

Policy Department  
Economic and Scientific Policy

# THE SMALL BUSINESS ACT FOR EUROPE

## NEW IDEAS TO BOOST SMES

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## List of abbreviations

ADIE	Association pour le Droit à l'Initiative Economique
CCCTB	Common Consolidated Corporate Tax Base
CIP	Competitiveness and Innovation Framework Programme
CPVO	Community Plant Variety Office
CRAFT	Co-operative Research Action for Technology
EASA	European Aviation Safety Agency
ECHA	European Chemicals Agency
EIB	European Investment Bank
EIP	Entrepreneurship and Innovation Programme
FdP	Fonds de Participation
GIF	High Growth and Innovative SME Facility
IASB	International Accounting Standards Board
IPs	Integrated Projects
ICT	Information and Communication Technology
IPR	Intellectual Property Rights
IFRS	International Financial Reporting Standards
IASB	International Accounting Standards Board
JEREMIE	The Joint European Resources for Micro to Medium Enterprises initiative
SMEG	SME Guarantee Facility
SEPA	Single Euro Payments Area
UEAPME	European Association of Craft, Small and Medium-sized Enterprises

## Executive Summary

The Small Business Act for Europe was adopted by the European Commission in June 2008. It is an initiative by the European Commission to address the needs of Europe's small and medium-sized businesses, consisting of a set of 10 principles to guide the conception and implementation of policies at EU and Member State level.

The aim of this study is to present the European Parliament with new ideas, food for thought and critical perspective for the Members of the ITRE Committee on the Small Business Act for Europe and the work leading to it, such as the Impact Assessment carried out in advance. The focus is put on three policy areas:

- Cutting red tape and bureaucracy for SMEs
- Improving access to finance for SMEs
- SME participation in EU programmes

### Cutting red tape and bureaucracy (reducing administrative burdens) for SMEs

For many SMEs, administrative burdens are their number one problem. The conclusion of this study is that reduction of administrative burdens (red tape, bureaucracy) for SMEs – and for enterprises in general – is thoroughly addressed by Commission initiatives already. This goes both for the SBA and, not least, for the large on-going Commission programme for measuring the current administrative burdens and proposing measures to alleviate them wherever possible. Thus, there are few areas that can be identified as presenting significant potential at Community level for reducing administrative burdens for SMEs that are not already being addressed. The areas considered under this heading include statistics requirements, certain aspects of environmental regulation, and EU agency fees.

- In the field of **statistics requirements**, the SBA proposes reductions in the frequency of statistical surveys for micro-businesses and that Member States refrain from asking SMEs for information which is already available within the administration. This is assessed as a reasonable level of burden reduction, but it is crucial that information which has already been submitted to one administration is made available to other relevant administration levels through streamlining of information requirements and proper ICT systems.
- As regards **environmental legislation** this study proposes that, in relevant areas of environmental legislation involving SMEs, it should be considered to introduce more risk-based regulatory approaches, where the companies are allowed to simply notify the authorities of the environmental risks involved in their activity and the measures taken to address these, instead of having to go through a complicated procedure to achieve a permit.
- Concerning **EU agency fees**, those agencies that supply services for which fees apply, do not generally provide specific SME discounts (with the exception of ECHA) even though SMEs are disproportionately affected by such fees. The fee structures identified are fairly simple, with flat rates for different kinds of services, and discounts for SMEs could, in principle, easily be introduced. This is however complicated by the fact that many of the relevant agencies are self-financed through fees. This provides little flexibility for price differentiation as, all other things being equal, the lowering of fees for some types of enterprises would mean increasing fees for others.

As regards the Commission **working with the Member States** to help them reach the overall goal of reducing administrative burdens by 25%, a number of recommendations were made:

- It is recommended that the Commission revises the Guidelines for **Impact Assessment** to make assessment of administrative burdens for SMEs, particularly small and micro enterprises, a mandatory element of *all* Impact Assessments of new regulation and other Commission initiatives (including expenditure programmes). This should include an explicit requirement for the IA to present concrete proposals for simplification/reduction of administrative burdens for SMEs/micro enterprises whenever relevant.
- Similar initiatives should be introduced at Member State level, and the Commission should thus be encouraged to promote this to Member States, e.g. by providing good practice examples.

### **Improving access to finance for SMEs**

Access to finance is another area which presents a significant barrier to the establishment and growth of SMEs. The role of the SBA is in this connection to pioneer and support measures which give credit institutions an incentive to offer loans to SMEs that would otherwise be too great a risk.

A number of issues were discussed in this report that could make life easier for SMEs in terms of access to finance. These mostly have to do with alternative sources of finance to those provided by the bank sector today, such as micro-finance, mezzanine finance, the access to risk capital, as well as the question of taxation. However, many of these areas are within the domain of the Member States, meaning that the EU may not be in a position to regulate directly, but will have to work to influence the Member States to change their legislation and/or their practices through e.g. exposing the differences between Member States across the Union, providing best practice examples, and providing support to awareness raising and education.

Among the recommendations put forward in this area are:

- **Lower tax rates should be introduced for SMEs** as proposed in the SBA. However, this should only be applicable for a certain period of time in order not to promote socially sub-optimal behaviour, such as using different means to stay SMEs in order to make use of the favourable tax rates. The rates could possibly continue for micro-enterprises.
- **Thin capitalisation rules should be abolished.** Equity financing should be treated the same way as debt financing. Member States should initiate a change in the taxation system.
- **Lending by institutions that are not banks** should be increased in the EU, in order to increase the availability of finance for SMEs. The EU and the Member states should pave the way for this possibility. The EU should initiate activities to investigate how this could be done in practice.
- **Micro credits** should be available in banks, and Member States should cap the interest rates that banks can charge at an appropriate level, so that the incentive for banks to supply micro credits is present. The EU should initiate activities to investigate the differences between Member State systems in this respect, and whether there is basis for action at Community level.
- **Credit guarantee schemes or funds** could be established by Member States and used to secure banks' high risk loans, thus making them more willing to provide micro credits to SMEs. The EU can provide support in the form of exchange of best practices.

- The EU should promote a **single market for risk capital** such as venture capital in order to increase the access to venture capital for SMEs.
- Increased **transparency and open exchange of information** is needed from SMEs if venture capitalists are to invest more in SMEs. Industry organisations could play a role in helping SMEs adjust.
- **Loss carry-forward** (transferring losses on future tax years) should be applicable for SMEs in all Member States, promoted by the Member States.
- Banking associations and industry organisations (in particular SME organisations) could work together to arrange **training** courses for SMEs on alternative financing tools and how to attract alternative financing, including making them aware of the value of their intellectual property and how this can be utilised to attract financing. The EU could support this work in the form of grant schemes or providing a forum for knowledge sharing.

### **SME participation in EU programmes and public procurement**

The European Commission has made numerous efforts to increase the number of SMEs participating in its research programmes. However, there are still major barriers for SME participation in general, and in particular for the most innovative and growth-oriented SMEs. Many of these present barriers can be alleviated through the implementation of “lighter” procedures that reduce barriers for SMEs to participate. Some success has been achieved in this area already, but more can be done.

It is also recommended that the Commission monitor and push for the utilisation of new financial instruments facilitated by EIB/EIF, such as the JEREMIE.

In the area of **public procurement**, it was concluded that the current legal framework provides adequate room for the Member States to implement practices that would create better opportunities for SMEs to gain access to public procurement, but that these are not sufficiently exploited by the Member States. Thus, the authors of this report do not see any immediate need for revision of the legal framework.

### **Overall**

Overall, with the SBA not being a legally binding instrument, and many of the problem areas addressed in the SBA being the domain of the Member States, there is a limit to how much the SBA can achieve in and of itself, and there is a risk that the objectives may not be realised, or only partly so. However, this risk can and should be reduced by Member States committing themselves to improving the climate for SMEs, and the EU actively supporting these initiatives through information and awareness-raising activities, grant schemes etc. for benchmarking, studies of current practices and issues, exchange of good practices, etc.

The financial crisis may also impact the business climate for SMEs, as the turmoil in the financial markets may slow down banks’ and other investors’ willingness to invest in businesses such as SMEs where a reasonable return on investments often cannot be expected in the near future. The authors of this report are not in a position to foresee exactly how the financial crisis will affect the current and proposed initiatives for SMEs, but it is not likely to reduce the need for action in this field.



# 1 Introduction

## 1.1 The Small Business Act

The Small Business Act for Europe was adopted by the European Commission in June 2008. It is an initiative by the European Commission to address the needs of Europe's small and medium-sized businesses<sup>1</sup>. Most jobs in the EU are being created by Small and Medium-sized Enterprises (SMEs). SMEs are thus highly important for the future development in the European Union, but are often met with large bureaucratic hurdles and other obstacles. To assist European SMEs better in unlocking their potential of long term sustainable growth and of more job creation, the European Commission introduced the Small Business Act<sup>2</sup>. The act aims at making Europe more entrepreneurial and at helping its businesses thrive by improving framework conditions for SMEs while taking into account their diversity.<sup>3</sup> As stated in the Small Business Act, the “symbolic name of an “Act” given to this initiative underlines the political will to recognise the central role of SMEs in the EU economy and to put in place for the first time a comprehensive policy framework for the EU and its Member States”<sup>4</sup>.

The Small Business Act for Europe consists of a set of 10 principles to guide the conception and implementation of policies at EU and Member State level. The principles are as follows<sup>5</sup>:

- I Create an environment in which entrepreneurs and family businesses can thrive and entrepreneurship is rewarded
- II Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance
- III Design rules according to the “Think Small First” principle
- IV Make public administrations responsive to SMEs’ needs
- V Adapt public policy tools to SME needs: facilitate SMEs’ participation in public procurement and better use State Aid possibilities for SMEs
- VI Facilitate SMEs’ access to finance and develop a legal and business environment supportive to timely payments in commercial transactions
- VII Help SMEs to benefit more from the opportunities offered by the Single Market
- VIII Promote the upgrading of skills in SMEs and all forms of innovation
- IX Enable SMEs to turn environmental challenges into opportunities
- X Encourage and support SMEs to benefit from the growth of markets

Moreover, a set of new legislative proposals are introduced, which are guided by the “Think Small First” principle. These are as follows:

- General Block Exemption Regulation on State Aids
- Regulation providing for a Statute for a European Private Company
- Directive on reduced VAT rates

<sup>1</sup> [http://ec.europa.eu/enterprise/entrepreneurship/sba\\_en.htm](http://ec.europa.eu/enterprise/entrepreneurship/sba_en.htm)

<sup>2</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1003&type=HTML&aged=0&language=EN&guiLanguage=en>

<sup>3</sup> [http://ec.europa.eu/enterprise/entrepreneurship/sba\\_en.htm](http://ec.europa.eu/enterprise/entrepreneurship/sba_en.htm)

<sup>4</sup> Communication from the Commission to the European Parliament, The Council, the European Economic and Social Committee and the Committee of the Regions (2008): Think Small First: A Small Business Act for Europe (COM(2008) 394)

<sup>5</sup> Communication from the Commission to the European Parliament, The Council, the European Economic and Social Committee and the Committee of the Regions (2008): Think Small First: A Small Business Act for Europe (COM(2008) 394)

Moreover, two upcoming proposals will be introduced as well, these being:

- A proposal to further modernise, simplify and harmonise rules on VAT invoicing
- An amendment to the Directive 2000/35/EC on late payments.

The 10 principles presented above are translated into a set of policy actions and recommendations to implement the 10 principles according to the needs for SMEs at Community and Member State Level<sup>6</sup>.

## **1.2 The scope and objectives of this study**

The aim of this study is to present the European Parliament with new ideas, food for thought and critical perspective for the Members of the ITRE Committee on the Small Business Act for Europe and the work leading to it, such as the Impact Assessment carried out in advance.

Problems and challenges for SMEs in the EU are well-known and thoroughly studied in the literature. Thus, detailed analyses of the problems are not provided in this report. Instead, focus will be on new and innovative ideas for solutions to the problems and challenges that SMEs face, including examples of best practices from different Member States.

The focus in the current study will be on three policy areas:

- Cutting red tape and bureaucracy for SMEs
- Improving access to finance for SMEs
- SME participation in EU programmes

The first area, cutting red tape and bureaucracy for SMEs, is mentioned in principle IV in the Communication. It is a very important measure for facilitation of cross-border business within the EU, the access to markets and the modernisation and simplification of administrative procedures. However, apart from the regular "de minimis" provisions and certain lower fees for SMEs (e.g. in REACH), no Commission initiatives foresee specific exemptions for SMEs. It will therefore be investigated further if more could be done in order to relieve SMEs from administrative burdens.

