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EU investment support for small and medium-sized enterprises in southern Europe: to be recommended?

Bernhard Forstner
Ulrich Koester

The president of the European Parliament, Martin Schulz, has repeatedly pointed out that small and medium-sized enterprises (SMEs) in some southern European countries face major constraints to access to credit and that removing these constraints for SMEs could contribute to reducing unemployment. He promised to support special loans programs. According to press reports the European Central Bank is also considering low-cost loans for national banks if they provide credit for SMEs.

In this article it is argued theoretically and empirically that the single-business investment support does not address the causes of high unemployment and could result, due to the difficulty in monitoring, in great inefficiencies. Studies that have focused on rural development measures to improve regional economic structures do not show that investment support is an efficient economic policy measure. There are more efficient measures available. An ex-ante evaluation, which is in accordance with EU regulations for the conception of new policies, projects and programs (EU Commission 2006), was conducted to test this recommendation. Any adoption of such policy, should be based on the results of economic analyses and – if available – empirical studies.

Reasons for market failure of credit markets

Credit contracts in a market economic system rely on free decisions by the loan provider and recipient. Both parties would only sign a contract if it improves their economic situation. The success of the transaction can only be known at the end of the loan period. Both business partners have assumed some risk in the loan transaction associated with the uncertainty in the dealings or the framework conditions. Investors face especially high risk if the economic and political environments are not secure, which in turn increases the risk for the loan provider. Loan providers must not only rely on the economic worthiness of potential loan recipients but also on their creditworthiness, such as for example the equity base of the loan recipient, and the existence of collateral to secure the loan. So the existence of institutions in the country that provide credit information on potential loan recipients, can greatly lessen the uncertainty of loan providers: for example, Schufa in Germany (acronym for General Credit Protection Association) or any other sources where one can easily obtain business credit ratings. Such information is easier to obtain for large, and in particular market-listed, companies than from SMEs. Large enterprises also have the advantage to own more capital and are better able to compensate individual risks due to their diversification in production and sales.

These considerations can explain the reasons why the banks that Schulz criticized, prefer to provide funding to larger companies. Consequently, the investment volume for SMEs is less than desirable from a private and economy-wide perspective.

The economic problem of direct investment promotion

Economic policy measures are only efficient when they target the cause of the problem. As indicated in the previous section, the cause for the low investment volume is the uncertainty faced by the credit recipient and the loan provider when assessing the viability of the planned investment. Investment support may reduce these uncertainties but does not address the cause. In addition, a number of problems emerge in promoting investment support. First, state promotion of investments must necessarily be selective. Not every investment that applies for subsidies can be promoted. In a market economy, professional lenders undertake the selection. The question is whether the government can address the selection process better than a professional lender. This is doubtful. Where will the decision maker for providing the credit obtain better information on the creditworthiness of the applicant? Why would government agencies be in a better position than professional lenders to evaluate the risk tied to the investments? Governments do not have either the incentives, since decision makers do not personally carry the responsibility of a bad selection, or the information to make a better selection. If the selection is left to the banks, the subsidized investments decrease their liability of bad decisions. Concurrently, credit applicants face lower costs associated with the economic viability and the related risk of the loan because of subsidization. Thus, distorted incentives are given to the credit recipient and the loan provider.

The problem with co-financing

Incentives can be even more distorted if the credit is co-financed by the EU, national and regional budgets. The EU is unique in its complex multi-level system, which also has an impact on state subsidies. Every Euro of investment subsidies in the regions with so-called delayed development can be financed up to 75% of the total costs from EU sources. This also holds true for the eastern European accession members as well as for the southern European member states. With the low co-financing levels by the states, it can be advisable for EU member countries to exploit the EU budget allocation to the member countries as much as possible even if the expenditure is inefficient from an EU perspective. Serious distortions in capital market inputs could result. Responsibility and efficient funding are often overlooked, particularly if federal financing structures also exist on the national level.

Empirical monitoring of investment support policy

Public support for business investments, for example, through low interest rates, subsidies or government loan guarantees, is found particularly in the agricultural sector but also in programs for the improvement of regional economic structures and the promotion of rural areas. In so far as the support is co-financed with EU funds, the member states are obligated to carry out regular monitoring with regard to the impact and efficiency of the use of this funding. Also, in the German budget regulations, regular monitoring of the success of public funding is required. Studies often only investigate whether the measure (e.g. support of single farms) has a positive effect, such as for example, an increase in the number of employees (see Bade and Alm, 2010). Such findings only indicate that the policy intervention has not led to an absolute policy failure. Such an evaluation is not adequate for investigating the efficiency of the funding and for detecting the absence of relative policy failure. These studies do not explore the cost/benefit evaluation of input resources related to the (gross/net) effects of the support measures and whether an increase of employment in supported enterprises resulted in displacement effects elsewhere. An exception is the study by Petrick and Zier (2012) who, despite finding positive occupational effects of the investment support, declare it a significant relative policy failure.

