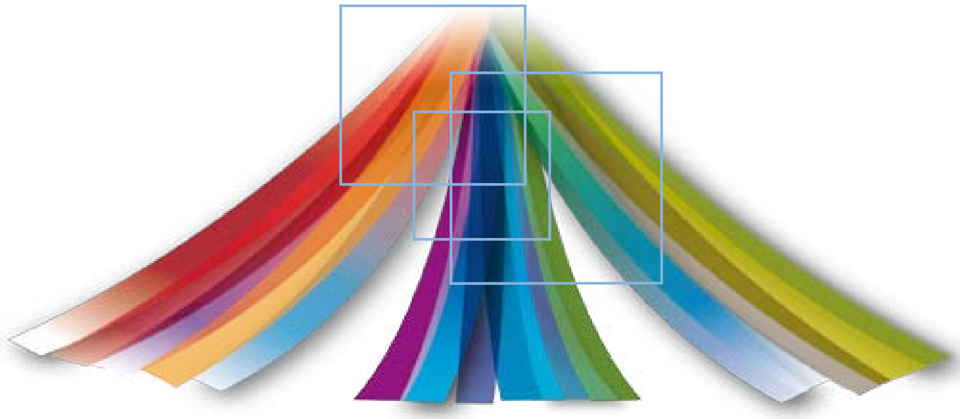
BRIEF Nº 12

GLOBAL JOBS PACT POLICY BRIEFS

International Labour Organization



FINANCING JOB CREATION – WHY ACCESS TO FINANCE IS KEY AND WHAT POLICY CAN AND CANNOT DO

1. Executive summary

SMEs create and retain most jobs, between 60 %-70 % in rich economies, even more in emerging economies.[1] In the EU alone "around 23 million SMEs provide around 110 million jobs and account for 99 % of all enterprises…".[2] For most SMEs access to finance is a major issue, regardless of the level of development and the competitiveness and efficiency of the financial sector.[3]

Because of their role in job creation SMEs are critical vectors for any policy that seeks to mitigate the effects of the crisis on employment. In order to allow SMEs to invest and create jobs, they need to have the financial means to do it: capital. This comes in two forms: own capital through retained profit generated over past business periods; or debt capital from suppliers, clients and especially banks and other financial institutions.

On both accounts SMEs face challenges. Their equity position is weak in relation to total liabilities and they are undercapitalized. On the debt capital side SMEs face obstacles to obtain the resources on affordable terms. Both issues reinforce each other.

[1] OECD: Financing SMEs and Entrepreneurs, Policy Brief (Paris, Nov. 2006) available at: http://www.oecd.org/dataoecd/53/27/37704120.pdf

[2] EU Commission: DG Enterprise and Industry, Staff Working Document SEC (Brussels, 2006) 842/2 p. 6

[3] idem p. 3

2. Description of the policy challenges

Undercapitalization is partly due to the refusal of small business owners to be transparent to banks, the tax office, and their workers about the real situation in assets and liabilities. They are not keen to allow in new associates who could bring along fresh capital. And even if they were, many small business owners have only rudimentary notions of financial management. The personalized style of running their shops reinforces a perception in banks that SMEs are not really trustworthy. When compared to larger companies and corporations, small enterprises the world over show fairly similar characteristics:

- a low proportion of fixed assets to total assets;
- a high ratio of current liabilities/total liabilities;
- a relatively low return on equity or total assets;
- a preference for informal sources of capital;
- entrepreneurs have other goals and motives apart from profit orientation.

Another reason for undercapitalization is related to financial institutions, their operating practices and their perception of default risk, justified or not. There is a range of suppliers of capital, private commercial banks, savings banks, cooperative banks, credit unions, suppliers, guarantee and equity funds, insurance companies, leasing companies, etc. All face two basic cost and risk problems: the small size of transactions and the opaqueness of small enterprises.

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More briefs can be found and downloaded at http:www.ilo.org/jobspact

A third cause for difficulties to access capital is the organization of financial markets. The financial market is a market dominated by scale advantages. Whenever there is little choice between commercial banks, savings banks and cooperative organized banks or non-bank financial institutions, small businesses are obliged to accept prices and lending conditions. They tend to be rationed out because of the limited size of transactions with them individually. They cannot negotiate costs and conditions of debt financing. Deficiencies in the financial infrastructure are another cause for dysfunctional local financial markets: in the absence of credit rating agencies it is costly to generate information about the repayment morale of potential household and enterprise clients; information such as that provided by rating agencies helps to contain default risk.

