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# The EU and Innovation

## When Business Meets Politics

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Innovation, entrepreneurship, growth and competitiveness go hand in hand. Yet, this association remains too theoretical in Europe. Innovation within the European Union remains underexploited, to say nothing of entrepreneurship. This short paper, which analyses the role of the EU on innovation and entrepreneurship, is part of a broader research on the European company. The objective is to briefly look at two areas where the EU plays a role to help drive innovation: regulation and financing. These two areas are very often cited as key to helping innovation and entrepreneurship.

### Innovation as a political objective

Innovation can be a powerful driver for growth. The OECD identifies four types of innovation:[1]

- Product innovation, which implies a new or significantly improved good or service.
- Process innovation, which refers to a new or significantly improved production or delivery method
- Marketing innovation, which deals with new or significantly improved changes in product design and packaging, or the pricing of goods and services for instance.
- Organisation innovation, which involves changes in business practices or workplace organisation for instance.

Innovation can only occur if the adequate balance is achieved between the right incentives in place and entrepreneurs willing and able to create and/or seize the momentum. Incentives often take the form of financial assistance and a regulatory environment conducive to innovation. To be successful, it is, however, essential that innovation and entrepreneurship are embedded in the society.

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The European Union can play a significant role to foster innovation through the internal market. Its objective is to build a "highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment" (article 3.3 of the Treaty of the EU). Innovation is key to achieving this goal and to leading to greater productivity and competitiveness.

This imperative is ever more pressing as the EU faces two momentous challenges. First, the economic crisis has been impairing the already tarnished EU image. As long as unemployment remains high and growth sluggish in many Member States, citizens are unlikely to have a more positive view of the EU. Successful innovation with its positive consequences may not entirely reverse the trend of unpopularity towards the EU, but it would surely help. Second, European countries face greater global competition from usual places, such as the United States, but increasingly from Asia as well. This is a long-term trend, which is critical to factor in.

These two challenges question the role of the European Union. Since 2008, it has launched many policies to address deficiencies within the Eurozone, to decrease youth unemployment, or to provide funding to investment projects, with the creation of the European Fund for Strategic Investments (EFSI). Other policies are expected to bolster growth, and intrinsically innovation, such as the launching of a Capital Markets Union.

Innovation is therefore a primary political objective for the Union. It can both help restore a more positive view in the eyes of the citizens and eliminate the risks of seeing the EU turning into a no-innovation's land.

However, all stakeholders are links to the chain. National authorities can favour innovation, especially when it comes to funding, regulation and education. But companies and entrepreneurs, themselves, are essential to the success of the whole enterprise. It is indeed not enough for public authorities to provide a springboard for innovation. The momentum has to be seized and sustained.

## Regulation and innovation

Regulation is ambivalent with respect to innovation, since it can both facilitate and hamper it. Moreover, its impact over innovation can only be analysed on a case-by-case basis.[2]

Without delving into the definition of regulation, three dimensions help understand how it can affect innovation. First, it matters how flexible the path is to comply with the regulation. The more restrictive it is, the more it can play out negatively on innovation. Second, regulation can provide more information on the functioning of the market – the more the better to avoid information asymmetry. Lastly, stringency governs how much regulation imposes a compliance burden on a firm.[3]

Regulation can act as a barrier to innovation in four cases: when it is ineffective or incomprehensive; when it is too rigid; when it lags behind innovation cycles; or when it requires complex and expansive market approval procedures.[4]

However, regulation can also provide favourable conditions for innovation when it lays the ground for certainty and stability. It can also facilitate cross-border trade. The establishment of the passport in financial services has been instrumental to the development of the so-called "fintech" for instance.[5]

The importance of an adequate regulatory framework cannot be understated, since the European project is intimately linked with the internal market. Regulation lies at the core of its success and the European Commission is prompt to initiate legislative proposals to correct market or regulatory failures, to promote long-term goals or to promote fairness between the actors involved.

However, tension can run high between market players and the European legislators. Companies often prefer a light-touch regulation, whereas legislators may seek a more comprehensive agenda, often to take into account social and environmental elements.

