The new community framework for state aid for research and development and innovation (1)

Thibaut KLEINER and Renate REPLINGER-HACH, Directorate-General for Competition, unit I-1

On 22/11/2006, the Commission has adopted a new Community framework for state aid for research and development and innovation. The new framework has been published in the Official Journal on 30/12/2006 (2) and has entered into force on 01/01/2007. This document modernises the 1996 R&D framework, introduces new possibilities for granting State aid to innovation and implements the refined economic approach outlined in the State Aid Action Plan. It requires better economic justification for State aid measures in order to be approved and introduces a detailed assessment to deal with large aid amounts. The new framework is a significant contribution from the Commission to the re-launched Lisbon Strategy and it offers an opportunity for Member States to better use their State budget to deliver growth and jobs in the Union.

A process of analysis and consultation

The Commission adopted a Community framework on State aid for research and development (R&D) already in 1996. With the State Aid Action Plan (SAAP) of June 2005, the Commission set out an ambitious roadmap for State aid reform, where it inter alia announced its intention to review the current State aid framework for Research and Development (R&D) and considered extending the scope of the framework to certain innovative activities, thereby creating a Framework for R&D and Innovation (R&D&I). Given the high expectations associated with the new R&D&I framework, its adoption, following a substantial process of analysis and consultation, represents a noticeable achievement for the SAAP.

Several activities preceded the adoption of the new framework: DG Competition conducted an analysis of its case practice on State aid for innovation, resulting in a staff paper, the Vademecum on Community rules on State aid for Innovation (3) of November 2004. In 2004, the Commission had also launched a study on the R&D State aid rules (4). In 2005, it conducted a study on innovation market failures and state aid (5) and developed some ideas on a series of innovation activities that could benefit from State aid. This resulted in September 2005 in the Commission adopting a Communication on State aid for Innovation (6). Stakeholder consultation on State aid for innovation, following the communication and following a conference organised by DG Competition, made it possible to integrate new measure in a draft new R&D&I framework. This draft itself was subject to extended consultation: two draft versions were submitted to public scrutiny in May and September 2006 and discussed with Member States twice. Besides, on a more political level, the European Parliament issued an opinion on the Communication on State aid for innovation, and the European Council referred several times in its conclusions to the new R&D&I framework. As a result, the text of the new framework has been improved throughout 2006 and has benefited from the insight of experts not only from national and regional governments, but also from industry.

The new framework illustrates how the Commission is implementing the refined economic approach introduced in the SAAP and already used for the new State Aid Risk Capital Guidelines (7) adopted in July 2006. Both texts form part of the Commission’s State aid package for the re-launched Lisbon Strategy. They also show that competition policy, one of the few areas where the Commission has exclusive competence, can be mobilised pro-actively towards the objectives of growth and jobs.

The new framework plays a prominent role in this Commission’s work programme. It corresponds to Action 6 in the ten priority actions to achieve a broad-based innovation strategy for the European

Union (9) and to Action 10a in the Community Lisbon programme (10). By adopting this new framework, the Commission demonstrates its commitment to supporting innovation, growth and jobs in the European Union.

A better use of State aid

European companies must invest more in R&D and Innovation if they are to strive in front of global competition. The most important way to stimulate innovation is by fostering effective competition. As recognized both in the Commission’s Communication to the Lahti informal European Council (9) and in the Aho report (10), effective competition and a fully-functioning single market are pre-requisites for more innovation. Innovation is a way for firms to differentiate their products, increase their appeal to customers and thereby survive competitive pressures. Preserving free and fair competition is therefore the single most important contribution to innovation policy.

By contrast, State aid can be abused to protect national players, keep inefficient firms afloat, distort competition and artificially maintain costly, fragmented markets. This creates disincentives for State aid beneficiaries and non-aided companies alike. What is more, State aid is not some sort of ‘magic wand’ to solve Europe’s innovation problems. It is only one complementary element in the much larger tool-box needed to spur R&D and innovation. State aid can not replace the structural reforms Europe badly needs — and it should certainly not delay them. This is why State aid control is necessary.

At the same time, there are situations where the market on its own fails to deliver an optimal outcome. Sometimes, private firms consider that their investments in R&D and Innovation will not bring them any profit, either because they cannot avoid that the results of their research will be appropriated by competitors, because of uncertainties about the success of their efforts or because of difficulties to coordinate with business partners. As a result, private firms will refrain from investing in R&D&I projects, which would however bring benefits to society. In such cases, State aid can help change the incentives of private firms and make them invest in R&D&I. State aid can contribute to generate more R&D&I if it addresses those well identified market failures which prevent markets from reaching optimal R&D&I levels, and if it is well designed to limit distortions to competition to the minimum.

The primary objective of this new framework is therefore essentially twofold:

- Help Member States invest more in R&D and Innovation and increase the share of aid for R&D&I as a percentage of total State aid budgets; and
- Use better economics to help Member States target State aid on the right projects, so that distortions of competition and trade are minimised and public spending efficiency maximised.

A refined economic approach

The new R&D&I framework is a concrete implementation of the refined economic approach laid down in the SAAP. More economic analysis should help Member States better design their State aid measures, taking due account of the risks for competition and trade, so that only valuable projects are aided.

The framework recalls the overall methodology, based on the ‘balancing test’ which outlines how the positive and negative effects of State aid are analysed. The balancing test specifies that State aid for R&D&I is only acceptable in so far as i) it addresses a well-defined market failure, ii) it is well targeted and iii) it does not distort competition too much so that it can be on balance compatible with the common market. The market failures hampering R&D&I are clearly identified, as are possible distortions of competition and trade that may be triggered by State aid.

