposed to support the creation and growth of innovative start-ups through tax exemptions and subsidies as explained below.

To support the creation and growth of innovative start-ups and to help make Europe the most attractive market place for entrepreneurs and investors, for the

European Private Equity and Venture Capital Association
Minervastraat 4, B-1930 Zaventem, Belgium
Tel: + 32 2 715 00 20 Fax: + 32 2 749 95 15

last two years EVCA has been calling on EU governments to create a specific scheme for young innovative companies, which would provide them with tax exemptions and subsidies for a limited duration.

EVCA is glad to see that the Commission has integrated a definition of innovative start-up in this consultation document to determine the allocation of state aid for a limited duration to those companies. *Although EVCA acknowledges the widespread differences that exist between different sectors, it agrees on the specific criteria[1] given in the definition of innovative start-up included in this consultation document.* EVCA believes that this measure will allow Member States to encourage small, innovative firms to develop their potential provided that the state aid is limited in time (after such period the subsidised innovative company must face the competitive market and pass the reality test or die).

The state aid for innovative start-ups would take the form of exemption from social contributions and other local/regional taxes, and in addition, a possible aid of up to €1 million over three years, provided that this is not additional to any other State Aid and that the company receives the aid only once. That amount of €1 million is ten times the amount of the current De Minimis threshold. EVCA believes that the previous amount (€100,000) was insignificant for young companies with high growth potential and therefore *EVCA supports the raising of the De Minimis threshold.*

Another point which could be further explored by the Commission and which is not included in this communication, is how state aid can provide incentives to invest in stocks of young innovative companies. This would help those companies to gain access to further financing and to grow.

Tackling the equity gap to increase risk capital in the EU

The Commission considers making rules more flexible, notably for the very early project stages and for the development phase. As EVCA has stated in its public policy recommendations, public funds should only be invested where a tangible or imminent market gap in the private sector is evident. *EVCA believes that to address a potential early stage market failure, best results can be achieved when the public sector works in partnership with the private sector and creates incentives for funds to improve performance. This principle also applies for the development phase.* As EVCA has defended in previous position statements on this subject, the deployment of public funds should always be channelled through existing market-based operators, namely private equity and venture capital funds, using the skills of professional investors, and shaped with a clear market approach to yield the intended results. Only such an approach will guarantee that the financed companies are developed on the basis of a business strategy capable of competing in the open market.

Furthermore, the public contribution should be limited to less than 50% of the total funding. EVCA supports the current approach followed by the European Investment Fund (EIF), which is an example of an efficient framework.

---

[1] **Start-up criterion**: must have less than 5 years of existence; must be small companies, independent from large companies (more than 50 employees).
Innovativeness criterion: either the products are technologically innovative or R&D expenses represent a minimum (15%) of the beneficiary's overall expenditure.

European Private Equity and Venture Capital Association
Minervastraat 4, B-1930 Zaventem, Belgium
Tel: + 32 2 715 00 20 Fax: + 32 2 749 95 15

EVCA believes that the involvement of a significant amount of private capital in investment funds is only one manner in which it is possible to ensure that investment decisions are taken on a commercial basis.

It is necessary to ensure that within any Government intervention there is a sufficient degree of additional “incentive effect” to attract institutional investors.

Moreover, in order to help European SMEs grow beyond the start-up phase, and as another type of state support apart from those currently granted in respect of risk capital, _EVCA recommends the European Commission to examine the case for arrangements like the US Small Company Set Aside Scheme._

Technological experimentation and risks launching innovative products

Until the current R&D framework, it was not possible to grant state aid beyond the first prototype. The Commission proposes to include a series of activities qualifying for R&D state aid which would belong to the experimental development stage of a product.

EVCA agrees that these activities can be prone to market failure and that state aid could stimulate companies to launch more innovative products in the market.

Regarding the question whether these provisions should be extended to larger companies, although EVCA acknowledges that the basic rationale for state aid for R&D and innovation is exactly the same for large companies as for SMEs, _EVCA does not find any evidence to allow state aid for activities related to experimentation and commercialisation granted to larger firms_, for which such aid would generally be seen as a welcome contribution to the reduction of program cost rather than make something possible which otherwise would not be started by lack of funding.

Encouraging innovation intermediaries

Innovation intermediaries provide infrastructure and services to those undertakings involved in innovative activities. The Commission proposes to authorise State aid to these intermediaries when they carry out activities which are not market-oriented and which do not create any selective advantage for the benefit of individual undertakings.

EVCA has concerns regarding the necessity to provide a 100% state aid for innovation intermediaries who carry out those activities, to stimulate the private sector to enter the market and believes that it will be very difficult to distinguish between those services that are not market-oriented and in the public interest, and those that are not.

Encouraging training and mobility

EVCA recognises that promoting training for and developing the research capacities of small firms is crucial for the overall development of the European economy. In this regard, _EVCA particularly welcomes the proposal to provide subsidies for SMEs to recruit highly qualified researchers and engineers, and to benefit from exchanges of personnel with universities and large companies_. These measures encourage the hiring of specialist personnel and researchers, and help gaining access to the knowledge and expertise of individual researchers. In this

European Private Equity and Venture Capital Association
Minervastraat 4, B-1930 Zaventem, Belgium
Tel: + 32 2 715 00 20 Fax: + 32 2 749 95 15

way, R&D activities carried out in a university or in a public research centre will be transferred to companies and will lead to innovation projects. This measure would mean an improvement in the current environment which often encourages researchers at universities to stay at the university and strongly discourages them to move to a company. The “temporality” possibility introduced by this measure is a strong incentive for risk-averse research groups to test and contribute to a company’s life.

Supporting the development of poles of excellence through collaboration and clustering

EVCA believes that it is important that knowledge and research are transformed into new products, procedures and services. Therefore, EVCA supports state aid flexibility for the generation of innovative ideas in public sector research bodies and universities and clear, simple and generous rules governing attempts to transfer such ideas and expertise to businesses and to generate further innovation through public/private collaboration. Particularly where Member States seek to encourage universities and entrepreneurs to commercialise technology and to start up and develop small, technology-based companies, the risk to competitive markets is very small and the benefit to the EU knowledge economy base is potentially great. The State aid rules must not delay innovative projects which carry little risk to competitive markets.

The Communication underlines the geographical dimension of innovation, notably through the role of innovative clusters. EVCA believes that the existence and the development of business clusters and networks with specific competences create positive spill-over effects for innovation, especially for smaller enterprises. Therefore, *EVCA supports the idea that state aid could be used to build up or strengthen regional clusters and to create European poles of excellence.* EVCA believes that the development of such clusters and networks has to be managed by regional institutions and publicly supported by related training facilities. As long as such networks are open, they will create minimal distortions of competition and yet may generate external benefits which are economically advantageous. Finance is important at the start, otherwise it is very unlikely that the cluster will ever get off the ground and be self-sustaining. But this should decrease as the cluster starts functioning. However*, EVCA strongly warns of the risk of misallocation of resources if regions would pretend to support the creation of clusters in all or in a large number of technology areas rather than concentrate on a few where they do have a strong knowledge or specific advantage.*

Finally, to determine the usefulness of public sector initiatives, it is essential to evaluate both the operations and the results. Therefore, EVCA recommends having yearly reports on the application of those policies to assess their effectiveness.

EVCA remains as ever committed to an ongoing dialogue with policy officials and interested stakeholders and can be contacted at the address below:

EVCA - European Private Equity & Venture Capital Association
Minervastraat 4
B-1930 Zaventem
Belgium
Tel: + 32 2 715 00 26
Fax: + 32 2 725 07 04
www.evca.com