The main difficulty for regulation at the EU level is to balance possibly contradictory objectives: ensure the good functioning of the internal market, guarantee top-notch social and environmental standards, promote an innovation-friendly environment for companies and implement long-term objectives, such as the completion of the internal market. It is fundamentally a political question. The Commission seems to have now opted for a lighter footprint in prescriptive regulation as the "Better Regulation" agenda illustrates, especially for SMEs, but this raises concerns that this trend could lead to a decrease of high social and environmental standards.

Innovation is just one element in the policy decisions to adopt new legislation or review existing acts. In order to put a premium on innovation, calls for an "innovation principle" within the regulatory decision-making process have been gathering momentum. This principle should in particular be incorporated in the Commission's impact assessment. This cannot be a definitive exercise as it is difficult to gauge ex ante the impact of a future legislation, but it raises awareness on the centrality of innovation. Other ideas have been proposed, such as the "innovation deals".[6]

This renewed focus on innovation in EU regulation is certainly helpful to steer directives, regulations and decisions in the right direction. This is unlikely to be enough, especially since innovation cannot be the sole guiding principle for the European Commission. Moreover, the initial version of any legislative act greatly evolves before it is finally adopted, possibly undermining elements conducive to innovation present at the outset.

## Financing and innovation

Funding ranks high in the list of concerns for start-ups and SMEs. The EU is keenly aware of this and has strived to address this issue. As part of its innovation policy, the EU deploys three mechanisms to help companies: financial support, state aid exceptions, and public procurement.[7] Financial support occurs in various forms, including framework programmes, such as Horizon 2020, EU programme for the Competitiveness of Enterprises and SMEs (COSME) or the EFSI. These support mechanisms can be either grants, loans or calls for projects or tenders.

State aid is also an important tool. The European Commission scrupulously monitors state aid to avoid any distortion of the internal market. However, it can make exceptions if it is aimed at supporting research and innovation.[8]

Finally, public procurement is considered a useful tool to support the demand for innovation. The EU provides a harmonised framework, which creates a level playing field for market actors, and has portrayed itself as a strong advocate for public procurement to promote innovative solutions, not just to rely on existing ones. In the revised EU directive on public procurement adopted in 2014, several elements focus on innovation, such as the pre-commercial procurement and public procurement of innovation solutions. Nonetheless, the EU's room for manoeuver is relatively limited in this area, since public procurement is mostly conducted by national, regional and local authorities.

The EU has also attempted to shape up the venture capital (VC) environment in Europe. VC investment remains marginal in Europe compared to the United States. It reached USD 4.2 billion in Europe in 2015, paling in comparison with the USD 59.7 billion invested in the US.[9] It goes beyond the scope of this article to address the reasons for this great gap, but in order to facilitate cross-border financing, the EU launched the European Venture Capital Funds (EUVeCA) label in 2013. It creates an EU-wide passport for VC managers to market their funds across the EU with a single set of requirements and harmonised rules. The objective is to bypass the myriad of different national legislations in the matter. However, facing a number of constraints, the regulation was updated last July, especially to broaden the eligibility criteria to adopt this label.[10] It has yet to be approved by the co-legislators.

Perhaps the greatest political challenge for the EU lies in the establishment of the Capital Markets Union (CMU). The CMU aims to create a legislative environment conducive for European companies to tap into the potential of capital markets. The economic crisis has highlighted European business' dependence on banks, which has proven detrimental. The banking sector has indeed been severely hit by the financial crisis and banks have consequently reduced risk-taking activities, such as credit lending, and have also had to adapt to new legislations, such as a significant increase of their capital requirements.

The CMU should not be seen as the absolute fix or the short-term solution to a financing shortage in Europe.[11] Yet, it could spread risk-taking in Europe and bolster alternative funding schemes beneficial to businesses and innovation. According to preliminary results from a survey conducted for this research (see figure 1), the development of a CMU is seen favourably by most companies (55.5 per cent).

