Market failures in SME finance markets and the design of State Aid policy

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Rationale for State aid: market failures

- Presence of market failures is a direct source of inefficiency in the economy
- Public intervention can aim at correcting market failures so as to improve the level of efficiency in the economy
- Benefits of public intervention should outweigh the costs

Market failures in SME finance markets

- Asymmetric information: firms are generally better informed about their prospects than investors
- How do financial markets deal with that?
  - Demand collateral or invest in screening → both are costly
- When are market solutions generally not available?
  - For young firms with no track record or insufficient collateral

Screening of investment opportunities

- Investors want to distinguish "good" from "bad" investments and can invest in research to reduce the asymmetry of information
- Screening costs would typically not depend on investment size
- Therefore, only worthwhile to invest in screening for potential investments of a minimum size (high absolute returns)

Improving on the inefficient market outcome

- The State needs to be better informed than private investors in order to improve on the market outcome
- Financing SMEs may result in significant positive externalities for society
- Investors may undertake too little screening from the point of view of society as a whole, and State intervention can establish a more efficient outcome

Drivers of productivity and innovation

- Market entry and exit of firms
  - Successful sectors witness productivity growth because more efficient firms grow at the expense of the less efficient ones
  - Exit, entry and market share change account for 50% of productivity growth at establishment level and 80%-90% of total factor productivity growth *(Disney, Haskel and Heden, Economic Journal 2003)*
- Exit of less efficient firms makes resources available for new ideas/innovation
- Comparing Europe to US:
  - Fewer low productivity/badly managed firms in US *(Bloom and Van Reenen, 2010)* and efficient firms grow much more quickly in US *(Bartelsman et al. 2009)*

Problem: Firms with good ideas do not get financing

- Consequences of a firm not receiving finance may well go beyond that single firm
  - Firms with good ideas not entering the market means that bad firms stay in the market
- Subsidies can lead to entry of financially constraint firms with good ideas
  - This sharpens the selection effect
- Providing incentives to financial sector to increase financing to young firms (namely subsidizing screening) can therefore lead to faster growth

Design of State aid policy

- Increase *entry* by incentivizing investments in young firms, but condition on the amount of asymmetric information

- Once enough performance data is available, the asymmetric information problem no longer exists (e.g. 5 years after commercializing the product/service)
  - "good" firms should be able to obtain private financing
  - "bad" firms should *exit* the market and replaced by new promising firms

Exiting the investment

- On the one hand, you want to avoid firms still getting subsidised financing once track record has been built up (bad ideas need to disappear)
- On the other hand, you want to allow for the possibility to provide staggered finance and model the refinancing process of the VC industry
  - The attractiveness of investment in young firms largely depends on exit strategy, and therefore on ability to follow up with additional investments without facing equity dilution

Financing instruments

- Asymmetric information problem applies equally to different types of financing instruments
- The problem is that too little screening is undertaken
- Once screening is subsidized, it can be left to the expert to decide on the type of instrument to provide the most efficient financing

Involvement of intermediaries

- State aid in the form of incentives to investors is less distortive than direct aid from State to SME

  → selection and choice of instrument is undertaken by experts

- Different forms of aid:

– Directly: subsidizing screening cost (conceptually best way)

– Indirectly: increasing the cost-adjusted returns

Neutral on form

- Subsidizing screening costs
- Providing tax incentives
- Setting up public/private funds
  - Essential that fund is managed based on profit maximizing principles: fund manager should have strong incentive to maximize performance of the fund (e.g. performance-based remuneration or co-investment)
- Setting up development bank
  - Could reduce subsidies by developing expertise, but should be based on profit-maximizing principles

Concluding remarks

- Subsidies can reduce the cost of financing to young firms, but allow us to obtain the selection that the market would be providing
- Once the problem is clearly identified, intervention can be well targeted and flexibility can be increased (e.g. size/timing of investment or type of instrument)