

## Moving Beyond State Aid: How Can Public Policy Better Support SME Financing?

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### Executive Summary

- > Across the EU, state aid granted to SMEs has declined since 2009. Simultaneously, SMEs have adjusted their financing behaviour and reduced their use of state aid instruments.
- > To substitute for the decreased state financing, SMEs have made more use of financing by banks and trade financing. This reinforced the predominant reliance on bank loans.
- > Market financing continues to play a minor role for SME financing. A genuine Capital Markets Union could help SMEs diversify their funding sources.
- > An effective EU public policy in support of SME financing should adopt a more risk-based approach and focus on removing structural barriers to investment.

In recent years, Small and Medium-sized Enterprises (SMEs) have increasingly become the object of attention of European policy-makers. This is not only due to the fact that SMEs are often referred to as the growth engine of Europe and constitute the main source of jobs. There are also political considerations motivating the focus on SMEs. Supporting small firms with – in many cases – strong local and regional identities is likely to be more popular with voters than endorsing big multinational corporations. Following this economic and political rationale, public funding of SMEs can indeed be considered as a desirable policy option. However, the sovereign debt crisis in the Eurozone has strained public budgets and led to cuts in state aid to SMEs. How have SMEs compensated the decline of state financing? What alternatives forms of support do policy-makers have in their tool-box, given tight public budgets?

Public funding of SMEs comes from both national and European coffers. At the European level, there are various programmes under which SMEs are financially supported. Funding comes in virtually all forms of financial instruments, including grants, loans, guarantees, and equity. Next to a variety of EU programmes, national authorities also offer funding possibilities for SMEs, subject to EU state aid rules. The expectation is that more state aid given to SMEs should increase the demand for state-subsidised financing by SMEs. Ideally, SMEs would take up all of the state aid available to them. Therefore, policy-makers could expect that the higher the amount of state aid they offer, the more SMEs should make use of that financing instrument.

However, the supply and demand relationship is more complex in this case: SMEs form the demand side of the market for capital, while the state is only one of many actors on the supply side. The main sources of capital available to SMEs in the Eurozone include funding from banks, trade financing, market-based financing and internal financing. The fluctuations in demand for these different financing alternatives seem to reflect the general economic trends across the member states, especially during and after the crisis.

In the post-sovereign debt crisis Eurozone, national budgets have been subject to austerity measures, leading to a decline in state aid for SMEs over time. In this Policy Brief, we look at the developments in the demand for different sources of financing. In particular, we analyse the extent to which decline in available state aid and demand for public money have been compensated by other financing sources. We argue that given their tight budgets, policy-makers across member states might look to move away from state aid and support other forms of SME financing instead.

## The EU's regulatory framework on state aid

Different forms of SME financing by member states fall under the EU rules on state aid. Loan guarantees are subject to the Notice on state aid in the form of guarantees, which allows for simplified procedures for SMEs and defines safe-harbour premiums (considered free of aid), a 3.8 per cent premium for start-ups, and across-the-board premiums for all borrowers participating in schemes guaranteeing up to 2.5 million EUR per company. The Notice applies when the guarantee implies a transfer of risk and requires it to be linked to a specific transaction. In general, the guarantee may not exceed 80 per cent of the underlying loan.

Aid is also possible in the form of risk finance, exempted up to 15 million EUR per target SME. This form of aid is designed to address the funding gap of SMEs and should support venture capital funds and investment in high-growth companies. The EU guidelines provide for a wide range of instruments, including equity, quasi-equity, loans and guarantees, and require a minimum of private funding between 10 per cent and 60 per cent of the investment, depending on the risk involved and age of the SME. Risk finance may also support alternative trading platforms and provide tax incentives for investors, creating more favourable financing conditions for SMEs across the EU.

Importantly, not all measures available to member states to support SMEs constitute state aid. The so-called "general support measures", including reduced labour taxation, lower social costs, investment in education and training, guidance and counselling, and improvements in labour law, as well as facilitating SMEs' cash-flow through the Small Business Act are not considered state aid. Some instruments designed by public administrations to provide aid also do not qualify as state aid. Grants of up to 200 000 EUR of aid per company over three fiscal years fall under the *de minimis* rule, having negligible impact on competition and trade in the EU single market. Moreover, some subsidized loans below 1 million EUR can also be considered *de minimis* aid.