There are government interventions that paradoxically also contribute to undercapitalization in small firms and their suboptimal provision with debt capital. An often quoted example is government agencies that operate at the retail level, i.e. in direct competition with banks, have a narrowly targeted approach and distribute credit at preferential, subsidized interest rates. Such social fund mechanisms are set up with the best of intentions, namely to rectify market failure. However, the effects are counterproductive: they distort the retail market, they attract the wrong clientele i.e. more influential businesses – not usually small – that have the political connections to get the benefits of attractive lending terms; misguided policies such as these also perpetuate the gulf with commercially operating banks and, they provide a pretext to private capital providers not to make an effort in SME finance.

Another example of a policy measure that fails to have the desired effect on SME finance is the fiscal treatment of the personal income of SME business owners. Their income could be assessed and taxed differentiating between the portion that is paid out and another that is retained in the firm. That would have an incentive effect to plough back profits into the firm and bolster its equity. However, fiscal regimes in mayn countries fail to make that distinction.

There are also some legal and regulatory rules, such as the definition of the scope of property rights, the treatment of bank-acceptable collateral, as well as some monetary policies, such as interest rate ceilings or the weighing of bank assets etc. That fail to bring supply and demand in SME finance together. In these cases the policy objective - more equity and better chances for smaller firms - remains unattained, but as the effect of a disincentive.

There is a long list of reasons why SME finance is often suboptimal in volume, price and conditions. This is valid generally, in the North and the South, in normal times and in economic downturns. Logically, there is also a long list of policy options on the menu that address these market and policy failures. Whatever the merits in each and every instance, identified in the next section, one fundamental fact has to be understood: that scale and the sheer size of demand matter in any financial transaction, to the detriment of smaller market participants. It is not the bad will or arrogance of bankers but the nature of the production function in delivering financial services. There are enormously high fixed costs. It costs a bank almost as much in staff and other costs to produce a US$1000 loan as a US$100,000 loan. To a bank it makes sense therefore to go for the comparatively larger transactions promising more attractive net revenues. The history of small business finance is the history of attempts to counteract this fundamental microeconomic fact.

3. Policy options to address the challenges

As most jobs are created in the SME segment of the real economy, crisis or no crisis, policy makers tend to turn their attention first to the SME part of the economy. There are multiple things that need to come together to put SMEs in a position to grow, to invest, diversify, modernize, become more productive and in the process - create jobs. Access to finance in SMEs is one key condition for such stimuli policy measures to work. It is an important ingredient of policy menus because in no other market are unincorporated firms equally penalized because of their size and legal form.

Targeting or not – what works better?

One of the first choices policy makers face is whether they should design measures with eligibility criteria that can only and exclusively be fulfilled by small businesses, and no other segment of the economy. Targeting is an approach often used to rectify an imbalance created by the market if left alone. The question is whether these measures reach and actually benefit the intended segment, and if so, for how long? Another question is the transaction cost involved: somehow it has to be checked and verified whether the rules are respected, to avoid spill-over and deadweight effects. Then there is the question of whether measures can be designed to be precise. All this translates into red tape and public administration costs.

These can be offset by benefits accruing to the targeted SMEs. However, that depends on the duration and scope of impact: will commercial banks take over after some time and finance the targeted market segment, or on the contrary, will the intended SME segment continue to depend on subsidies? How much of a splash can an intervention really make, given budgetary constraints? Surely reaching out to just a few hundred SMEs in an economy that counts several tens of thousands will not make a dent unless more sustainable set-ups are found.

These are some of the reflections that policy makers need to consider to start with. After all, there are a few positive reasons for not specifically seeking out SMEs, but rather to stimulate the economy as a whole and trust on the effects of trickle down benefits. Some such general macroeconomic policies are measures to ensure price stability, facilitate the creation of new, small, and foreign banks, to facilitate diversity in the financial sector by allowing for a minimum presence of double bottom line operators of capital and, to encourage savings. In the area of law and regulation measures are needed to confirm and bolster property rights and rules to ensure compliance with contracts and a better flow and accessibility of information. Low interest-rate policies are another example: they benefit all firms, but small firms perhaps even more.