Various surveys have stated that access to finance is an issue for SMEs<sup>7</sup>. Thus, the study will focus on whether the proposed measures in the Small Business Act are adequate, and whether and how additional measures could be designed to improve access to finance for SMEs.

SME participation in EU programmes is an issue that has been raised continuously in evaluations of the Commissions' research programmes and other support programmes, where SMEs tend to be heavily underrepresented among the participants. Some of the most pertinent programmes will be looked into in this report and some suggestions made for what can be done to improve SME participation.

Where applicable, the study will in its recommendations differentiate between different types of SMEs (micro-enterprises, small and medium-sized companies).

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<sup>6</sup> Communication from the Commission to the European Parliament, The Council, the European Economic and Social Committee and the Committee of the Regions (2008): Think Small First: A Small Business Act for Europe (COM(2008) 394)

<sup>7</sup> 21 % indicated this in the 2007 observatory of EU SMEs, ToR, page 3

### 1.3 The need for a Small Business Act: Current situation and problems for SMEs

As mentioned, the majority of enterprises in all EU Member States belongs to the category of SMEs, and the majority of employed citizens in the Member States are employed by SMEs. Thus, SMEs prosperity is a crucial factor for achieving more growth and more and better jobs in the EU. SMEs are highly different; they comprise all types of firms ranging from one-person businesses and other micro-enterprises (with less than 10 employees), many of which are start-ups, to medium-sized companies with up to 250 employees, and while some SMEs offer very traditional services or craft products, many others are fast-growing high-tech companies.

Despite their differences, Europe's SMEs share many challenges, such as the need to reduce administrative burdens, access to finance, taxation, lack of skills, access to public procurement, unfair competition, internationalisation, trade regulation and labour law. Excessive payment delays are also described by many SMEs as an important problem.<sup>8</sup> Examples of some of the large issues currently impacting negatively on the creation of SMEs and their ability to grow are briefly presented below.

**Administrative Burdens:** For many SMEs, the administrative burden is their number one problem, and for this reason also one of the thematic areas of the SBA. The relative cost of administrative procedures for a small company can be up to ten times more than for a large company, making this burden disproportionately heavy for small business. The importance of a less complicated regulations and bureaucracy for SMEs and industry in general can be illustrated by the findings from the European Commissions report on "*Models to reduce the disproportionate regulatory burden on SMEs*": On average, where a big company spends one Euro per employee to comply with a regulatory obligation a medium-sized enterprise might have to spend around four Euros and a small business up to ten Euros.<sup>9</sup>

Several factors are causing this disproportionate distribution of regulatory costs. First, a large part of regulation results in costs that are fixed or do not change much with the size of a business. Second, larger businesses can employ specialists to deal with regulatory obligations more efficiently. Third, in small enterprises the entrepreneur himself will often be responsible for taking care of the regulatory obligations. This means that the most valuable resource of the small business will be occupied with tasks that do not directly contribute to the success of the enterprise.<sup>10</sup>

Hence, SMEs in particular are in need for a more transparent and less bureaucratic and regulated business environment, as the current level of administrative burdens on SMEs may be considered an obstacle to further growth of SMEs and to entrepreneurial activity in general. The European Commission is currently working towards reducing the administrative burden on businesses by 25% before 2012 and towards ensuring that all new legislation affecting business is SME-friendly<sup>11</sup>, but more might need to be done, which will be further investigated in this report in Section 2: '*Cutting red tape and bureaucracy for SMEs*'.

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<sup>8</sup> [http://ec.europa.eu/enterprise/entrepreneurship/docs/sba\\_consultation\\_report\\_final.pdf](http://ec.europa.eu/enterprise/entrepreneurship/docs/sba_consultation_report_final.pdf)

<sup>9</sup> [http://ec.europa.eu/enterprise/entrepreneurship/support\\_measures/regmod/regmod\\_en.pdf](http://ec.europa.eu/enterprise/entrepreneurship/support_measures/regmod/regmod_en.pdf)

<sup>10</sup> [http://ec.europa.eu/enterprise/entrepreneurship/support\\_measures/regmod/regmod\\_en.pdf](http://ec.europa.eu/enterprise/entrepreneurship/support_measures/regmod/regmod_en.pdf)

<sup>11</sup> [http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc\\_id=806&userservice\\_id=1&request.id=0](http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=806&userservice_id=1&request.id=0)

**Finance:** The future of European competitiveness depends on an integrated, open, and competitive financial market that allows new ideas to get quickly to the market. For growth-seeking innovative entrepreneurs, external financing becomes necessary, when their initial funds have been exhausted. Knowledgeable private investors are critical for identifying businesses with growth potential, but there is still a lack of professional investors in Europe.<sup>12</sup>

Access to finance is an issue frequently mentioned as one of the greatest obstacles SMEs face. Measures as to how this challenge could be relieved are discussed in this report. For instance, if SMEs lack access to finance this might be compensated for by improving the supply of micro-credit and mezzanine finance and to develop new financial products and services. Furthermore, many entrepreneurs need guidance and education on the advantages and disadvantages of different forms of finance and on how to best present their investment projects to potential financiers<sup>13</sup>. The role of the SBA is in this connection to pioneer and support measures which give credit institutions an incentive to offer loans to SMEs that would otherwise be too great a risk.

**Internationalisation of SMEs:** SMEs find it more difficult than large enterprises to engage in cross-border activities within the Internal Market. Only 8% of SMEs trade across borders, compared to 28% of large enterprises<sup>14</sup>. The European Commission is targeting this problem for instance through a new business support network in the framework of the Competitiveness and Innovation Programme (from January 2008 onwards). The network will advise SMEs on the opportunities provided by the Single Market and help them to find business partners in other countries, including non-EU countries. However, in order to assist SMEs in the best possible way towards internationalisation, SMEs' capability for internationalisation (e.g. market knowledge, trade practices and management skills) should also be supported, at EU and national level, if more innovative and competitive SMEs are to become global.<sup>15</sup>

**Inclusion of SMEs in research programmes:** The European Commission has made numerous efforts to increase the number of SMEs participating in its research programmes. For instance, in the 6<sup>th</sup> Framework Programme (FP6) the Commission had a target that the SMEs participating in the programme should amount to more than 15% of the entire population. However, although this target was met in for instance the ICT part of FP6, the majority of the SMEs receiving funding were not highly innovative. Hence, although a reasonable number of SMEs participate in the programme, it seems that there are major barriers to involving the most innovative and growth-oriented SMEs. A number of reasons have been cited, including long time-to-market and complexities (including administrative burdens) of participating in FP6 projects. Barriers also include concerns over lack of IPR protection<sup>16</sup>. This will be discussed in more detail in section 4: '*SME participation in EU programmes*'.

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<sup>12</sup> [http://www.min-economia.pt/document/PPUE\\_CCCompetitividade\\_Doc\\_PME.pdf](http://www.min-economia.pt/document/PPUE_CCCompetitividade_Doc_PME.pdf)

<sup>13</sup> [http://ec.europa.eu/enterprise/entrepreneurship/docs/sba/com\\_2008\\_394\\_sba.pdf](http://ec.europa.eu/enterprise/entrepreneurship/docs/sba/com_2008_394_sba.pdf)

<sup>14</sup> European Commission: Communication from the Commission to the European Parliament, The Council, the European Economic and Social Committee and the Committee of the Regions (2008): Think Small First: A Small Business Act for Europe (COM(2008) 394)

<sup>15</sup> [http://www.min-economia.pt/document/PPUE\\_CCCompetitividade\\_Doc\\_PME.pdf](http://www.min-economia.pt/document/PPUE_CCCompetitividade_Doc_PME.pdf)

<sup>16</sup> Information Society Research and Innovation, Evidence Synthesis Report prepared for the evaluation of the IST Thematic Priority of the 6<sup>th</sup> FP, DG Information Society and Media, June 2008.

## 2 Cutting red tape and bureaucracy for SMEs

Reduction of red tape and bureaucracy for companies will generally have bigger impacts on SMEs because they are – as discussed above - disproportionately affected by administrative burdens in the first place. That said, it must be concluded that the Commission is already very active in the field of reduction of administrative burdens (red tape), and that this issue, in the opinion of the authors of this report, is rather well covered in the SBA, as well as in the ongoing Action Programme on reducing administrative burdens in the European Union.

There are substantial on-going activities concerned with measuring administrative costs arising from legislation in the EU and putting forward proposals for reduction of red tape. The goal is to reduce administrative burdens on enterprises by 25% by 2012. Thus, the number of proposals which can be put forward in addition to those already included in the SBA and the Commission's on-going effort to reduce administrative burdens is limited, and in some cases we can simply offer additional perspectives on issues which are already included in the SBA.

### 2.1 Potential areas for relieving red tape and bureaucracy for SMEs in EU legislation and other areas

In this section, we discuss some areas where there may be potential SME benefits to be gained in the form of reduction of administrative burdens (including fees to be paid). These areas include:

- Statistics requirements
- Environmental legislation
- Agency fees

#### 2.1.1 *Statistics requirements*

Reduction in statistics requirements is already addressed by the SBA, inviting Member States not to ask micro-businesses to participate in statistical surveys more than once every 3 years, and to refrain from asking SMEs for information which is already available within the administration. Given the need for updated and accurate statistics, this is assessed as a reasonable level of burden reduction. It should however be stressed that it will be crucial that information which has already been submitted to one administration is made available to other relevant units of local, regional, and national administration. This would require both an effort to streamline information requirements and proper ICT systems to allow for easy and safe exchange of information between authorities and/or central storage of data which can be accessed by the relevant authorities.

Best practice example:

In **Norway**, the Brønnøysund Register Centre<sup>17</sup> is a government body under the Norwegian Ministry of Trade and Industry, consisting of several different national computerised registers. These registers contain information and key data about matters such as liabilities and titles in mortgaged movable property, almost 400 000 business enterprises, more than 2 300 000 annual accounts and auditor's reports of limited companies, bankruptcies and compulsory liquidations, etc. The objective of the Centre is to eliminate duplication of collection and registration of data, in particular from SMEs. The "Oppgaveregisteret" (Task Register) has an overview of which information the various registers and public authorities require from the enterprises, and compare the information requests sent out by public authorities. In case two or more public authorities pose the same questions to the same types of enterprises, the authorities are obliged by law to ask for this information only once.

<sup>17</sup> <http://www.brreg.no/om.html> (mostly in Norwegian)

### 2.1.2 Environmental legislation

Although their combined environmental impacts are substantial, SMEs are often not bound to more comprehensive and effective environmental schemes or legislation (such as the IPPC Directive or the Emission Trading Scheme). This is due to the fact that they often fall below the thresholds that trigger the application of instruments that concentrate on major individual sources of pollution. Where environmental legislation is applicable to SMEs, they often do not have the necessary legal and environmental expertise to cope with environmental legislation, as well as limited financial resources to deal with compliance<sup>18</sup>.

Changes to the design and operation of legislation can, in some cases, help SMEs meet their obligations more easily, by making requirements clearer and using simpler ways to achieve the same environmental objectives. As part of the better regulation effort, the Commission is examining all its legislation to identify where it can cut unnecessary costs in terms of requiring information from SMEs. In addition, Member States have a role to play in this exercise. Costs can often be cut at national level by not duplicating information requests (cf. also above), using IT solutions and sampling techniques, streamlining permit procedures, simplifying the way information has to be presented, and using one-stop-shops for permitting and other regulatory procedures<sup>19</sup>. It has furthermore been proposed to consider applying risk-based regulatory approaches, in particular when SMEs are involved – i.e. simplifying procedures, in particular as regards environmental permits, in areas where the environmental risk is relatively low<sup>20</sup>. For such low-risk activities, a trust-based (self-regulation) approach could be applied, where the companies are allowed to simply notify the authorities of the environmental risks involved in their activity and the measures taken to address these, using a simple reporting format (preferably electronic rather than paper-based) instead of having to go through a complicated procedure to achieve a permit.

