until at least the end of 2011.[12] The *Wirtschaftsfonds* industry fund has helped reduce pressures from demand for loans, during the recession – in spite of a considerable decrease in new lending business. It thus has played an important role in assuring financing for business enterprises, which of course is indispensable for continuation of research and innovation. In September 2010, the KfW Bank Group found that the situation in the German credit market had eased considerably.[13] Nonetheless, small and medium-sized enterprises (SMEs) that lack first-class credit ratings continue to face problems in obtaining loans from commercial banks.[14] Such difficulties affect innovation projects, as the capital goods required for such projects are often financed via loans.

What is more, the availability of equity plays a key role in financing of research and innovation activities in companies.[15] Banks and savings banks are already taking measures designed to assist SMEs in closing gaps in their financing, with a view to ensuring that SMEs are able to exploit the recovery. Initially, companies showed hesitancy in drawing on funding from equity funds that were made available. Relevant demand developed positively through the end of 2010, however.[16]

Support R&D in companies via tax-based incentives

As the Expert Commission has repeatedly emphasised in the past, introduction of tax-based R&D support would provide important incentives for expansion of R&D in business enterprises. The tax-based R&D support announced by the governing coalition has not yet actually been implemented, however. This is unfortunate, and it is hindering the development of the German innovation system. Necessary cutbacks must not be permitted to have impacts on research and innovation, which would reduce potential for future growth. German tax policy also runs counter to innovation in a further respect. The current limitation on tax deductibility of losses in connection with share transfers amounting to more than 25 percent (Art. 8c Corporation Tax Act (KStG)) urgently needs to be eliminated. In particular, it tends to hinder initial financing of young, innovative companies by venture-capital providers. Venture-capital providers provide capital for start-ups, often for limited periods of time, oriented to companies' establishment and initial-growth phases. Losses incurred by companies in such development phases cannot be deducted from later profits if the relevant venture-capital providers later sell their pertinent shares. That, in turn, tends to hinder the establishment and development of new companies, especially in capital-intensive sectors of cutting-edge technologies. Most other European countries do not impose such limitations.

Young biotechnology companies tend to be especially strongly affected by limitations on use of losses carried forward, since such companies tend to incur high initial losses. While research and innovation policy seeks to promote the establishment and growth of such companies, the tax system tends to hinder such development systematically. As this clearly indicates, tax policy is always also innovation policy.

VENTURE-CAPITAL MARKET A 2

Provide incentives for use of venture capital

Germany's economic recovery in 2010 has also made itself apparent in the venture-capital market. In 2010, after a period in which the investment volume in this area had declined enormously as a result of the financial crisis, investments of capital investment companies began growing again.[17]

At the same time, the current figures for this area should not blind us to the fact that the German venture-capital market, notwithstanding its current recovery, has low rates of investment in light of relevant international rates. The German risk-capital market continues to be plagued by a structural problem. In 2009, for example, venture-capital investments in Sweden amounted to 0.07 percent of that country's gross domestic product, while such investments in the UK reached 0.05 percent of GDP. The corresponding figure for Germany was just less than 0.03 percent.[18] Another problem, apart from such low investments by international standards, is that Germany's market for early-phase venture-capital financing is clearly underdeveloped. That conclusion is supported by a recent study. As the study shows, in early phases of business enterprises, private investments are decreasing, in relative terms, in comparison to funding under public-sector financing programmes.[19] This lasting underdevelopment of the venture-capital market is problematic especially in that young innovative companies are often able to gain a market foothold only if they receive venture capital from private investors in their start-up and development phases. And “big money” rarely is the issue. For years, available funding in the area of small investment amounts has fallen far short of demand.[20] That conclusion is supported by information from market participants who have been calling attention to the lack of financing partners for young companies.[21]

Comparative studies have repeatedly confirmed that tax incentives play the most effective role in helping to mobilise venture capital for young companies. A number of countries, including the UK, France and the U.S., have much more extensive systems of tax-based support than Germany does, and their systems are oriented both to increasing relevant investments and to guiding investments’ long-term orientation.[22] It is scientifically substantiated that venture capital, especially in the form of early-phase financing, can contribute significantly to economic growth.[23] The Expert Commission has repeatedly called for creation of incentives for provision of venture capital, and such creation is thus overdue.

Weaken the impacts of the AIFM Directive

In November 2010, the European Parliament addressed the financial crisis by issuing a directive focused not directly on regulation of funds, but on control of managers of alternative investment funds (Alternative Investment Fund Manager [AIFM] Directive).[24] Examples of the managers aimed at by the legislation include managers of hedge funds, of buyout funds and of venture-capital funds.[25] The AIFM Directive is designed primarily to limit the systemic risks involved in the actions of various financial-market players. It imposes extensive constraints on managers who manage alternative investment funds within the European Union, even in cases in which the funds in question are based in third countries. The directive applies to managers of funds with cumulative assets of more than EUR 500 million.[26]

It does indeed make sense to tighten regulation of alternative investment funds. At the same time, the oft-cited reason for such tightening, namely the need to contain systemic risks, cannot apply to buyout and venture-capital funds. Those two categories of funds present no systemic risks. Nonetheless, managers of such funds can fall within the scope of the directive. Enforcement of the directive can thus be expected to have negative impacts on venture capital companies.