In many countries SMEs have considerable political clout. SME promotion has always been a staple item in election campaigns, crisis or no crisis. Not surprisingly, despite some of the drawbacks outlined above, measures that are targeted on SMEs and visibly carry that label will always have a privileged place in the arsenal of policy options. Being targeted does not make such policy options necessarily good or bad.

The scaling up potential, the costs of possible distorting effects, fiscal efficiency and the time it takes for effects to show up are what makes a difference. Targeted SME policy can start by simply removing blatant discriminatory measures that favour corporations, for example in public tender procedures. Another very light and non-distorting measure is the encouragement of self help organizations and, the constitution of chambers and professional associations to channel and articulate common SME interests. At a higher level public authorities can create institutions with the aim to intermediate or share risk with SMEs. This affects the financial infrastructure between SMEs and banks; it is not yet the provisions of finance. Classical examples are guarantee funds accessible above all to SMEs or leasing schemes expressly to serve the SME sector. So far, these are all measures that change the environment of resource allocation decisions, and they do not interfere with financial intermediation directly.

The next degree of intervention is reached with refinancing facilities. Here the government uses taxpayers' money, and gets involved in financial intermediation, although not yet at the retail level. Preferential credit lines to commercial banks imply an attractive net margin to the retail bank if it lends to SMEs. Here banks still retain the freedom to go into SME lending or not. SME credit lines are probably the most common instrument of policy makers to try and close the credit gap between banks and SMEs. Other indirect instruments to prod banks and financial intermediaries are reserve requirements and preferential discount rates. These monetary tools give retail banks a small cost advantage if they demonstrate that they have made an effort to finance SMEs. Loan portfolio quotas are less prevalent. They are still applied in India and a few other countries where they impose a minimum portion of the loan portfolio outstanding that should go to SMEs. Banks and other financial institutions strongly dislike such direct interventions in their allocation decisions, and prefer to pay a penalty for non-compliance than to move into the direction of more SME lending.

The most interventionist type of measure is the direct provision of credit by government controlled agencies at the retail level, in competition with private sector operators. Development banks, social or other funds that lend directly to SMEs illustrate an approach which is favoured by governments that want to be seen doing good things for the small businessman.

On the demand side, policies that prod the small business community into making adjustments that bring it closer to bank practices are incentives for more self-financing: these include depreciation allowances, preferential fiscal treatment of the constitutions of reserves, tax credit for employee ownership, assistance in succession arrangements, improved financial management in SMEs that make them more transparent as regards the valuation of liabilities and assets, information and awareness raising campaigns on the advantages of taking in more associates as sources of equity finance and so forth.

A forthcoming ILO publication[4] takes a look at these options on the menu of policy makers. Using criteria such as cost efficiency, precision in targeting, deadweight effects, income and substitution effects, outreach, scope for replication, displacement and market distortion, the study finds that indirect policies that bind in banks provide effective incentives, and emphasize longer-term and scaling up effects are more sustainable. What they often lack is the PR benefit of immediate, massive and tangible benefits that can be cashed in political votes.

What works?

Among the factors of success are prudent pilot schemes to start with, that are gradually built up, rather than massive schemes from the start. The commitment and participation of local, representative and legitimate small business associations is the key. Often SME associations are just the prolonged arm of an influential business individual, and this is obviously not useful. Interventions should be oriented at market prices and, the interest rate should reflect the real cost of intervention.

[4] B. Balkenhol, Financing Job Creation – good and less good policies to encourage small business finance, (Palgrave MacMillan/ILO, Geneva, 2010)

4. Conclusions and recommendations

The officers of the GB identified six measures to address the impact of the crisis on the real economy: the first one being measures to "ensure the flow of credit" (March 2009). At its meeting in Pittsburgh in September 2009 the G20 created a "Financial Inclusion Experts Group" (FIEG) to look at access to finance problems for SMEs, amongst other issues of financial inclusion. The ILO participates in this group and submitted a paper on the strengths and weaknesses of different guarantee fund models.

5. Further reading and resources

- http://www.ilo.org/socialfinance
- http://practicalaction.org/?id=sed_journal
- http://www.enterprise-development.org/
- http://ec.europa.eu/enterprise/policies/finance/
- http://www.oecd.org/department/0,3355,en.html
- http://www.ifc.org/sme
- http://www.ifc.org/ifcext/sme.nsf/Content/Linking_SMEs_to_Investments