#### **Recommendation:**

**In relevant areas of environmental legislations involving SMEs, it could be considered to introduce more risk-based regulatory approaches, including use of a ‘de minimis’ rule for low-risk activities where notifications are less costly than permitting procedures**

### 2.1.3 Agency fees

Concerning EU agency fees, those agencies that supply services for which fees apply such as, for instance, the Community Plant Variety Office (CPVO), the European Aviation Safety Agency (EASA), and the EU Trademarks and Designs Registrations Office (OHIM), do not provide specific SME discounts. Taking OHIM as an example, its fees for granting EU-wide trademark rights were lowered across the board in 2005, but with no differentiation for different types of companies. It was expected, however, that the fee reductions would benefit in particular SMEs, for whom the costs of IP protection and enforcement are often a challenging proposition<sup>21</sup>.

<sup>18</sup> Commission Communication: Small, clean and competitive. A programme to help small and medium-sized enterprises comply with environmental legislation, COM(2007) 379 final, pp. 3-4.

<sup>19</sup> Ibid, p. 7.

<sup>20</sup> Fifth Report of the High Level Group on competitiveness, energy and the environment, contributing to an integrated approach to competitiveness, energy and environment policies addressing both international action on climate change and better regulation, 8.11.2007, [http://ec.europa.eu/enterprise/environment/hlg/doc\\_07/hlg-fifth-08-11-07.pdf](http://ec.europa.eu/enterprise/environment/hlg/doc_07/hlg-fifth-08-11-07.pdf)

<sup>21</sup> As a self-financing agency, OHIM’s budget comes entirely from the fees paid by the businesses that use its services, and the fee reduction was only made possible through a successful effort aimed at increasing productivity and improving efficiency. Source: OHIM Press release: Trade mark protection in the EU gets cheaper, 17 October 2005, <http://oami.europa.eu/en/office/press/pdf/20051017-fees.pdf>.

There is one example of a differentiated price policy, namely the fees payable to the European Chemicals Agency (ECHA) in Helsinki, which has differentiated fees and charges for registration, evaluation and authorisation of chemicals under the new REACH registration procedures. In order to keep the burden on SMEs to a minimum, a differentiated price policy between the different groups of companies is applied, with the following reductions:

- 30% for medium sized companies
- 60% for small sized companies
- 90% for micro enterprises<sup>22</sup>.

The fee structures identified are fairly simple, with flat rates for different kinds of services, and discounts for SMEs could, in principle, easily be introduced. The issue of whether a differentiated price policy could be introduced for more agencies is however complicated by the fact that whereas ECHA is not fully self-financed through fees (i.e. part of the costs of running the Agency are covered by a Community subsidy), other agencies such as the CPVO and the OHIM are. This provides less flexibility for price differentiation as, all other things being equal, the lowering of fees for some types of enterprises would mean increasing fees for others.

## **2.2 Working with the Member States to reduce their administrative burden by 25%**

The reduction of administrative burdens is, as previously mentioned, quite thoroughly covered by the SBA, and covers both Commission and Member State level. In particular, the Commission stresses the "Think Small First" principle in connection with new and revision of existing regulation, including the "SME test" to be included in the impact assessment of new initiatives. The Commission will "rigorously assess the impact of forthcoming legislative and administrative initiatives on SMEs ("SME test") and take relevant results into account when designing proposals". It is however not mentioned whether the SME test will become a mandatory element of all impact assessments, not only on those aimed at SMEs.

### **Recommendation:**

**It is recommended that the Commission revise the Guidelines for Impact Assessment to make assessment of administrative burdens for SMEs, particularly small and micro enterprises, a mandatory element of *all* Impact Assessments of new regulation and other Commission initiatives (including expenditure programmes). This should include an explicit requirement for the Impact Assessment to present concrete proposals for simplification/reduction of administrative burdens for SMEs/micro enterprises whenever relevant**

### **Recommendation:**

**Similar initiatives could be introduced at Member State level, and the Commission should thus be encouraged to promote this to Member States, e.g. by providing good practice examples.**

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<sup>22</sup> EUROPA Press release: Fees and charges payable under REACH adopted, IP/08/582, 16 April 2000, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/582&format=HTML&aged=1&language=EN&guiLanguage=en>

## **Best practice examples: General reduction of administrative burdens for companies (not necessarily directed specifically at SMEs)**

A large number of Member States have initiatives/programmes in place for reduction of administrative burdens. Best practice examples include:

In the **UK**, Regulatory Impact Assessments (RIAs) are generally applicable to all Government interventions affecting the private sector, the third sector and public services, regardless of source (domestic or international). Any proposal that imposes or reduces costs on businesses or the third sector requires an Impact Assessment. In practice, the RIA is a short structured document which briefly describes the issue which has given rise to a need for regulation and compares various possible options for dealing with that issue, including their benefits, costs, and effects.<sup>23</sup>

In **Denmark**, all ministries with regulation affecting enterprises have since 2001 worked to reduce their share of administrative burdens for enterprises. A baseline measurement of administrative burdens has been carried out and is updated annually. All new legislation undergoes an impact assessment which must include an assessment of financial and administrative consequences for businesses and for public authorities at all levels, environmental consequences, administrative consequences for citizens, and the relationship with EU legislation. The objective of the Danish government is to reduce administrative burdens for enterprises by 25% before 2010<sup>24</sup>.

In **Belgium** (at federal government level) a “Kafka-meldpunt” (Kafka reporting point) has since 2005 been part of a broader programme to reduce administrative burdens. Anyone (citizens, businesses, organisations, public administrations, etc.) can use the Kafka-meldpunt to report unnecessary bureaucracy and administrative burdens, and provide suggestions for simplification through a simple electronic format on the website of the Dienst voor de Administratieve Vereenvoudiging (Administrative Simplification Services). The reports are screened for simplification opportunities by Administrative Simplification Services staff<sup>25</sup>.

In **Estonia**, an important aspect of the ambitious e-government programme is to reduce the administrative burden of businesses through implementation of ICT solutions. The Implementation Plan 2007-2008 of the Estonian Information Society Strategy contains the development of an electronic business environment that will enable businesses to exchange data in a universal form. The plan is to ensure conditions for exchanging machineprocessable data both with central and local level government agencies and between enterprises, including a one-stop Entrepreneur Portal with functionalities for licenses, company registration, export and import declarations, TIR-carnets etc. Conducting public procurement processes (including electronic invoicing) as well as submitting declarations to government agencies will be made entirely electronic by 2013<sup>26</sup>.

In **Slovenia**, The reducing administrative burdens (RAB) system is a government programme that reviews all new and existing regulations to eliminate existing bureaucratic obstacles and prevent new ones. RAB works through an annual programme with clearly defined measures, activity leaders and deadlines.

<sup>23</sup> Source: Impact Assessment Guidance, Better Regulation Executive, Department for Business Enterprise and Regulatory Reform, UK. <http://www.berr.gov.uk/whatwedo/bre/policy/scrutinising-new-regulations/preparing-impact-assessments/page44077.html>

<sup>24</sup> [http://modernisering.dk/da/projekter/mindre\\_bureaukrati/administrative\\_lettelser\\_for\\_virksomhederne/](http://modernisering.dk/da/projekter/mindre_bureaukrati/administrative_lettelser_for_virksomhederne/)

<sup>25</sup> [www.kafka.be](http://www.kafka.be), <http://www.dav.be/showpage.php?iPageID=3&sLangCode=NL>

<sup>26</sup> [http://www.riso.ee/en/information-policy/policy-document/implementation\\_plan](http://www.riso.ee/en/information-policy/policy-document/implementation_plan)

<sup>27</sup> [http://ec.europa.eu/enterprise/enterprise\\_policy/charter/gp/index.cfm?fuseaction=practice.detail&gp\\_pk=1973&tr\\_pk=3251](http://ec.europa.eu/enterprise/enterprise_policy/charter/gp/index.cfm?fuseaction=practice.detail&gp_pk=1973&tr_pk=3251)



The project has also had a big influence on e-services provided by the Slovenian authorities through the “e-uprava” portal <http://e-uprava.gov.si/e-uprava/en/portal.euprava>. Objective: To prevent administrative obstacles by making it a requirement that bodies proposing new legislation assess the additional burden involved<sup>27</sup>.

### **Best practice examples: SME-oriented initiatives to help reduce administrative burdens**

**Cheaper and faster start-up for entrepreneurs via Single Registration Points (Czech Republic):** From 2004-2007 the Czech Ministry of Trade was responsible for setting up Single Registration Points for entrepreneurs. Legislative proposals were prepared to provide legal backing for setting up the registration points. It was decided that the registration points would be located in the Trade Licensing Office, and the employees from the Trade Licensing Office were trained so that they were able to provide the updated information stemming from the legislative proposals to entrepreneurs. In 2006, the legislative proposals came into effect, and the Single Registration Form began to be used. The registration form was updated in 2007 where a simplified two-page unified registration form was prepared. In 2008, an electronic version was introduced which allows the automatic addition of data about natural persons from civic records. The electronic version was expected to be fully operational in 2008<sup>28</sup>.

**Reducing administrative burdens and government induced costs to SMEs (Malta):** Archaic systems of licensing and registration created discrimination between shops in different localities and even between shops in the same street. Licensing fees varied not only by location but also by rental value and type of commercial activity. Hence, the Trade Services Directorate in Malta took steps to create a new system of licensing fees, aiming at encouraging new commercial activities in areas where shop rents have become very high, regenerating abandoned commercial premises, and encouraging more entrepreneurs to start a business. The new measure eliminated the discrimination between shops by applying fixed registration rates on the footprint of the shop only, e.g. 0 - 200 m<sup>2</sup>: app. 70€, 201 - 400 m<sup>2</sup>: app. 140€, and 401 - 800 m<sup>2</sup>: app. 420€. Due to this, many shops in the city centres will now benefit from reductions amounting to hundreds of € in registration fees, irrespective of type of activity and locality. Also the time for issuing a new licence has been reduced from 8 weeks to 10 working days.<sup>29</sup>

### **2.3 The role of the fragmented taxation policy within the EU**

The different tax systems within the EU present barriers for SMEs operating across borders, e.g. in terms of attracting venture capital from abroad, working for customers, contracting with partners, or hiring staff living in other Member States. Recent figures by the European Commission have shown that costs for complying with cross-border tax legislation can be up to 2.5% of turnover for small businesses, as opposed to a mere 0.02% for larger corporations. Small businesses are placed at a competitive disadvantage, since they cannot afford to indulge in “fiscal engineering” or invest in expensive “tax optimisation” services<sup>30</sup>.

The problem with taking any action at EU level in addressing cross-border issues is that it is exclusively the competence of Member States to define the tax rates applicable to businesses and individuals. Member States are initially rather reluctant to harmonise tax systems as it touches upon the very way the society is structured in each Member State.

<sup>28</sup> [http://ec.europa.eu/enterprise/enterprise\\_policy/charter/gp/index.cfm?fuseaction=practice.detail&gp\\_pk=1691&](http://ec.europa.eu/enterprise/enterprise_policy/charter/gp/index.cfm?fuseaction=practice.detail&gp_pk=1691&)

<sup>29</sup> [http://ec.europa.eu/enterprise/enterprise\\_policy/charter/gp/index.cfm?fuseaction=practice.detail&gp\\_pk=1712&tr\\_pk=2810](http://ec.europa.eu/enterprise/enterprise_policy/charter/gp/index.cfm?fuseaction=practice.detail&gp_pk=1712&tr_pk=2810)

<sup>30</sup> [http://www.ueapme.com/docs/press\\_releases/pr\\_2008/080407\\_tax\\_forum.pdf](http://www.ueapme.com/docs/press_releases/pr_2008/080407_tax_forum.pdf)

Moreover, relatively lower corporate taxes can be used by the Member States as a competitive advantage in attracting businesses, and advantage which they are likely to be reluctant to give up, if tax systems were to be harmonised.

Some recent progress has however been made on the issue of VAT. In December 2007, the ECOFIN Council gave the green light to schemes under which cross-border service providers would be subject to a single set of obligations for VAT registrations, declarations and payments in their home country, but limited their use only to services provided electronically. The European Commission's Directorate-General for Taxation and the Customs Union is currently working on two approaches to remove tax obstacles which companies face in the Internal Market, namely the Common Consolidated Tax Base and a possible pilot scheme for Home State Taxation for SMEs<sup>31</sup>. A Common Consolidated Tax Base would provide SMEs with a set of simple and workable rules, while the Home State Taxation system would allow companies operating cross-border to calculate their taxable profits on the basis of their home country's taxation system<sup>32</sup>. A proposal for these two approaches was, according to the original plan, expected during 2008, but has been delayed.