If such impacts occurred, companies financed by funds affected by the directive would be at a special disadvantage as a result of special disclosure provisions. In cases in which a fund had a controlling majority (more than 50 percent of voting rights) of such a company, for example, the company would have to disclose sensitive information concerning its business operations. In general, no detailed disclosure obligations should be imposed on the basis of shareholding structures, i.e. such obligations should also not be imposed on companies financed via venture capital.

What is more, the negative impacts of the AIFM Directive’s disclosure provisions are probably not limited to young companies. They could also well apply to family-owned companies, which often have reservations with regard to private equity as it is. As a result, in their choices for growth-oriented financing, family-owned companies may begin relying on private equity financing even less frequently than they now do. A reduction of options for growth-oriented financing is significant, since such financing plays a key role in development of innovative business ideas.

The administrative costs that companies incur in implementing the directive’s provisions are another problematic aspect of the directive. For example, the AIFM Directive requires venture capital funds that fall within its scope to have independent assessments of their assets carried out annually. Such assessments entail extensive organisational overhead. Their usefulness, on the other hand, is not apparent. The provision does enhance security in the area of hedge funds that undergo market valuation. Venture capital funds tend to hold their shares for years, however; they generate capital yields only when they sell their stakes.[27] Interim assessments of such funds thus have no key significance and this also applies to such assessments’ relevance for fund managers’ compensation, which is oriented to yields.

As a result of the high fixed costs incurred in implementation of the AIFM Directive, funds could find it necessary to maintain higher investment volumes in future. And the need for such increases, in turn, could force funds to focus their investments more on larger companies. Funds with large numbers of small investments would have even greater administrative overhead. Consequently, companies would find it even more difficult to attract smaller investments. Ultimately, such developments could worsen the shortage of financing in this area.[28]

Furthermore, restriction of institutional investors to investments in European-regulated venture capital funds, as is currently planned, would increase risks for investors, since such restriction would hamper regional diversification. In all likelihood, investments would tend to concentrate largely on European funds.

The Expert Commission also maintains that venture capital investors based outside of the EU would then become reticent to invest in European companies. To be able to invest in Europe, fund managers from third countries have to apply for an EU passport, and thus they have to fulfill the same provisions that European fund managers have to fulfill. In particular, such a trend would tend to close access to the expertise that capital providers – especially venture-capital providers from the U.S. – often also provide.

The venture capital market for early-phase financing is likely to shrink as a result of implementation of the AIFM Directive. And yet German start-up entrepreneurs need more venture capital, not less. At the same time, the European provisions in this area are an opportunity, as well as a challenge, for German policymakers. In implementation of the directive, by no means should any attempt be made to make use of the option for expanding the directive's scope to include smaller funds that manage less than EUR 500 million in assets.[29] Instead, AIFM implementation should be taken as an opportunity, finally, to draft legislation for an internationally competitive, growth-promoting framework for venture-capital providers and business angels.

EDUCATION AND RESEARCH A 3

The Federal Government boosts financing for education and research

The 2011 federal budget earmarks more than EUR 11 billion for the BMBF. That figure is 7.2 percent higher that last year's allocation. And it will benefit the three central Federal-*Länder* programmes. The Higher Education Pact, the Initiative for Excellence and the Pact for Research and Innovation will all be continued and expanded.[30]

In 2011, the Higher Education Pact will enter a second project phase. The *Länder* are to be enabled to accept additional numbers of new students (pillar 1). Along with the increase originally planned, the measure now, following the discontinuation of conscription for the military and alternative civilian services, includes funding for an additional 35,000 to 59,000 new students through 2015.[31] The second pillar of the Higher Education Pact comprises federally funded overhead payments, amounting to 20 percent of the relevant project volume, for research projects, at higher education and research institutions, receiving grants from the *Deutsche Forschungsgemeinschaft* (German Research Foundation).[32] Through 2015, the Federal Government is providing over EUR 5 billion for those two measures. The Quality Pact on Teaching (*Qualitätspakt Lehre*) is the new, third pillar of the Higher Education Pact. The Federal Government plans to invest some 2 billion euros in it through 2020.

Cutting-edge research is being funded in the framework of the *Initiative for Excellence II*. From 2012 to 2017, it will provide support to universities amounting to a total of 2.7 billion euros.

Financing of the country's five non-university science and research organisations[33] is managed via the Pact for Research and Innovation. From 2011 to 2015, funding in that framework will be increased by 5 percent, for an expected total volume of some 4.9 billion euros.[34]

The Expert Commission welcomes the clear commitment to education and research seen in these measures. At the same time, it notes that the Federal Government's own goal of having the country's