While the rules on state aid are rather generous for supporting SMEs, many channels for funding from the EU exist. Loans, guarantees, equity, and grants are available from the European Structural and Investment Funds (ESIFs) to improve competitiveness of European businesses. The COSME (Competitiveness of Enterprises and Small and Medium-sized Enterprises) programme aims at facilitating access to financing for SMEs, to help firms access markets, to support entrepreneurs and improve business conditions through guarantees, loans and equity capital. Research and innovation funding instruments are also available in the framework of Horizon

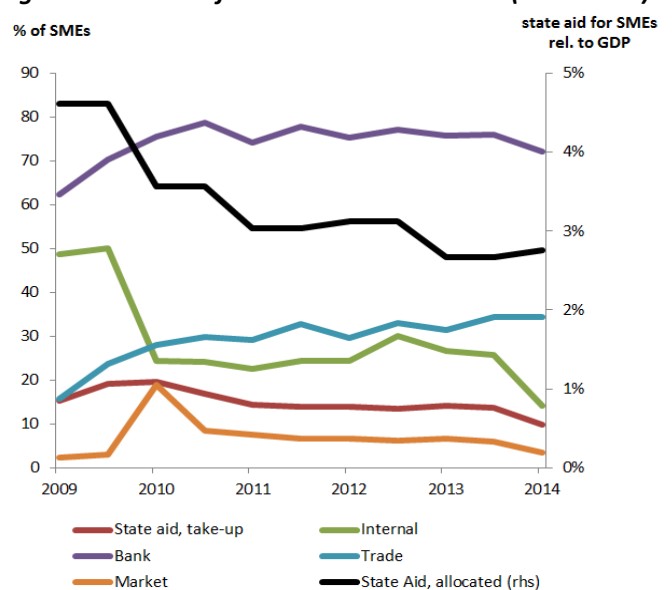
2020. Microloans for micro firms and funds for investment in social enterprises come from the budget of the Employment and Social Innovation (EaSI) programme. Finally, the European Investment Bank (EIB) as well as the European Investment Fund (EIF) co-fund projects aimed at product innovation and partnership creation as well as provide expertise in the field of investment. Such an array of funding possibilities reflects the strong political desire in the EU to support SMEs through public measures.

Apart from financing instruments, the EU is also active in creating a business-friendly environment for SMEs through softer means. This is done, for example, via the Small Business Act for Europe or the Entrepreneurship Action Plan, both aimed at promoting SME activity through sharing of best practices and education. The EU also supports the building of networks and information centres for SMEs, such as Your Europe Business Portal or Enterprise Europe Network. While some soft measures are in place, the main focus of policy-makers seem to still lie with financial instruments.

## State aid versus other financing instruments

As depicted in Figure 1, state aid to SMEs in the Eurozone has decreased steadily between 2009 and 2014 from 4.6 per cent to less than 3 per cent of GDP. On the one hand, this is a consequence of the sovereign debt crisis, which led many member states to reduce deficits and stop the increase of public debt. On the other hand, the cuts in state aid allocated to SMEs might stem from the fact that there are other possibilities for the public sector to provide financing to SMEs.

**Figure 1: State aid for SMEs in the Eurozone (2009-2014)**



Source: ECB SAFE Survey, own calculations.

As argued above, some aid given by member states to SMEs is not considered state aid under certain conditions. Moreover, parts of public funding of SMEs come from the EU level and are thus not included in the indicator used for this analysis.

As a consequence of the reduction in allocated funds to SMEs, the take-up of state-supported funding by SMEs adjusted over time to lower levels. The indicator for the take-up of state-sponsored funding, as well as the indicators for the use of other financing sources, was developed by the European Central Bank (ECB). The SAFE survey *inter alia* asks SMEs in the euro area about their use of financing instruments within the past six months on a quarterly basis. The indicator therefore gives the share of SMEs that made use of a particular financing source in the recent past. Accordingly, the share of SMEs making use of state-subsidised grants or loans declined gradually between 2009 and 2014 from a peak of 20per cent to 10per cent. All things remaining equal, this means that SMEs' use of state aid declined. This finding is in stark contrast to our initial expectation that increased supply of state aid would lead SMEs to increasingly use this tool.

Relying less on the state for financing purposes, SMEs had to substitute this form of financing with others. While internal funding became less common, financing by banks and trade financing substituted state-sponsored funding. Using internal funds for financing investments requires first of all that enough profits are made. This proved difficult during the height of the crisis. Thus, SMEs were faced with a decline in both state-sponsored and internal financing. The data shows that since the crisis SMEs have made more use of bank and trade financing instead. The share of SMEs making use of bank financing increased from 60per cent to more than 70per cent, reaching almost 80per cent in 2010 and 2011. Prevalence of trade increased from 16per cent to 24per cent over the sample period. While bank financing was the dominant source already before the crisis, its importance increased as it was relatively easy for SMEs to rely on the established relations with their bank, e.g., making use of credit lines or overdrafts. The increase in trade financing follows a similar logic. It is relatively easy to use trade financing tools and, second of all, trade financing is most often intermediated through banks. Somewhat ironically, the importance of banks therefore was fostered in times when they were struggling to keep themselves out of market turmoil.