While the proposals on removing tax obstacles seem beneficial to SMEs, as it will remove some of the costs for SMEs associated with complying with different tax legislations in the different Member States, the Member States may have incentives to slow down the process. As previously mentioned, the tax schemes are an integral part of the set-up of the different social systems in the Member States, and a common set of rules may not be consistent with the tax schemes in different Member States. Moreover, the possibility for SMEs of calculating their taxable profits on the basis of their home country's taxation system may deprive the Member States' of some of the tax income that they otherwise could have gotten, which may also cause resistance to harmonisation.

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<sup>31</sup> [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm)

<sup>32</sup> [http://www.ueapme.com/docs/press\\_releases/pr\\_2008/080407\\_tax\\_forum.pdf](http://www.ueapme.com/docs/press_releases/pr_2008/080407_tax_forum.pdf)

### 3 Improving access to finance for SMEs

SMEs are faced with a number of challenges in e.g. areas like finance, research, innovation and the environment, which can affect the way SMEs operate and compete with other players. For example, about 21% of SMEs indicate that accessing finance is a problem, and in many Member States the percentage is much higher for micro-enterprises.<sup>33</sup> The SBA aims to help alleviate such challenges as they are regarded as constraining the growth and development of SMEs in Europe.

Access to finance is an area prone to be affected by the current financial crisis. The authors of this report are not in a position to assess exactly how and to what extent the financial crisis will affect SMEs' access to finance; however, the current crisis is not likely to reduce the need for action in this field.

#### 3.1 Market failures affecting SME access to finance

The policy objectives which have until now been used to address these challenges have mainly been associated with the policies that:

- Affect the rate of business start-up;
- Improve the survival or growth of existing SMEs;
- Improve the general environment for all firms while targeting effort where most benefit accrues to SMEs (e.g. information, skills, access to finance); and
- Reduce the burdens, regulations, and compliance costs for SMEs (e.g. by various special tax and exemption requirements for SMEs).<sup>34</sup>

These kinds of support policies are based on the premise that correcting these market failures will improve the business environment for SMEs, meaning that market failures can be eased through policies and other institutional instruments. One of the market failures addressed in the SBA concerns the aforementioned lack of availability of financing for SMEs. The SBA sets out to find new ways for attracting risk and venture capital for SMEs, resting on the premise that small businesses are denied adequate credit in the free market because of market failures. According to theory, in a perfect market, lenders (providers of risk and venture capital) would increase their prices to adjust for the higher risk of lending to SMEs, and in equilibrium, no small businesses would be left without access to credit.

The aforementioned 21% of SMEs needing finance however indicate that European capital markets are not perfect and small businesses cannot always get the capital they need to get started or to expand. One of the reasons for this could be that the SMEs are not aware of – or do not have the possibilities to examine - the available sources for finance, which in turn leads to a suboptimal use of these sources.

Different explanations are offered for this “equity paradox”, including on the demand side that there is asymmetric information between the entrepreneurs' and investors' worlds. Entrepreneurs may confuse risk capital and credit. Also, many SMEs/entrepreneurs only use debt financing, but banks have a tendency to be less willing to lend money to indebted SMEs. This tendency is thus creating a vicious circle that makes it more difficult for SMEs to loan money from banks, and if they are not aware of other financing possibilities this is a serious problem.

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<sup>33</sup> [http://ec.europa.eu/enterprise/entrepreneurship/docs/sba/com\\_2008\\_394\\_sba.pdf](http://ec.europa.eu/enterprise/entrepreneurship/docs/sba/com_2008_394_sba.pdf)

<sup>34</sup> <http://www.envplan.com/abstract.cgi?id=c07118>

Secondly, entrepreneurs may not be well enough prepared for meetings with potential investors. Lastly, the entrepreneurs and the investors may have different perceptions of the innovativeness of the entrepreneurs' projects<sup>35</sup>. Also, it seems that while the offer of risk capital is there, not enough equity is dedicated to seed or early stage investment<sup>36</sup>.

It should also be noted that of the 21% of SMEs not getting the finance they need, it is not clear if their projects were financially viable, if they had made a solid business plan/concept etc. The question still remains what kinds of SMEs that are not receiving finance. If it is the ones with unviable business plans, which are not likely to survive regardless of future capital investment, the tendency can actually be seen as healthy. On the other hand, if SMEs with strong projects cannot receive funding, this indicates a market failure that should be looked further into.

The Commission defines market failures as "cases where it is believed that a serious misallocation of resources has occurred"<sup>37</sup>. There are two main sources of market failure relevant to risk capital markets which particularly affect access to capital by SMEs and companies at the early stages of their development and which may justify public intervention<sup>38</sup>:

- Imperfect or asymmetric information: potential investors face more difficulties in gathering reliable information on the business prospects of an SME or a new company. Particularly if these are involved in highly innovative projects or risky projects, imperfect information will aggravate problems related to difficulties in the assessment of risk;
- Transaction costs: small deals are less attractive to investment funds due to relatively high costs for investment appraisal and other transaction costs.

Based on the above definition, it can be seen that market failures exist in the sense that asymmetric information seem to exist – both in the sense that potential investors do not have all the needed information from the SMEs, but also in the sense that SMEs are not aware of the different funding opportunities available to them. With respect to transaction costs, it might be that small deals are less attractive to some investment funds – both other funding types such as micro credits, mezzanine funding and business angels are available for SMEs. Again, the challenge is to make SMEs aware of the funding types present in the market.

An issue in Europe has traditionally been that when making Euro retail payments in other Euro area countries, stakeholders were subject to different rules and requirements depending on their country of origin<sup>39</sup>, and these payments therefore often turned out to be time-consuming. This has especially been problematic for SMEs, for which it was too expensive to establish and maintain bank accounts in the countries in which they do business, in order to manage their payments. However, the recent initiative Single Euro Payments Area (SEPA) which was launched in January 2008 has helped businesses overcome this. SEPA involves the creation of a Euro-zone in which all electronic payments are considered domestic, and difference between national payments and cross border payments among Member States thus does not exist<sup>40</sup>.

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<sup>35</sup> Eurada (2004): All money is not the same! SME access to finance

<sup>36</sup> Eurada (2004): All money is not the same! SME access to finance

<sup>37</sup> Official Journal of the European Communities: State Aid and Risk Capital (2001/C 235/03)

<sup>38</sup> Official Journal of the European Communities: State Aid and Risk Capital (2001/C 235/03)

<sup>39</sup> European Commission (2006): SEPA Brochure

<sup>40</sup> Contractlessnews (2007): SEPA strives to ease electronic payments across European Union

Another problem for companies, which again especially has been a problem for SMEs, is the differences in national accounting standards. These differences have recently started to decline with the International Accounting Standards' Board's (IASB) introduction of a set of international financial reporting standards (IFRS) in January 2005. However, many private entities say that full IFRS impose a burden on small private entity preparers — a burden that has been growing as IFRS have become more detailed and more countries have begun to use them.

This could be characterized as a market failure for SMEs, however, the IASB responded to this by developing International Financial Reporting Standards for Small and Medium-Sized Entities (renamed IFRS for Private Entities), which was released in September 2008. The IFRS for Private Entities aims at developing an International Financial Reporting Standard (IFRS) expressly designed to meet the financial reporting needs of entities that do not have public accountability and publish general purpose financial statements for external users<sup>41</sup>. Hence, the unfair burdens put on SMEs with the full IFRS seem to be lifted in the near future.

Finance providers' requirements for SMEs to be eligible for mezzanine and micro credits have been mentioned as a possible market failure. It is true that the providers of such loans have rather strict requirements for a feasible business idea, a solid business plan etc<sup>42</sup>. However, certain providers of these loan types, such as French ADIE, Dutch Startersfond Amsterdam and German Investitionsbank Berlin also have a social focus of creating jobs and self-support in areas with a high level of unemployment.

For instance, the French-based company ADIE has established work-sharing partnerships with over 50 French banks: the micro-finance organisation looks after the loan and the banks are responsible for handling repayment. Since 1994, around 10 000 'solidarity loans', with a total volume of more than EUR 30 million, have been awarded. The repayment rate is currently 93% and is expected to increase even further. Compared to the cost borne by the French government for one unemployed individual (around EUR 18 000), the costs of subsidising a founder, between EUR 1 800 to EUR 3 000, are very low. This investment can also be termed sustainable, because the average survival rate amongst the companies established using this money, 75% after two years and 52% after five years, is in line with the French average<sup>43</sup>. So there are currently mechanisms in the market to offset a possible market failure.

However, investment capital is definitely an issue for SMEs, and they have not had sufficient access to it<sup>44</sup>. Since 2001, the availability of risk capital for SMEs has been declining<sup>45</sup>. This can partly be explained by the fact that the availability of venture capital is highly determined by the state of the economy, which means that in 2001 with the IT-bubble burst, access to venture capital for SMEs was limited. However, in 2006, when there was a boom in the Euro zone in general, a study showed that on average, more than three quarters of the SMEs had sufficient financing to see their projects through.

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<sup>41</sup><http://www.iasb.org/NR/rdonlyres/BBF5F938-93E7-44D1-85FD-A87D35415F03/0/SMEprojectupdateAug2008.pdf>

<sup>42</sup><http://www3.kk.dk/FaktaOmKommunen/PublikationerOgRapporter/Rapporter/~media/publikationer/Voksenuddannelse/Publikation/flere%20etniske%20virksomheder.pdf.ashx> and [http://www.oecd.org/secure/pdfDocument/0,2834,en\\_21571361\\_40643279\\_39144920\\_1\\_1\\_1\\_1,00.pdf](http://www.oecd.org/secure/pdfDocument/0,2834,en_21571361_40643279_39144920_1_1_1_1,00.pdf)

<sup>43</sup> [http://www.oecd.org/secure/pdfDocument/0,2834,en\\_21571361\\_40643279\\_39144920\\_1\\_1\\_1\\_1,00.pdf](http://www.oecd.org/secure/pdfDocument/0,2834,en_21571361_40643279_39144920_1_1_1_1,00.pdf)

<sup>44</sup> European Commission, DG ENTR and United States Department of Commerce, International Trade Administration (2005): Working group on Venture Capital, Final Report

<sup>45</sup> European Parliament, DG Internal Policies of the Union (2005): Access to Finance and venture Capital for Industrial SMEs

The survey however revealed large differences between countries<sup>46</sup>, but still indicates that the European risk/venture capital market might be (too) dependent upon the state of the economy. This makes it even more important for there to be alternative financing sources such as access to mezzanine and micro credits available for SMEs.

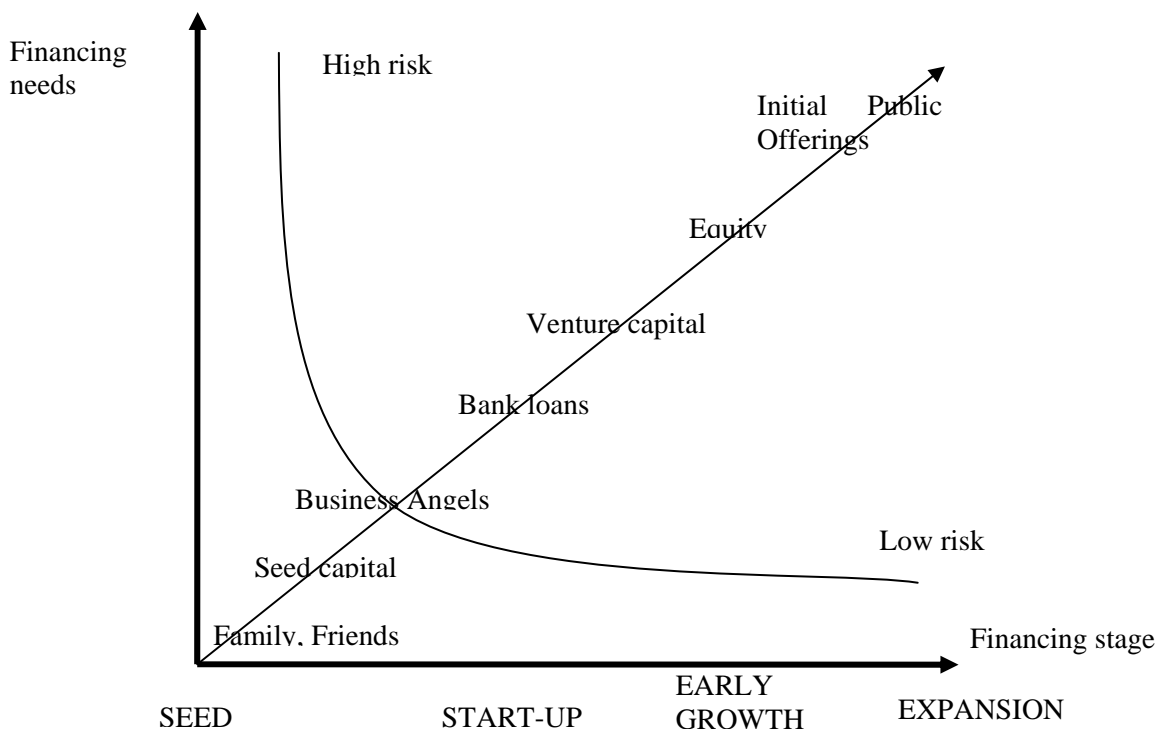
### 3.2 Measures proposed in the SBA

It is our impression that the proposed measures of the SBA are relevant. Below we have commented on two important proposals, namely the development of alternative financing tools and the taxation system.