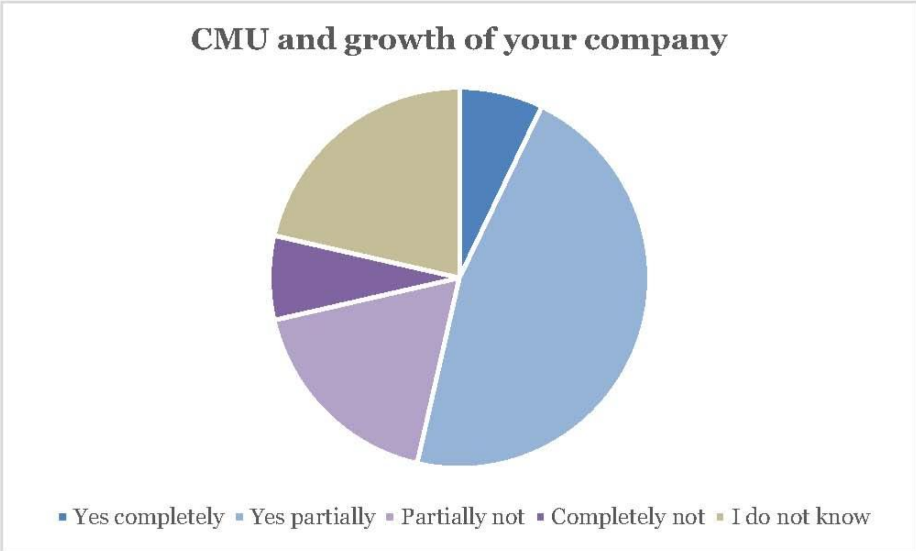


*Figure 1 – Answer to the question: "Do you consider that the development of the European Capitals Market Union would benefit the growth of your company?" (source: Ifri, preliminary results).*

Additionally, the creation of the CMU, perceived as offering a more diverse access to capital, can fuel entrepreneurship across the EU (figure 2). It is important to note however that the CMU is not yet a very well-known policy project. For both questions, more than 20 per cent of the respondents each time do not know how to answer.[12]

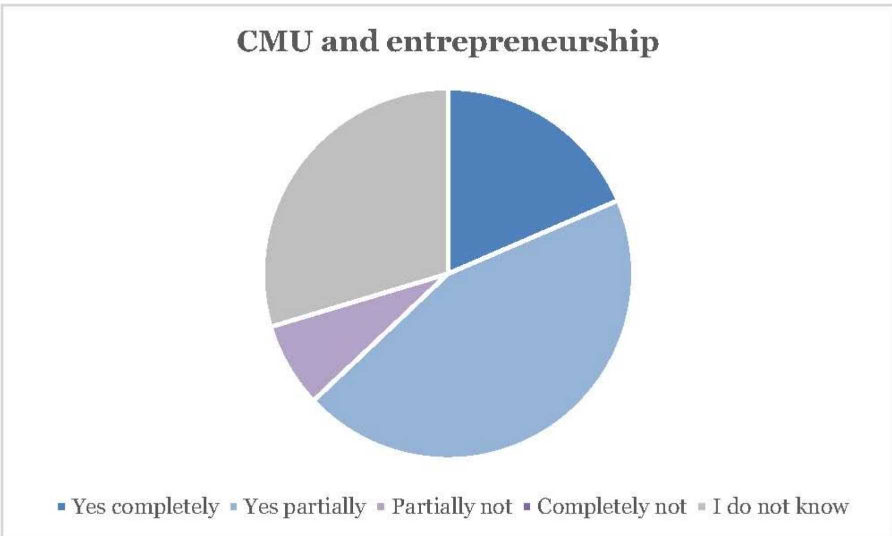


*Figure 2 – Answer to the question: "Do you consider that the development of the European Capitals Market Union could fuel entrepreneurship in the EU with a more diverse access to capital?" (Ifri, preliminary results)*

Access to funding will remain a concern for innovation, but other concerns are important to keep in mind. There has been a proliferation of funding instruments (loans, grants, guarantee schemes etc.) in the past few years to address supply-side issues. Similarly, many initiatives have aimed to limit the administrative burden over SMEs and start-ups. But this has often come at the expense of demand-side interventions, such as human capital development for instance.[13] The EU has not been immune to this phenomenon.