The following market failures were considered relevant, on the basis of the existing economic literature, consultations and dedicated studies on state aid and innovation:

- Positive externalities: R&D&I activities generate new knowledge, which is beneficial to society because it can be used by many companies to invent or improve products and services. However, from the perspective of a single company, only the private benefits from investing in R&D&I are accounted for. As a result, R&D&I activities are sometimes not undertaken by private companies, because they consider the
resulting private benefits too limited, whereas the benefits for society, due to the knowledge spill-overs of R&D&I, could be important.

- Public goods: R&D&I activities generate new knowledge, which cannot always be protected (e.g. through patents). Private companies may thus refrain from investing in R&D&I because they are afraid that the results of their investments may be used by competitors and they consequently cannot generate any profit from their investments.

- Imperfect and asymmetric information: R&D&I activities are particularly risky and uncertain. This means that they are affected by imperfect and asymmetric information. As a result, too few human and financial resources may be invested in R&D&I projects, which would however be highly valuable for society.

- Coordination and network failures: R&D&I activities are often unsure and complex and it is not easy for private companies to work together, identify suitable partners and coordinate R&D&I projects. As a result of these coordination and network failures, R&D&I projects that could have been conducted in common between a group of firms are sometimes not undertaken at all, whereas society as a whole would have benefited.

As a result, permissible aid measures, eligible costs, aid intensities and other conditions are designed to address the identified market failures and ensure that such aid is compatible with the common market.

A flexible package offering more possibilities for Member States to support R&D&I

The new rules on Research, Development and Innovation contain a flexible package of measures which can be used by Member States to tailor their support to R&D&I according to their national preferences, needs and specificities. On the basis of economic analysis a series of measures are offered to Member States to grant aid, to help them direct more aid to R&D&I than currently the case and to better target their funds to measures that are on balance beneficial to the common interest.

The framework pays great attention to the needs of small and medium-sized enterprises, which are most affected by market failures. But it also offers many possibilities for large enterprises to receive support, when duly needed and justified. Consequently, the new framework in principle maintains high aid intensities for large enterprises, and even increases aid intensities for SMEs by comparison with the previous framework. A new category of experimental development is introduced, which substantially broadens the previous category of “precompetitive development” to include innovation activities. The bonus system is simplified, with increased incentives for collaboration. Due account is also taken of regional considerations when assessing the justification of State aid.

New measures on support for innovation are introduced. They include:

- aid for young innovative start-ups;
- aid to SMEs for innovation advisory and support services,
- aid for the loan of highly qualified personnel;
- aid for process and organisational innovation in services; and
- aid for innovation clusters.

Last but not least, the new framework provides more guidance as regards the question whether State aid is involved in an R&D&I project. Under the old framework, need for clarification existed in particular for public-private partnerships, universities and innovation intermediaries. Special efforts are now made to be more transparent and secure legal certainty for research organisations, to ensure they can perform non-economic and economic activities, subject to meeting clear and simple rules. All this should enhance the role of public research entities, and facilitate public-private collaboration.

An improved architecture of the rules

The framework relies on an improved architecture to help the Commission focus its scrutiny on the potentially most distortive cases. Whereas measures including high aid amounts are subject to a detailed assessment (and -as previously- the incentive effect of aid to large enterprises must be demonstrated), lower aid amounts, and aid for SMEs, are subject to a lighter assessment and may in the future benefit from the forthcoming General Block Exemption.

Thresholds are established to fix a ceiling above which large R&D-projects must be notified individually to the Commission, even if they come under an aid programme already approved by the Commission. Aid above the ceiling has a greater risk of distorting competition and trade, and will therefore be subject to a detailed assessment. The new framework has introduced differentiated thresholds of €20 million for projects that are predominantly for fundamental research, €10 million...
for projects that are predominantly for industrial research and €7.5 million for projects that are predominantly for experimental development. The Commission considers that such differentiated ceilings best reflect the underlying risks of distortions of competition. These risks depend primarily on the amount of aid a Member State wants to grant, but also on the question how far the research project is away from the market, since aid to a close-to-the-market experimental development project has a much greater potential for distortion than aid for fundamental research.

The new framework presents a series of criteria and explanation about how the Commission will undertake its detailed assessment. The focus of the analysis is on the concrete effects that the aid may have on the beneficiary’s behaviour, and on markets. Even though the central part of the analysis is on the ability of the aid to change the incentive of the company to conduct more R&D&I, the Commission will also assess more specifically whether the market actually fails to deliver on its own the expected outcome, whether the aid is properly designed and whether its impact on competition is not exaggerated. Risks are in particular that the aid leads competitors to the beneficiary to reduce their R&D&I efforts, or that the beneficiary increases of maintains market power.

Finally, to avoid circumvention of the State aid rules, ex-post monitoring is enhanced to allow effective Commission control. This means, in particular, that Member States will need to be transparent about the aid above €3 million they grant under approved schemes to individual companies, even though this aid does not have to be notified to the Commission. Annual reports will also have to provide basic information to allow the Commission, if needs be, to verify the correct application of the framework.

**Conclusion**

The new Community framework for State aid to R&D&I is a document, which not only promotes a better use of State aid but also establishes with a comprehensive methodology to assess State aid measures. It represents an important contribution to the State Aid Action Plan and offers an opportunity for Member States to use State aid wisely, in order to support growth and jobs.