#### 3.2.1 Development of alternative financing tools such as mezzanine finance

In its SME consultation, the EIB states that SMEs continue to depend mostly on bank debt as a means of finance. Showing a high indebtedness in the balance sheet impedes the chances to obtain further loan financing for expansion phases. A high dependence on lending in many SMEs can influence the access to further lending, thus creating a vicious circle<sup>47</sup>.

The reluctance of banks to offer additional loans if companies show high indebtedness means that - besides maintaining a strong presence in classical loan financing – SMEs will have to be made aware of the alternative financing tools present in the market. Which type of funding to aim for depends on where the SME is in its lifecycle, as the different funding sources available are often tailored to a specific stage in a SMEs' life cycle. The below graph gives an overview of the different loan types which could be relevant for SMEs in their different life cycles.



Source: Inspired by Eurada (2004): All Money is Not the Same! SME Access to Finance

<sup>46</sup> European Commission, DG ENTR and United States Department of Commerce, International Trade Administration (2005): Working group on Venture Capital, Final Report

<sup>47</sup> UEAPME (2004): UEAPME Position Paper on the Future of SME Finance

There is currently a low use of risk capital in SMEs, which is often a result of the entrepreneurial culture particular for SMEs, as it is more difficult for an individual entrepreneur to accept a financial investor to participate in the decisions about the development of his company than for owners and managers of large companies<sup>48</sup>. Another solution for SMEs is mezzanine finance, which does not give the financial investor owner status and influence. Moreover, the costs in relation to the loan depend on the company's economic performance, which is favourable for especially SMEs.

However, the development of mezzanine financing demands that a market for mezzanine financing be developed, including appropriate financial tools, but also based on an increased awareness building amongst SMEs through advisory and technical assistance programmes<sup>49</sup>. Financial institutions that have the task of improving SMEs' access to finance should develop programmes of mezzanine finance focusing on smaller amounts. In particular, securitisation of such mezzanine finance should be facilitated and the Member States should encourage the expansion of the mezzanine finance market overall<sup>50</sup>. In this context, an institution such as the European Investment Bank could play a specific role in close cooperation with the European Commission<sup>51</sup>.

### **3.2.2 Taxation system**

One of the reasons why SMEs increasingly rely on bank debt as a means of finance could be that the SMEs may not have the incentive to finance growth through retention of earnings, as this is closely linked to taxation<sup>52</sup>. If the company and income taxation systems provide the company with negative incentives to build up capital within the companies by reinvesting the profit, this may prevent companies from doing this. This can be especially harmful to SMEs as they may not have other options than debt-financing at hand.

Lower tax rates for SMEs as proposed in the SBA could be beneficial as, in general, companies in the EU Member States experience a lock-in effect, where the total tax burden on companies increases when companies distribute their profits. For SMEs, the tax increase can be a problem as they often have to distribute at least part of their profit (for instance, if the owner/shareholders need it to live on). If the tax liability is low, companies are able to reinvest an increasing part of their profits, which makes it possible for even SMEs to build up equity and become less dependent on bank lending. Moreover, lowering tax rates is a favoured measure by Business Owners that is expected to promote greater retention of earnings<sup>53</sup>. It could therefore be beneficial to introduce specific tax rates for new SMEs<sup>54</sup>.

More and more Member States are already introducing reduced tax rates for SMEs, while ensuring that the reduced tax rates are operative under certain conditions so that they are only beneficial to SMEs<sup>55</sup>. An example of a country promoting this is France, which is presented below:

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<sup>48</sup> European Investment Bank (2008): SME Consultation 2007/2008 – Findings and Conclusions

<sup>49</sup> European Investment Bank (2008): SME Consultation 2007/2008 – Findings and Conclusions

<sup>50</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions

<sup>51</sup> European Investment Bank (2008): SME Consultation 2007/2008 – Findings and Conclusions

<sup>52</sup> Hoche (2008): Study on Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity

<sup>53</sup> Hoche (2008): Study on Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity

<sup>54</sup> European Parliament, DG Internal Policies of the Union (2005): Access to Finance and venture Capital for Industrial SMEs

<sup>55</sup> Hoche (2008): Study on Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity

Best practice example:

**France** has introduced a system which reduces tax rates for SMEs. Starting rates at 0% apply for newly created companies in the first two years, followed by a modest taxation of 15% for SMEs. These tax concessions are granted to corporations until they reach certain profit or turnover levels. **The UK** has introduced a similar system.

However, it might not be sufficient to set a limit on certain profits or turnovers, as this could promote socially sub-optimal behaviour among companies, using different means to stay SMEs in order to make use of the favourable tax rates. Instead, we propose to set a fixed time period in which the company can benefit from the modest taxation rates. After a certain period of time, the company, SME or not, will be subject to the same tax rates as larger companies. Another solution could be to only allow micro-enterprises the modest taxation rates after a certain period of time.

#### **Recommendation:**

**Lower tax rates should be introduced for SMEs as proposed in the SBA. However, this should only be applicable for a certain period of time in order not to promote socially sub-optimal behaviour. The rates could possibly continue for micro-enterprises.**

### **3.3 Measures that could be taken on community level to provide the right kind of finance**

#### **3.3.1 Abolishment of thin capitalisation rules**

Thin capitalisation refers to the possibility for an owner of a company to take up loans in the company in question. For instance, if company A owns company B, company A can take up loans in company B. This opens up for the possibility of the owner to keep the debt in company B, which will then be entitled to a deduction on the interest of the loan, while company A can have its income registered in another country with low or no tax rates.

This has been deemed unfair by numerous Member States and thin capitalisation rules have been set up to avoid this. For instance, in Denmark, if a company's debt surpasses its equity with more than a factor 4:1, the right to deduct interest and possibly capital loss is limited<sup>56</sup>.

Hence, thin capitalisation rules limits the SMEs' possibility to choose their own financing means, and can contribute to SMEs continuously relying on debt financing. This can be problematic as high indebtedness in SMEs sometimes discourage banks to lend the entrepreneur more money. Hence, the abolishment of thin capitalisation rules<sup>57</sup> initially seems beneficial for SMEs, as we agree that a shareholder's freedom of financing his own corporation is highly important. However, a number of issues should be discussed.

First of all, many smaller companies are family-owned and are not influenced by the thin capitalisation rules. Hence, this way of taking up loans are not relevant for them and thus, abolishment of thin capitalisation rules does not create an alternative loan type for them. Secondly, there is always the possibility that companies may take advantage of the situation and move the profit away from the EU and into a tax haven. SMEs in the EU differ largely in size and it could be beneficial to discuss how many SMEs the abolishment will actually affect.

<sup>56</sup> Revitax (2004): Skatteinformation August 2004 (in Danish)

<sup>57</sup> European Parliament, DG Internal Policies of the Union (2005): Access to Finance and venture Capital for Industrial SMEs



As discussed above, debt financing is tax-privileged compared to equity financing in most Member States, and this can be inconvenient for especially SMEs as their dependence on debt financing can make it difficult for them to loan additional money in the banks. The fact that debt financing is tax privileged compared to equity financing is not helping SMEs focus more on equity financing. Taking the above comments into account, we still believe that equity financing across Europe should be treated similar to the interest treatment of debt financing<sup>58</sup>. This practise is not very widespread in the EU, where only Austria treats equity financing differently to the other countries.

Best practice example:

In **Austria**, equity financing is treated the same way as debt financing<sup>59</sup>. There are no specific thin capitalisation rules in Austria, but certain broad and rather liberal guidelines are established, which are used to determine whether the equity for commercial purposes is adequate for the purpose of taxation. If the equity is inadequate, a portion of the indebtedness to shareholders may be regarded as the equivalent of shareholders' equity. Such interest may not be deducted from the taxable income.

Any changes to Member States' taxation system must be initiated by the Member States themselves, as these are the ones responsible.

#### **Recommendation:**

**Equity financing should be treated the same way as debt financing. Member States should initiate a change in the taxation system.**

### ***3.3.2 Open up for lending by institutions that are not banks***

The Small Business Act discusses how to facilitate SMEs' access to finance, in particular risk capital such as venture capital, micro-credit and mezzanine finance. One way of doing so is for the EU to allow lending by institutions that are not banks. In order to make SMEs less dependent on bank lending, and thereby open up the possibilities for SMEs to have increased access to external risk capital, institutions that are not banks should be introduced to a greater extent to the market. As can be seen from the above table on different types of funding possibilities for SMEs, there are numerous funding possibilities other than banks, including business angels and venture capital. Equity funding could also be promoted to a larger extent<sup>60</sup>.

One way to open up for lending by institutions that are not banks could be to increase the availability of venture capital through tax incentives for private investors. The conditions for investment of venture capital in SMEs can be improved via the development of a secondary market for such investments.<sup>61</sup>

Another way to promote lending by institutions that are not banks is to open up for micro credit schemes. National legislation could allow a range of financial institutions to lend, including institutions focusing on micro credits, which is possible under the European banking legislation.

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<sup>58</sup> European Parliament, DG Internal Policies of the Union (2005): Access to Finance and venture Capital for Industrial SMEs

<sup>59</sup> European Parliament, DG Internal Policies of the Union (2005): Access to Finance and venture Capital for Industrial SMEs

<sup>60</sup> Eurada (2004): All Money is Not the Same! SME Access to Finance

<sup>61</sup> UEAPME (2004): Unlocking the Doors to SME Finance

This would be especially beneficial for those borrowers that cannot get loans from banks, for example people that are socially or financially excluded or companies with great indebtedness which banks are reluctant to lend money, as micro-credit sets out both to assist micro enterprises and so-called “disadvantaged people” (unemployed or inactive people, immigrants, etc.) Hence, aside from providing an alternative to traditional loans in banks, micro credits can also help to move people from unemployment into self-employment, thus promoting social security<sup>62</sup>. Potential benefits for Member States include reduction in unemployment and its costs if the expanded provision of micro credit leads to increased self-employment<sup>63</sup>. The EU could play a role in promoting this secondary market, in co-operation with Member States.

The above also implies that the Member States should pay attention to the framework regulating micro credit providers that are not banks. The issues that need to be addressed do not necessarily need legislation. They include the registration and legal charters of entities; the disclosure of ownership and control; the publication of financial statements; the transparent disclosure of interest rates to clients; and the submission of names of borrowers and status of their loans to credit bureaus<sup>64</sup>.

#### **Recommendation:**

**Lending by institutions that are not banks should be more present in the EU. The EU and the Member States should pave the way for this possibility. The EU should initiate activities to investigate how this could be done in practice.**

This conclusion will obviously depend heavily on what will happen in the financial markets in the nearby future. It is at the moment very uncertain how the future size and scope of the financial markets will look like, and this should be taken into consideration when reading these conclusions. With the current financial situation, venture capitalists may have problems raising money to fund the entrepreneurial project.

In a recent report from the Danish entrepreneurial organisation Vækstfonden, it can be seen that in Denmark, the investments have gone down a bit in the ICT segment in Q2 2008 compared to Q1<sup>65</sup>. The tendency is however not seen in the other segments, but if the financial turmoil continues there is a risk that investments might go down. However, it should also be noted that the financial institutions that are not banks are not there to fund the more dubious companies, but merely to act as an alternative for SMEs that seek to avoid debt-financing. Thus, in spite of the financial crisis there might still be room to increase a secondary market for financing in the EU.

One way to promote increased lending by institutions that are not banks could be to enhance investor cooperation in seed investment, paying particular attention to business angels, by identifying and spreading good practices<sup>66</sup>.