This leads to a second concern. While the rise of funding mechanisms for early seed financing is a welcome development, Europe is still lagging behind when it comes to developing a sustainable "scale up" model. Too many start-ups in Europe simply do not grow enough.

## Scaling up support for the EU

Funding is only part of the reason why in Europe too few start-ups scale up and SMEs grow. It has a lot to do with broader issues, such as the completion of the internal market and education policies (to drive an entrepreneurial spirit in the society and to train a solid pool of talents).

None of these two policy domains are unlikely to experience radical sudden changes. Leaving aside education policies, which are national competences, the future of the internal market is a strategic objective for the European Union, since it can drive growth, innovation, and most importantly job creation. This virtuous cycle is of imperious importance today with the rise of euroscepticism in many countries. Preliminary results of our survey show that many companies are concerned by some form disintegration in the future, which would likely impact their capacity to do business.

At a time of strategic juncture for the EU, businesses have a role to play if they consider, and many do, that the European project is essential to their growth. After the creation of the internal market in the 1980s, many companies increasingly disengaged from European debates to invest intellectual capital in other regions or to focus more narrowly on sectoral policies.

However, it is no longer a given that the completion of the internal market will actually occur or that an ambitious and far-reaching project like the CMU will live up to the expectations. Resistance rarely comes from Brussels. The business community is anchored at all levels of the society and cannot disregard the political challenges the EU is facing today. It can play a role in changing perceptions among the population. Scaling up the support for policies, such as the internal market or the single currency, as tools to boost growth, ease innovation, and encourage job creation is not a political stand, it is a business case. Europe remains the foundations for the vast majority of companies which trade across borders. A weakening EU does not serve the economic interest of these companies.

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1. OECD, *Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data*, 2005, http://www.oecd.org/.

2. J. Pelkmans and A. Renda, "Does EU Regulation Hinder or Stimulate Innovation?", *CEPS Special Report*, No. 96, November 2014.

3. L. A. Stewart, "The Impact of Regulation on Innovation in the United States: A Cross-Industry Literature Review", Paper commissioned by the Institute of Medicine Committee on Patient Safety and Health IT, June 2010, http://www.itif.org/.

4. European Political Strategy Centre, "Towards an Innovation Principle Endorsed by Better Regulation", *EPSC Strategic Notes*, Issue 14, 30 June 2016, p. 4-5, https://ec.europa.eu/epsc/.

5. For an endorsement of the regulation in this sector, see for instance D. Guermonprez, "Nous devons tout à l'Europe", *Revue Banque*, No. 799, 30 August 2016, http://www.revue-banque.fr/.

6. See for instance European Commission, "Better regulations for innovative-driven investment at the EU level", Commission Staff Working Document, p. 12, https://ec.europa.eu/research/.

7. For a detailed list, see V. Reillon, "EU Innovation Policy – Part II: EU Policies and Instruments Supporting Innovation", *EPRS In-Depth Analysis*, May 2016, p. 14-20.

8. European Commission, Regulation No. 651/2014 declaring certain categories of aid compatible with the internal market, 17 June 2014, http://eur-lex.europa.eu/.

9. OECD, *Entrepreneurship at a Glance 2016*, Paris, OECD Publishing.

10. European Commission, "Capital Markets Union: New Rules to Support Investment in Venture Capital and Social Enterprises", 14 July 2016, http://europa.eu/.

11. N. Véron and G. B. Wolff, "Capital Markets Union: A Vision for the Long Term", *Bruegel Policy Contribution*, April 2015, http://bruegel.org/.

12. These figures do not mean that all those who reply "I do not know" are unaware of the CMU. They may not have a definitive opinion or may be unsure at this stage of its potential.

13. Karen Wilson and Filipe Silva, "Policies for Seed and Early Stage Finance: Findings from the 2012 OECD Financing Questionnaire", *OECD Science, Technology and Industry Policy Papers*, No. 9.