Market financing continues to play a minor role for the financing of SMEs with a prevalence of 5per cent to 10per cent, although there was a sharp temporary increase of market-based financing instruments around 2010, when both state and internal funding sources became scarcer. While there is, since 2009, quite a high degree of

homogeneity with respect to the data on the use of financing sources across the euro area countries, the sharp increase of market financing only applied to Austria, Germany and Greece. Quite quickly, however, the share of SMEs making use of market-based financing reverted to a level close to pre-crisis. Therefore, market-based financing still plays a minor role.

Altogether, the crisis has reinforced the dominance of bank-based funding as intermediated financing compensated for a reduction in state-sponsored financing. More SMEs have either taken up new bank loans, extended their existing credit lines or made use of trade financing. The latter is often facilitated through banks. Therefore, the initiative towards a genuine Capital Markets Union (CMU) makes sense as it aims at diversifying funding sources available for SMEs.

### How can public policy improve SME financing?

Especially in times of tight public budgets, declining state-sponsored financing of SMEs demands alternative approaches. In 2014, the Organization for Economic Co-operation and Development (OECD) issued a set of principles of effective public investment in order to help governments design public funding policies in the most effective way. The sixth principle recommends states to "mobilise private actors and financing institutions to diversify sources of funding and strengthen capacities". The EU has followed the OECD's recommendation by implementing the European Fund for Strategic Investments (EFSI) that mobilises private sector funding through a public guarantee for viable but risky projects, a considerable part of which benefits SMEs. The EU is well-advised to continue this risk-based approach for public funding beyond the envisaged end of the EFSI investment period in 2017.

Furthermore, it is ever more important to continue removing structural barriers that limit the potential of market-based financing for SMEs in the context of the Capital Markets Union. The data from the crisis period have revealed that in some countries debt and equity instruments are already close substitutes to bank-based funding. On this basis, the OECD recommends that public administrations "strive for quality and consistency in regulatory systems across levels of government". In order to achieve a more level playing field between market-based and bank-based financing, the Commission needs to be more ambitious when it comes to harmonising insolvency and security law as well as information and tax barriers.

It might not be enough to focus on removing structural barriers to make market-based financing relatively more attractive. Instead, the analysis has shown that SMEs could benefit from a more diversified supply side in the trade financing market. Distress in the banking sector could still have the potential to cause receding trade finance activity as banks are very dominant in that sector. One policy action regarding the factoring market, a specific part of the trade financing sector, could be a review of national legal frameworks regarding factoring companies. This would help identifying important differences in national rules for factoring markets and serve as a basis for harmonisation.

In particular, member states should eliminate rules restricting market access to formally registered financial

institutions (banks). However, competition policy might also play a role. In the last decade, banks have increasingly bought into companies active in asset-based finance, that is, trade finance. In the factoring market, for example, banks control around 90 per cent of companies. Arguably, a genuine single market for capital in the EU has the potential to boost growth and employment beyond the short run, complementing direct public funding instruments.

Taken together, public policy should help in maintaining access to funding for SMEs in the short run, especially when market conditions worsen, while making SME financing more resilient to bank distress in the medium and long run.

## Further Reading

European Central Bank, *Survey on the Access to Finance of Enterprises (SAFE)*, available at:

<https://www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html>.

European Commission, *COSME: Europe's programme for small and medium-sized enterprises*, available at: <http://ec.europa.eu/growth/smes/cosme/>.

European Commission, *EU Programme for Employment and Social Innovation (EaSI)*, available at: <http://ec.europa.eu/social/main.jsp?catId=1081>.

European Commission, *HORIZON 2020: The EU Framework Programme for Research and Innovation*, available at: <https://ec.europa.eu/programmes/horizon2020/en/what-horizon-2020>

European Commission, *Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees*, Official Journal C 155, Brussels, 20 June 2008.

European Commission, *Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to de minimis aid*, Brussels.

European Commission, *Guidelines on State aid to promote risk finance investments*, doc. 2014/C 19/04, Brussels, 22 January 2014.

European Commission, *Regulation No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty*, Brussels.

OECD, *Recommendation of the Council on Effective Public Investment Across Levels of Government*, available at:

<http://www.oecd.org/gov/regional-policy/recommendation-effective-public-investment-across-levels-of-government.htm>.

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