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<sup>62</sup> Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions (2007): A European initiative for the development of micro-credit in support of growth and employment

<sup>63</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions

<sup>64</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions

<sup>65</sup> Vækstfonden (2008): Analyse 2. kvartal 2008: Det danske venturemarked – investeringer og forventninger

<sup>66</sup> European Commission (2006): Communication from the Commission to the Council, the European Parliament, The European Economic and Social Committee and the Committee of the Regions: Implementing the Lisbon Programme: Financing SME Growth – Adding European Value

The number of angel networks and active angels has increased in Europe. However, the picture is uneven, as many Member States need further work to attract more investors to become business angels and more entrepreneurs to become aware of the possibilities for business angel funding<sup>67</sup>.

Best practice example:

The European Business Angels Network is a cross-border initiative in the EU aiming at bringing together business angels and innovative young companies or start ups with good growth prospects. The business angels normally invest 25,000-250,000€ in a business, and *can* (but will not necessarily) become involved in the business as “active angels”, helping the entrepreneurs by sharing their managerial skills, specialist knowledge and networks. In turn, the angels will seek entrepreneurs with a strong business plan and a committed management, which means that this type of financing is mainly used in the start-up and early growth phases<sup>68</sup>.

The **UK** is currently one of the most developed angel markets, with the National Trade Association and the British Business Angels Association spearheading this development<sup>69</sup>.

### 3.3.3 *Micro Credits and Guarantee Schemes*

In addition to access to lending by institutions that are not banks, it is also important that banks are able to provide the kinds of loans that are necessary for SMEs. As mentioned, not all SMEs are willing to engage in venture funding as they are not used – or willing – to have foreign investors engaged in their business. Thus, a better solution for some SMEs is to continue with the bank lending. In this respect, it is important that the kinds of loans applicable for SMEs are available in banks.

These loans are for instance micro credits. Micro credits are also mentioned in the Small Business Act as one of the loan types that SMEs should have further access to, and can as previously mentioned also be offered by lending institutions that are not banks. As the benefits of micro credits are not only to provide suitable loans to micro enterprises, but also to move people from unemployment to self-employment, thus playing an important role in improving social inclusion and possibly even helping to integrate ethnic minorities, a favourable environment for micro credits should be established. To achieve this, the legal and institutional environment in the Member States could be improved<sup>70</sup>. Two issues are believed to be important in this regard:

Some Member States cap the interest rates that banks can charge, and if these caps are too low, they can hinder the provision of micro credit. As micro credit has higher risk and higher administrative costs, this needs to be reflected in the interest rate. In the long term, appropriate interest rates on micro loans should make risk-adjusted, cost-covering lending to business sustainable. However, Member States should ensure that there are minimum quality standards for the pricing of micro credit<sup>71</sup>.

<sup>67</sup> [http://www.insme.org/documents/EBAN\\_BA\\_Aug2006\\_EN.pdf](http://www.insme.org/documents/EBAN_BA_Aug2006_EN.pdf)

<sup>68</sup> <http://www.eban.org/>

<sup>69</sup> [http://www.eban.org/download/Standard%20EBAN%20Presentation\\_2008.ppt#275,13](http://www.eban.org/download/Standard%20EBAN%20Presentation_2008.ppt#275,13), Case Study: UK

<sup>70</sup> Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions (2007): A European initiative for the development of micro-credit in support of growth and employment

<sup>71</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions, and Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions (2007): A European initiative for the development of micro-credit in support of growth and employment

With the current financial situation, the high-risk micro credits might not be a solution that banks will promote extensively, but as it may be expected that the current financial crisis is temporary it might be relevant for banks to offer these loan types in the long run. However, it is very difficult to foresee how the financial markets will look like in the future; these recommendations should definitely be seen in the light of the further development in the financial sector.

#### **Recommendation:**

**Micro credits should be available in banks, and Member States should cap the interest rates that banks can charge at an appropriate level, so that the incentive for banks to supply micro credits is present. The EU should initiate activities to investigate the differences between Member State systems in this respect, and whether there is basis for regulation at Community level.**

However, banks should also have an incentive to engage in high-risk loan types such as micro credits. Increasing risk awareness by banks and the stricter interpretation of State Aid Rules will further increase the need for public support<sup>72</sup>. One way of making loan types such as micro credits more appealing to the banks is to introduce credit guarantee schemes to compensate the cautious attitude of the bank sector with regard to SME lending. This has been done in various countries, such as Greece, the UK, and Germany.

#### Best practice examples:

**Greece** has created a guarantee fund for Small and Very Small Enterprises providing guarantees to financial institutions on behalf of SMEs. The programme, Tempe, aims to improve the competitiveness of Greek enterprises, the quality and promotion of their products and services as well as the fulfilment of market needs and demands. The program focuses on the application of new technologies and innovation. Investment objectives include new start-ups, modernisation, improvement, expansion and fulfilment of needs and demands presented by existing enterprises, the technological and organisational development, as well as the introduction of innovation in the organisational structure of enterprises, the creation and development of new products and services and/or the improvement of existing ones, and the improvement of marketing and the development of contemporary logistics systems<sup>73</sup>.

**The UK** has operated an SME guarantee mechanism since 1981 but has recently reviewed and renewed it in terms of simplifying SME eligibility; providing increasing certainty etc. The Government funds 75 per cent of the Small Firms Loan Guarantee Scheme (SFLGS). This takes some of the risk away from the lender, making banks more willing to lend money to SMEs. Loan applicants are still very thoroughly checked and there are limits as to who can apply. A UK business that has been charged corporation tax for less than five years, with annual sales of less than £5.6 million is eligible. The scheme is provided by 27 participating lenders, including a number of high street banks, which can support SMEs with up to £250,000 for a maximum ten-year term<sup>74</sup>.

**Germany** has established a microfinance fund, which, for a fee, will take on the whole default risk for any banks providing microfinance. The fund supports microlenders in Germany to disburse small loans and thereby improves start-ups' and small enterprises' access to finance.

<sup>72</sup> UEAPME (2004): Crafts, Trades and SMEs need better access to finance

<sup>73</sup> [http://www.tempme.gr/en/products/pdf/Pr\\_4\\_en.pdf](http://www.tempme.gr/en/products/pdf/Pr_4_en.pdf)

<sup>74</sup> <http://www.smallbusiness.co.uk/channels/small-business-finance/dont-miss/30582/small-firms-loan-guarantee-scheme-explained.shtml>

<sup>75</sup> [http://ec.europa.eu/enterprise/enterprise\\_policy/charter/conf2007/p59510en.pdf](http://ec.europa.eu/enterprise/enterprise_policy/charter/conf2007/p59510en.pdf)

A central promotional impact is based on the interlocking of finance and entrepreneurial advice. The fund is backed by two development banks (GLS bank and the German government-backed development bank, KfW) and two German ministries, Economic affairs and Technology, and Labour and Social Affairs<sup>75</sup>.

Past experiences have shown that public funds used to support credit guarantee schemes have an exceptionally high multiplying effect (one Euro for guarantee schemes can stimulate up to 30 Euros' investment). The Member States could establish guarantee schemes or funds to take the risk for banks providing microfinance. Other instruments, such as the securitisation of banks' SME portfolios by the European Investment Fund could also help SMEs to have a greater level of self-finance<sup>76</sup>.

**Recommendation:**

**Credit guarantee schemes or funds could be established by Member States and used to secure banks' high risk loans, thus making them more willing to provide micro credits to SMEs. The EU can provide support in the form of exchange of best practices.**

Again, with the current situation on the financial markets this might not be a solution that Member States are able to provide banks with as of now. It might be a solution in the long run when the financial markets hopefully have regained their calm, but it will entirely depend on the future outlook for the financial sector.

**3.3.4 Single market for risk capital, such as venture capital**

Risk capital and external equity financing do not have a strong tradition among SMEs. This can on the one hand be due to the fact that small enterprises and family businesses have traditionally not been very open towards outside equity financing and are not used to the duties associated with this, such as informing transparently about their business.

On the other hand, many investors of equity finance, such as venture capitalists, are reluctant to invest small amounts in small companies, which may be more costly than investing larger amounts in large companies, as it might be more difficult to gain from the investments in smaller companies.

However, external equity financing could be an important instrument for highly innovative start-ups and fast growing companies, and it could also be an alternative financing tool helping to break the vicious circle of SMEs increasingly relying on bank financing. The Small Business Act also discusses this and notes that the Commission should evaluate the options for a private placement regime destined to strengthen European venture capital markets. In terms of availability of venture capital, the Member States could review their taxation systems in order to create incentives to invest private money in all forms of venture capital. Moreover, as previously mentioned, guarantee instruments for equity financing could also be further developed.<sup>77</sup>

The venture capital markets in the EU are largely domestic and therefore smaller than the market in the US. Hence, Member States should recognise venture capital funds from elsewhere in the EU as being equivalent to domestically registered funds. This would mean that a fund would be established and registered only in its home Member State but would be able to invest in others with the same terms as domestic funds.

<sup>76</sup> UEAPME (2004): Unlocking the Doors to SME Finance

<sup>77</sup> UEAPME (2004): UEAPME Position Paper on the Future of SME Finance

For this to happen, the competent Member State authorities should recognise that venture capital funds from other Member States are subject to equivalent regulatory regimes in their home country<sup>78</sup>. The Commission moreover aims at working towards a single market for venture capital funds that allow investments across borders without red tape<sup>79</sup>.

In concrete terms, the EU could promote a single market for venture capital in order for the funds to be able to invest cross-border, thus increasing the access to venture capital for all companies. This is especially expected to benefit SMEs, as their ability to seek funding outside their own country is believed to be limited due to lack of resources.

**Recommendation:**

**The EU should promote a single market for risk capital such as venture capital in order to increase the access to venture capital for SMEs.**

### *3.3.5 Increase awareness about the need for transparency towards investors*

If the market for venture capital is to be developed further, it is also important that SMEs realise what is needed from them in order for venture capitalists to invest in their company. SME owners will have to realise that in future, access to external finance (venture capital or lending) will depend much more on a transparent and open exchange of information about the situation and the perspectives of their companies. In order to fulfil these needs for transparency, SMEs will have to use new information instruments (business plans, financial reporting, etc.) and new management instruments (risk-management, financial management, etc.). Owner-managers must become more aware about the need for transparency towards investors<sup>80</sup>. However, as this is partly a question of resources and partly a cultural aspect, it should be recognised that it will take time for SMEs to get used to these requirements. Industry organisations could play a role in helping the SMEs with the paperwork and/or informing the SMEs of the potential benefits of private funding.

**Recommendation:**

**Increased transparency and open exchange of information is needed from SMEs if venture capitalists are to invest more in SMEs. Industry organisations could play a role in helping SMEs adjust.**

### *3.3.6 Transfer of losses*

A possibility of transferring losses on future tax years for SMEs in all Member States could be beneficial, as a young company is likely to generate losses in its first years of operation. Without a loss carry-forward option, the company's future business can be made very difficult<sup>81</sup>. It is in the hands of the Member States to promote such a system.

**Recommendation:**

**Loss carry-forward should be applicable for SMEs in all Member States, promoted by the Member States.**

<sup>78</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions

<sup>79</sup> European Commission (2006): Communication from the Commission to the Council, the European Parliament, The European Economic and Social Committee and the Committee of the Regions: Implementing the Lisbon Programme: Financing SME Growth – Adding European Value

<sup>80</sup> UEAPME (2004): UEAPME Position Paper on the Future of SME Finance

<sup>81</sup> European Parliament, DG Internal Policies of the Union (2005): Access to Finance and venture Capital for Industrial SMEs

### 3.4 Practical guidance and education for SMEs regarding access to finance

The guidance and education for SMEs are real concerns that should be taken into consideration by the EU. An SME consultation held by the EIB showed that the knowledge about EIB's products and intervention was rather limited on the SME side. This is also true for EU instruments and available state-supported national schemes<sup>82</sup>.

#### 3.4.1 Education of SMEs regarding financing tools and how to attract financing

As previously mentioned, loan types such as mezzanine financing has the potential to be beneficial for SMEs. However, it is important that SMEs are aware that this loan type exists and that they are aware of its potential benefits. Banks, banking associations, financial advisors (such as accountants) and SME associations (such as UEAPME) should consider introducing information programmes which would educate SMEs about alternative financing tools such as mezzanine finance<sup>83</sup>. Moreover, SMEs might need a better understanding of the financial terminology and concepts.