The European Court of Auditors (ECA) has published several special reports on the impact and efficiency of EU support in the framework of the structural promotion for the development of the agricultural sector and economics in rural areas. The ECA concluded that, despite monitoring and approval by the EU administration, the funds are for the most part granted without following a strict protocol, meaning without valid analysis or goal definition, and without specifying clear criteria for project selection. In the opinion of the Court, a better cost-use relation could be attained with more targeted funding input.

Scientific analyses in the field of agriculture also point to small effects – indication of small effectiveness – and do not clearly address the efficiency of the policies. Dantier (2011) concluded in his report on Austrian farms that the farms with and without subsidies do not differ in terms of changes in productivity and effectiveness, which suggests that subsidized investments are mainly for the fulfillment of legal conditions and less for an increase in productivity and efficiency. Similar conclusions were drawn by Kirchweger and Kantelhardt (2012) for Austria and by Michalek (2009) for Slovakia and for Schleswig Holstein. In an earlier analysis of dairy farms in Schleswig Holstein, Brümmer (1996) highlighted that the efficiency of subsidized farms is lower than that of non-subsidized farms. Also, Striewe et al. (1996) found on the basis of data from projected business plans of dairy farms in Schleswig Holstein at the time of application and actual data in the target year – which was by definition the fourth year after the implementation of the investment – that profit and equity development of the subsidized farms was less favorable than farms without subsidy. Particularly, the discrepancy between the plan figures and the actual outset situation of the farms led the authors to conclude that investment plans are often faked, which strongly limit the selection capabilities of the support system. Evidence of this deficit is found in Forstner et al. (2009) who showed that agricultural investment support resulted in high windfall profits in Germany. According to the study, 56 % of the supported and interviewed farmers would have undertaken similar investments in identical steps or sometimes even on a larger scale.

In a synthesis of ex-post evaluations of European Agricultural Fund for Rural Development (EAFRD) measures to improve competitive ability in the period 2000–2006, the measures seemed to have had positive effects on the income level of the subsidy recipients; however, significantly fewer positive impacts were found in the sector as a whole due to windfall gains, displacement and other effects (IfLS and Kantor, 2011). These consequences derive mostly from the inadequate focusing of the subsidized projects on the actual problems and objectives. Better targeted support as well as investment support combined with advisory service, training and good farm or investment planning could yield to higher efficiency. Investment support in the agricultural sector did not have a positive employment effect. In contrast, measures that target the economic development of rural areas as a whole could have a greater impact on income and employment.

Results from these studies and the appraisals of the ECA give serious concern and great skepticism with regard to the individual farm investment support. In any case, it is evident that the implementation of the support measures in terms of both consistency of the intervention logic and institutional requirements place high demands on policy and administrative agencies. Several studies even prove that the measures lead to absolute policy failure. We know of no study that clearly rejects the existence of relative policy failure.

Alternatives to investment promotion

Improvement of the economic framework conditions

It has been proven in numerous studies that governments can contribute significantly to the economic development of countries by securing the conditions of an appropriate economic framework, mainly by providing institutions that reduce the uncertainty of investors and loan providers. Of particular importance is the enactment of appropriate laws to counter corruption and improve internal economic competitiveness. The Corruption Perception Index of Greece, Spain and Portugal, which in 2007 already exhibited a high level of corruption, showed an increase in corruption in subsequent years. The Global Competitiveness Report of the World Economic Forum for the year 2013/2014 establishes that an inefficient government bureaucracy is among the greatest problems for the economy in these countries. Can one expect that government credit programs for SME will be efficiently implemented under these conditions? EU support for fighting corruption would make more sense.

Targeted measures to improve the functionality of the credit markets

To improve the functionality of the credit markets instruments should not target the credit recipients, but instead seek to improve information on the development of individual markets, create an expanded information system for loan providers, for example, with the Schufa, pursue the public support of costs that arise from checking the creditworthiness of SME, as well as promote training for credit appraisers who evaluate loan applications. In the case of a great need for small credits, the support of micro-financial organizations would also make sense.

Further information

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Contact

Bernhard Forstner
bernhard.forstner@ti.bund.de
Tel.: +49 531 596-5233
Fax: +49 531 596-5199

Johann Heinrich von Thünen-Institut
Bundesforschungsinstitut für Ländliche Räume, Wald und FischereiInstitut für Betriebswirtschaft
Bundesallee 50
38116 Braunschweig
www.ti.bund.de

Prof. Dr. Dr. h.c. mult. Ulrich Koester
IAMO Research Fellow
ukoester@ae.uni-kiel.de
Tel.: +49 431 880-4436
Fax: +49 431 880-4592

Christian-Albrechts-Universität zu Kiel
Institut für Agrarökonomie
Wilhelm-Seelig-Platz 6/7
24118 Kiel
www.uni-kiel.de