Banking associations could also initiate a dialogue with industry organisations, in particular SME organisations, about ways of increasing mutual understanding and arrange the training courses. The associations and SME organisations could also cooperate in developing tutorials and glossaries<sup>84</sup>. The EU could support this process by providing a forum for such discussions<sup>85</sup>, in the form of grant schemes to develop the tutorials and glossaries, or in the form of facilitating exchange of best practise among the banking associations and industry organisations.

An example of an organisation assisting SMEs with different issues, including finance, is Business Link Central Denmark. The set-up could be used and the guidance directed more towards financial guidance, if needed in a European context.

#### Best Practise Example:

Business Link Central Denmark is a non-profit organisation from **Denmark**, partly financed by national and regional authorities. Business Link Central Denmark is responsible for business support in the Central Denmark Region, and is active in creating the appropriate instruments and services for the growth of entrepreneurial businesses and SMEs in the Central Denmark Region. Business Link Central Denmark is specialised in assisting entrepreneurs and SMEs with growth and development of their businesses, and has among other things developed [www.100svar.dk](http://www.100svar.dk) (100answers) - the second most used web site in Denmark for entrepreneurs<sup>86</sup>.

Furthermore, SMEs can to a large extent use their intellectual property to attract finance. Intellectual property, human capital and organisational capabilities are responsible for an increasing share of the market value of firms. However, few innovative SMEs are aware of the value of their intellectual property, or of the potential that their patent portfolio provides for attracting finance, and intellectual property is often only viewed as a legal protection issue<sup>87</sup>. How SMEs can make the most of their intellectual property could be an important element in the training and information activities proposed above.

<sup>82</sup> European Investment Bank (2008): SME Consultation 2007/2008: Findings and Conclusions

<sup>83</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions

<sup>84</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions

<sup>85</sup> European Commission, DG INFSO (2007): Financing small businesses: Recommendations for actions

<sup>86</sup> <http://www.startvaekst.dk/vhmidtjylland.dk/english>

<sup>87</sup> European Commission, DG ENTR (2007): Financing innovation and SMEs: sowing the seeds

Hence, the following is recommended:

**Recommendation:**

**Banking associations and industry organisations (in particular SME organisations) could work together to arrange training courses for SMEs on alternative financing tools and how to attract alternative financing, including making them aware of the value of their intellectual property and how this can be utilised to attract financing. The EU could support this work in the form of grant schemes or providing a forum for knowledge sharing.**



## 4 SME participation in EU programmes

In this section, we first briefly summarise the efforts made and results achieved in involving SMEs in a number of EU programmes:

- The Sixth Framework Programme for Research (FP6)
- The Seventh Framework Programme for Research (FP7)
- The Competitiveness and Innovation Programme (CIP)
- The Structural Funds, and
- JEREMIE

### 4.1 SME aspects of relevant EU programmes

#### 4.1.1 FP6 (2002-2006)

Overall SME participation in the FP6 (in terms of funding) was 16%. The target was 15%, and as such, the programme fulfilled its objective in that respect. However, the position and participation of small and medium sized enterprises (SMEs) in the new instruments introduced in FP6 (Networks of Excellence – NoEs, and Integrated Projects – IPs) was not satisfactory (the overall average of 13% seems reasonable, but there are some difficulties in interpreting the figures, since e.g. small public sector organisations are also categorised as SMEs). According to the so-called Marimon report<sup>88</sup>, SMEs found it almost impossible to become involved in NoEs and tended to be dominated by larger organisations and disadvantaged in IPs. In general, SMEs preferred the traditional FP instruments of STREPS, Cooperative (CRAFT) and Collective Research. The overall barriers to SME participation in FP6 were:

- the high cost of making a proposal;
- the complexity and investment involved in managing large consortia and projects;
- the high responsibility of the co-ordinator;
- the long duration of projects: risks associated with it and the long-term commitments

Specifically for the ICT-oriented part of FP6 (IST-FP6), for which more data are available<sup>89</sup>, the level of participation of SMEs was sustained at more than 20% of participants (although fewer in the new instruments such as Networks of Excellence), but the SME participants were not very growth-oriented. Thus, although a fair number of SMEs participated in the programme, there were major barriers to involving the most innovative and growth-oriented SMEs.

In addition, a study on innovative ICT SMEs showed that only 22% of innovative European SMEs in the ICT sector receive funding from research and innovation programmes, and only around 5% of SMEs holding highly cited ICT patents participated in FP6. The long time to market and the complexities of participating in FP6 projects (cf. the issues mentioned above) were some of the barriers most often cited, but barriers also included concerns over lack of IPR protection<sup>90</sup>.

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<sup>88</sup> Evaluation of the effectiveness of the New Instruments of Framework Programme VI, Report of a High-level Expert Panel chaired by Professor Ramon Marimon, 21 June 2004

<sup>89</sup> Information Society Research and Innovation, Evidence Synthesis Report prepared for the evaluation of the IST Thematic Priority of the 6<sup>th</sup> FP, DG Information Society and Media, June 2008.

<sup>90</sup> IDC EMEA: Study on Innovative ICT SMEs in Europe (EU 25). Final Study Report D 5.3., DG Information Society, 31 October 2007

### 4.1.2 FP7 (2007-2013)

The first report on SME participation in FP7, which focuses on the Cooperation programme, reveals that increasing numbers of SMEs are participating in the various themes of FP7 compared with FP6: 29% of participants in research proposals were SMEs compared with 22.5% in FP6 (numbers on participation in *funded* projects are not provided). This also means that consortia are increasingly disposed to including SME participants in their research. The simplification procedures introduced in FP7 thus seem to have contributed to SMEs increasing their share of the research pie. Such procedures include less frequent reporting, the reduced need for audit certificates and bank guarantees, and increased funding levels for research - with the upper funding ceiling for SMEs being increased to 75% from the 50% that was available under FP6<sup>91</sup>.

The FP7 maintains its target of 15% SME participation, which is the same as for FP6. Throughout the seven years of FP7, the Community will have allocated over EUR 32 billion to collaborative research projects under the banner of the Cooperation programme. If the positive trend of increased SME participation continues, it is estimated that, on average, EUR 1 billion in research funding will be made available to SMEs annually throughout the lifespan of FP7. Divided into 10 distinct themes, the programme supports all types of research activities carried out by different research bodies in transnational cooperation. Within each theme, there are a variety of SME-targeted topics in which research-intensive SMEs should play a leading role.

The two SME-specific measures are: 'Research for SMEs', supporting small groups of innovative SMEs to tackle common or complementary technological issues, and 'Research for SME associations', enabling associations and groupings to develop technical solutions to problems shared by large numbers of SMEs in specific industrial sectors or value-chain segments. Also included among the SME-specific provisions are measures designed to help national and regional SME research programmes enter into transnational cooperations, based on Article 169 of the EC treaty, by means of European participation in programmes undertaken by several Member States.

The ERA-NET scheme provides another channel, promoting cross-border cooperation and coordination through the networking of research activities conducted at national or regional level. Finally, the Eurostars initiative, which is run by the intergovernmental EUREKA organisation and partly funded by the framework programme, is designed to stimulate transnational, multi-partner R&D projects initiated and led by research-performing SMEs. FP7 will also be supported by the 'Competitiveness and Innovation Programme' (CIP), which focuses on a range of downstream activities and on improving SME access to alternative sources of finance<sup>92</sup>.

### 4.1.3 Competitiveness and Innovation Programme (CIP)

The Competitiveness and Innovation Framework Programme (CIP) aims to encourage the competitiveness of European enterprises. With small and medium-sized enterprises (SMEs) as its main target, the programme is designed to support innovation activities, provide better access to finance and deliver business support services in the regions. In particular, the Entrepreneurship and Innovation Programme (EIP), which is one of the three pillars of CIP, focuses on:

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<sup>91</sup> SME Update, Issue 2, 15 April 2008, European Commission, Research-SME, [http://ec.europa.eu/research/sme-techweb/newsletter/issue2/facts-figures\\_en.html](http://ec.europa.eu/research/sme-techweb/newsletter/issue2/facts-figures_en.html)

<sup>92</sup> Supporting SME participation in research Framework Programmes, DG Research, 2007, [http://ec.europa.eu/research/sme-techweb/pdf/sme\\_support\\_en.pdf](http://ec.europa.eu/research/sme-techweb/pdf/sme_support_en.pdf)

- Better access to finance for SMEs through venture capital investment and loan guarantee instruments
- Business and innovation support services delivered through a network of regional centres (EuroInfoCentres and Innovation Relay Centres)
- Promotion of entrepreneurship and innovation (Europe Innova, Pro-Inno etc).
- Support for eco-innovation
- Support for policy-making that encourages entrepreneurship and innovation, improving SME access to EU research programmes in particular<sup>93</sup>.

It is still early days for those of the programme activities operating through calls for proposals, such as the ICT Policy Support programme where the first project contracts have just been signed. However, within the area of better access to finance for SMEs through venture capital investment and loan guarantee instruments, results are already starting to show. EIF has been allocated EUR 1.1bn of CIP funds to be split between venture capital – with the High Growth and Innovative SME Facility (GIF) - and guarantees – with the SME Guarantee Facility (SMEG).

Less than a year after being granted management of part of the facility, EIF has invested over EUR 100m of CIP resources in 10 venture capital funds under GIF<sup>94</sup>. Under the SMEG, EIF announced in September 2008 that it had signed its first guarantee agreement, with the Brussels-based Fonds de Participation (FdP). FdP is an autonomous Belgian public institution whose mission is to provide subordinated loans to SMEs and loans to micro-enterprises which cannot obtain commercial loans from the traditional banking lending system<sup>95</sup>.

#### **4.1.4 The Structural Funds**

The resources of the Structural Funds are delivered through multiannual development programmes, managed jointly by the Member States, the regions and the European Commission. The territorial cooperation aims at stimulating cross-border co-operation in order to find joint solutions to problems such as the networking of SMEs. The Strategic Guidelines for Cohesion Policy 2007-2013 complete this regulatory Framework.

A broad range of research and innovation related actions may be funded. The strategic guidelines put improving access to finance for SME development as a top priority. In particular, it emphasises the need to enhance support for start-ups and micro-enterprises, through technical assistance, grants, loans, equity, venture capital and guarantees. These actions will take place in close cooperation between the Commission and other stakeholders, such as the EIB and the EIF<sup>96</sup> (more on this below, in the section on JEREMIE).

#### **4.1.5 JEREMIE**

The Joint European Resources for Micro to Medium Enterprises initiative, known by the acronym JEREMIE, is an initiative of the European Commission's Directorate General for Regional Policy (DG Regio) and the EIB Group (European Investment Fund and European Investment Bank) to enhance SME finance. JEREMIE was launched in October 2005.

JEREMIE's resources are mainly derived from EU Structural Funds for the funding period 2007-2013. Traditionally, monies from EU Structural Funds have essentially been spent as grants, which are issued as one-off payments on a project basis.

<sup>93</sup> [http://ec.europa.eu/cip/index\\_en.htm](http://ec.europa.eu/cip/index_en.htm)

<sup>94</sup> <http://www.eif.org/venture/news/2008-100m-invested-under-EU-CIP-programme.htm>

<sup>95</sup> <http://www.eif.org/venture/news/2008-EIF-sign-first-agreement-under-CIP.htm>

<sup>96</sup> European Parliament's Committee on Industry, Energy and Research (2007): Synergies between the EU 7<sup>th</sup> Framework Research Programme, the Competitiveness and Innovation Framework Programme and the Structural Funds

The JEREMIE initiative offers new opportunities for Member States and Regions to invest and re-invest Structural Funds using a range of financial instruments, instead of grants. Investment and re-investment opportunities through JEREMIE mean that funds are used to maximum advantage, gaining additional value, or leverage, and also that funds can be used over a longer period for the benefit of SMEs. SMEs are the final beneficiaries and may obtain funding directly from the partner financial institutions.

The JEREMIE initiative will improve the SME financial environment at local level. Firstly, JEREMIE will increase the supply of SME finance in the regions, by matching product expertise and decision on investment schemes which are focussed on assisting SME growth with local need. JEREMIE will also contribute to the general improvement of regional financial conditions, by introducing flexible and tailor-made actions such as decreasing lending interest rates through JEREMIE guarantees, reducing the need for collaterals through the implementation of guarantee instruments, disseminating equity finance, and enhancing the availability of micro-credit.

JEREMIE is not an institution but a process made available for EU Member States through the EU Cohesion Policy, and managed by selected financial institutions such as EIF<sup>97</sup>.

A majority of Member States indicated their commitment to implementing the JEREMIE initiative during the negotiations concerning the Cohesion programmes for 2007-2013<sup>98</sup>. In terms of securing more concrete commitments, EIF has to date signed Memoranda of Understanding with the Slovak Republic, Greece, Romania, Bulgaria, Cyprus, and French, Spanish, and Italian regions on a future cooperation in the context of the JEREMIE implementation. In June 2007, the first JEREMIE Funding Agreement was signed between EIF and Greece. During 2008, Funding Agreements have been signed with Romania, Latvia, and Lithuania. Further Funding Agreements are currently under negotiation, for example with the Governments of the Slovak Republic and Bulgaria, as well as the Languedoc-Roussillon region in France<sup>99</sup>.

## **4.2 Proposals for initiatives to further improve SME participation in EU programmes**

### **4.2.1 Research programmes**

As was seen in the presentation of the results of FP6 and FP7 above, a number of simplification initiatives designed to increase SME participation have been introduced in FP7, including less frequent reporting, reduced need for audit certificates and bank guarantees, and increased funding levels for SMEs. The initial indications from the first FP7 calls for proposals are that this has helped increase SME participation. However, continued focus on this issue is necessary, and further improvements can be made:

- *Focus on the types of SMEs participating.* The Ex-Post evaluation of the IST Thematic Priority in FP6 showed that while the level of SME participation has been sustained at over 20% (well above the 15% target set by the European Council and the EP), the involvement of high-growth and highly innovative companies in the programme remained low. This raises questions about the degree to which the framework programme is attractive and accessible to high-growth companies. Research projects with a relatively long time horizon and, although reduced, still high administrative barriers, are often not attractive to this type of companies.

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<sup>97</sup> <http://www.eif.org/jeremie/activity/index.htm>, <http://www.eif.org/jeremie/operations/index.htm>

<sup>98</sup> Communication from the Commission on the results of the negotiations concerning cohesion policy strategies and programmes for the programming period 2007-2013, Com(2008) 301 final (p. 5-6).

<sup>99</sup> <http://www.eif.org/jeremie/activity/index.htm>, <http://www.eif.org/jeremie/operations/index.htm>

Thus, there is a continued need for the Commission to reduce time to market (shorter projects) and further reduce administrative barriers to participation in the programmes. Some measures in this respect are presented in the following.

- *Develop a more trust-based approach towards participants* at all stages of the programmes. Efforts should be made to further simplify and introduce flexibility in the three key phases of the project lifecycle – the application, the evaluation of proposals, and the management of funded projects<sup>100</sup>:
  - Application stage: require *shorter proposals* with fewer details of work packages and a focus on the appropriateness of partnerships, in particular the inclusion of highly innovative participants
  - Evaluation of proposals stage:
    - *more complete and helpful feedback* to be made available to proposers whose ideas are not funded, to encourage them to return to the programme. This is particularly important for participants who are new to the programme, especially SMEs.
    - Test a new approach whereby *proposals are not fully evaluated initially*. All applications passing a few basic checks should be given a small amount of "seed funding" for an exploratory phase. After this, exploratory projects with successful results would be selected for full project funding. Financing projects based on actual performance rather than promises and reputation could both reduce the initial paperwork and be a viable way of attracting innovative (small) companies which would not otherwise consider applying for Community funding.
    - Explore expansion of the use of the *two-step evaluation procedure tried in the FP6 "future and emerging technology" area* - prospective participants first provide a broad outline of their project idea, and only provide a more refined plan once they are selected. This may increase the workload for the Commission in the early phases, and lengthen the overall evaluation process, but it will significantly reduce the burden on the research community of preparing proposals, and would also be more in line with the way small, dynamic companies normally work towards acquiring funding for their projects.
  - Project management stage:
    - *further optimise reporting*, which is time-consuming and may be untimely, and allow the participants to report when there is something to report. Reduce the frequency of financial controls
    - Allow *the refocusing of the research* on different priorities if this becomes necessary during implementation
    - Allow more *flexibility in the composition of partnerships* during the project, including the possibility of changing partners if the project takes a direction which would benefit from new partners or replacement of partners. This may also provide more opportunities for SMEs to enter established consortia.

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<sup>100</sup> Information Society Research and Innovation: Delivering results with sustained impact. Evaluation of the effectiveness of Information Society Research in the 6th Framework Programme 2003-2006, May 2008 (European Commission, DG Information Society and Media)

- *Further develop and refine simplified/fast track processes for SMEs*, based on the experiences with the simplified requirements now being applied in FP7. This issue is also discussed in the Small Business Act.
- *Promote match-making and other initiatives to include more SMEs in project consortia*: Many networks and consortia tend to include only partners they already know, and this constitutes a barrier for new participants, especially SMEs without previous experience with research programmes. Enhance search facilities for consortium partners at relevant websites; arrange match-making events with key “network hubs” in e.g. research programmes or other programmes with a large number of established players that participate in many projects and are thus able to help introduce SMEs to established networks. The Small Business Act discusses developing a cluster strategy to encourage transnational cluster cooperation and take measures to ensure greater participation of SMEs in innovative clusters. It could be investigated if these two strategies could be developed together, as they share similar elements of wanting to include SMEs more in consortia and clusters.

#### **4.2.2 Other investment programmes**

- Regarding support measures for SMEs which are not the ‘top technology pioneers’, these could benefit from greater integration in transregional co-operation on technology development. As of now, neither FP7 nor CIP directly address this issue. The Structural Funds could support such actions, but are not doing so properly<sup>101</sup>
- *Monitor and push for the utilisation of new financial instruments facilitated by EIB/EIF*: The CIP, through its co-operation with the EIB/EIF, and the JEREMIE initiative provides new channels for funding SME development via financial instruments other than grants. Activities so far are at an early stage and it seems that actual disbursements and guarantees to SMEs through these instruments have yet to be made. However, early indications, at least for the CIP funds, are that prospects are good. It is strongly recommended that the Commission monitor the development of these instruments closely, and continues to push for their implementation – in particular as regards Member State use of the instruments for regional development under the Structural Funds.
- As for the programme activities operating through calls for proposals, for example parts of the CIP, the same problems regarding heavy administrative procedures presenting barriers to SME participation apply as for the research programmes. Thus, similar initiatives as those proposed above should be taken to eliminate as much red tape as possible to make it more attractive for SMEs to participate in these programmes.

#### **4.3 SME access to public procurement**

The public procurement market in the EU – covering all levels of government and public agencies – is estimated to be worth around one-sixth of total GDP in the EU, and SME access to public procurement is thus an issue of substantial importance. Overall, in the year 2005 SMEs secured 42% of the value and 64% of the number of contracts above the thresholds fixed by the EU directives on public procurement, which cover roughly 16% of the EU public procurement market.

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<sup>101</sup> European Parliament’s Committee on Industry, Energy and Research (2007): Synergies between the EU 7<sup>th</sup> Framework Research Programme, the Competitiveness and Innovation Framework Programme and the Structural Funds

In this connection, it is interesting to note that medium sized companies are performing much better than small and micro companies<sup>102</sup>. It should also be noted that the existing EU procurement directives are assessed by e.g. the European SME organisation UEAPME as already providing a good legal basis for increasing the share of public contracts awarded to SMEs, but their potential is not sufficiently exploited<sup>103</sup>.

Although SMEs are not specifically excluded from public procurement, the procedures and practices used in many tenders have the effect of disadvantaging SMEs over larger competitors. The barriers include basic difficulties in finding information about tenders, or about the procedures for bidding, or there are problems in understanding jargon; too short a deadline for responding and/or the costs of responding are too high; the administrative procedures are too complex, or particular certification is required; a high financial guarantee is required to bid; or companies may face discrimination on the basis that they are located in a different country from the contracting authority<sup>104</sup>.

These issues are to some extent already covered by the SBA; proposals mainly revolve around information initiatives (for SMEs to become more aware of procurement opportunities), inviting Member States to e.g. subdivide contracts into smaller, more accessible lots, and other ways to better exploit the opportunities within the current procurement regulation.

The EU procurement directives are considered as providing an adequate legal basis for increasing SME participation, in particular since the directives only apply to procurements above the threshold values. Thus, procuring authorities have ample room to apply e.g. simplified procedures for smaller procurements below the threshold, which will often be particularly attractive to SMEs. There are also multiple other opportunities for procurements for which the procurement directives apply, such as dividing procurements into smaller lots, reducing administrative requirements for proposers, providing longer deadlines for submitting proposals, etc. The majority of this type of improvements would favour SMEs and micro-enterprises in particular, since these are the enterprises suffering most under the current practices. The problem is that these opportunities are not exploited by the procuring agencies.

There is thus currently ample room for development of the public procurement practices to benefit SMEs and micro-enterprises within the framework provided by the procurement directives, and it is the opinion of the authors of this report that stronger initiatives should be taken by the Commission to promote such development among the procuring institutions both in the Member States and at EU level, before revisions of the procurement directives are considered.

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<sup>102</sup> [http://ec.europa.eu/enterprise/entrepreneurship/public\\_procurement.htm](http://ec.europa.eu/enterprise/entrepreneurship/public_procurement.htm)

<sup>103</sup> Public procurement: EC study backs SME calls for better admin rules, UEAPME press release, 29 November 2007.

<sup>104</sup> [http://ec.europa.eu/enterprise/entrepreneurship/public\\_procurement.htm](http://ec.europa.eu/enterprise/entrepreneurship/public_procurement.htm)

## **5 Overall considerations regarding the implementation of the SBA**

A key issue in relation to the SBA is that it is not a legally binding instrument, and that it does not have a budget of its own to implement the activities foreseen in the Act. Thus, there is a significant risk that initiatives may be delayed, implemented only partly or not implemented at all because resources (both funds for expenditure and human resources within the Commission) may be diverted to other purposes.

Another key issue is that since enterprise policy to a large degree is the domain of the Member States, a large number of the recommendations and initiatives listed by the Commission in the SBA are not – at least for the foreseeable future – subject to EU regulation and will thus largely depend on the capability and willingness of Member States to change their national regulations and administrative practices. Thus, initiatives at European level in these areas are restricted to working with the Member States, providing documentation, arguments, information – for example, on benchmarks and best practices - and possibly resources, that would act as incentives for the Member States to carry out the recommendations of the SBA in practice.

The “Think Small First” principle is central, since it provides an overall framework, or mindset, for what the SBA is about. Although there are areas where regulation is needed, *change in administrative practices* appears to be the single issue where most can be achieved, in terms of reducing administrative burdens for small enterprises and increasing their participation in public procurement and in EU programmes for research and innovation. Dedicated EU funds for promoting the implementation of the SBA should then be spent on “pushing” the Member States to take action. This could be done through initiatives to exchange and promote best practices, setting benchmarks (“naming and shaming”), elaborating and promoting guidelines and standards for SME-friendly administrative practices, etc.



## 6 Conclusions

Among the areas selected for analysis in this report, the **reduction of administrative burdens** (red tape, bureaucracy) for SMEs – and for enterprises in general – is thoroughly addressed by Commission initiatives already. This goes both for the SBA and, not least, for the large on-going Commission programme for measuring the current administrative burdens and proposing measures to alleviate them wherever possible. Thus, there are few areas that can be identified as presenting significant potential at Community level for reducing administrative burdens for SMEs that are not already being addressed.

In the area of **SME access to finance**, a number of issues were identified in this report that could make life easier for SMEs, increasing their potential to grow. Many of these have to do with alternative sources of finance to those provided by the bank sector today, such as micro-finance, mezzanine finance, the access to risk capital, as well as the question of taxation. Many of these areas are within the domain of the Member States, meaning that the EU may not be in a position to regulate directly, but will have to work to influence the Member States to change their legislation and/or their practices through e.g. exposing the differences between Member States across the Union, providing best practice examples, and providing support to awareness raising and education.

Finally, the EU funds a number of **programmes and initiatives** of relevance to SMEs – for research, innovation, and investment and general enterprise development. Many of these present barriers to SME participation that can be alleviated through the implementation of “lighter” procedures that reduce barriers for SMEs to participate. Some success has been achieved in this area already, but more can be done. In the area of **public procurement**, it was concluded that the current legal framework provides adequate room for the Member States to implement practices that would create better opportunities for SMEs to gain access to public procurement, but that these are not sufficiently exploited by the Member States.

Overall, with the SBA not being a legally binding instrument, and many of the problem areas addressed in the SBA being the domain of the Member States, there is a limit to how much the SBA can achieve, and a large risk involved that the objectives may not be realised, or only partly so.

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