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Designing SME support programs: International experience and implications for Belarus

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The main purpose of GET Belarus is to conduct a dialogue on economic policy issues with the government, civil society, and international organizations. Experts of German Economic Team have experience in policy advice in several transition economies, including Ukraine, Georgia and Moldova. In Belarus the German Economic Team provides information and analytical support to the Council of Ministers, the National Bank, the Ministry of Foreign Affairs, the Ministry of Economy and other institutions involved in the process of formation and implementation of economic policy.

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Designing SME support programs:
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Executive Summary

To date, SME support in Belarus has mainly consisted of concessional loans. The Belarusian government now wants to put SME support on a broader footing and, above all, to include non-financial support instruments such as training and advisory services in its range of support offers.

Since the reorganization of SME support is beginning from scratch, Belarus has the opportunity to take account of international experience and lessons learned.

40 years of international experience in SME support show that only a few growth-oriented start-ups and SMEs create innovation and jobs. SME support is therefore effective if it focuses on growth-oriented start-ups and SMEs. A broad support of SMEs, in particular a broad stimulation of start-ups in all sectors and in all regions, has little or even negative macroeconomic effects.

Sophisticated selection mechanisms are necessary for the selection of eligible projects to be supported. The form of state financing of the support infrastructure also plays an important role in the selection of eligible projects, as international experience has shown that some forms of financing provide false incentives for start-up centers and business incubators.

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1 Introduction

The promotion of small and medium-sized enterprises (SMEs) in Belarus has so far been based mainly on financial support in the form of concessional loans.

The Belarusian government plans to modernize and broaden the scope of SME support. A range of modern instruments for SME promotion is to be implemented.

GET Belarus aims at contributing to the reform process with this paper.

First, the paper discusses what expectations politicians can realistically have regarding the impact of SME promotion programs. In particular, if state funds are to be used for SME promotion, the results of SME promotion must be placed in relation to overall economic welfare. International scientific studies are used for this purpose.

The following section 3 outlines some best practice examples for grants as a form of start-up support. The Belarusian side had expressed a particular interest in the effectiveness of grants as a means of SME support.

Section briefly discusses several mechanism of allocating public financial resources to finance the offer of non-financial SME support such as training and consulting.

2 Fundamentals of SME promotion

2.1 Realistic economic policy objectives of SME promotion

Policy makers often have high expectations regarding the outcome of a policy that is aimed at supporting and promoting the development of small and medium-sized enterprises (SME).

The most popular expectations include: the SME can create jobs, contribute to the countries innovation and technological development and enhance the economic transition process. These expectations are valid, but there is a widespread misunderstanding of scientific research in the public discussion: It is not the SME sector in its entirety that creates jobs. It is only those companies that grow out of the small and medium-sized stage that create jobs and innovation, according to long-term scientific research.[1]

In other words, it is only the growth of companies that leads to positive effects for the economy.

Supporting SMEs for their sake is by no means a recommendable objective. Table 1 (see below) illustrates strikingly the fact that having a big SME sector is not a success itself.

Table 1 might even suggest instead, that there is a reciprocal correlation between the economic development of the country and the size of the SME sector: the most developed economy in the table has got the smallest SME sector. Such a correlation holds not true for all countries world-wide but it demonstrates that the size of the SME sector should not be a policy objective for its sake.

[1] Audretsch (2003b); Storey (1994); Van Stel/Storey (2004); Shane (2003).

Table 1: The size of the SME sector in different European countries

SME's share of	Bulgaria	Poland	EU 28	Germany
Enterprises	99.8%	99.8%	99.8%	99.5%
Employment	75.4%	68.1%	66.4%	63.2%
Value Added	65.2%	51.4%	56.8%	54.0%

Sources: Eurostat 2018

The productivity of medium-sized enterprises is higher than those of micro and small enterprises in all the countries shown. The share of medium-sized enterprises in employment corresponds to the share of medium-sized enterprises in value added in all countries listed in Table 1.

The productivity of micro enterprises is the lowest in all the countries shown, in other words the share of micro enterprises in employment is much higher than their share in value added in all countries listed in Table 1, which means that micro enterprises produce less value added per employee.

Moreover, according to scientific research, micro-enterprises and small enterprises

- are especially prone to closure and thus most vulnerable to economic shocks,
- (on average), usually have lower productivity than big private enterprises,
- (on average), usually pay lower wages then big private enterprises do,
- (on average), provide less training for their employees then big private enterprises do.

That is why a policy that attempts to keep companies at micro and small level - or even hinders growth - is counterproductive.

Conclusion 1: A modern SME policy helps companies to overcome their liabilities of newness and their liability of smallness and helps them to grow out of a premature stage until they reach a sustainable size as medium-sized private enterprises or big private enterprises.

Particular caution is needed if SME policy is linked to the objective of regional economic development. Here we must warn against exaggerated political expectations.

Great Britain, for instance, has had painful experiences here. Great Britain's policy of promoting regional economic development through SME policy, especially by promoting start-ups, can be regarded as a failure.

In England, economic policy in the 1980s used a large budget to promote start-ups, the number of which actually increased, but the overall economic effect in terms of the number of jobs was zero in

the medium term. In the economically weak regions of north-east England, the effect was negative, i.e. the start-up support program destroyed jobs in the structurally weak regions.

The start-up promotion policy failed particularly in regions in England which were characterized by low levels of education, low levels of home ownership, low-house prices, high unemployment, low levels of research and development and low proportions of business service employment.

As a direct effect of start-up support, unemployment initially fell for a short period, as more and more unemployed people became small entrepreneurs.

If individuals in economically underdeveloped regions start new firms that are financed initially from public funds and at the same time are heavily concentrated in low-skill personal services, then their short-term effect will be to displace existing competitors on grounds of price.

The 1990s saw a shift in Great Britain's SME policy, away from start-up promotion and towards providing support for existing SME with growth potential.

Whilst these policies were being implemented in Great Britain—and specifically in England—different policies were being adopted in Scotland in the 1990s. At a time when English policies focused upon growth businesses, Scottish policy makers became concerned that their new firm formation was much lower than that of England. To address this, Scotland launched its Business Birth Rate Policy in 1993. This program cost £140 m over the period until 2002. Its task was to close the gap between new firm formation rates in Scotland and those of the rest of UK by the end of the 1990s. In 2001 the policy was reviewed and it was concluded that it had failed to reach its main target. Following the review an overhaul took place, with Scottish SME-policy being less explicitly focused on raising new firm formation in underdeveloped regions.[2]

In Germany, too, in the 1990s it was only the small and medium-sized knowledge-based and high-tech companies that created jobs overall, while all other companies cut jobs net.[3]

The majority of scientists therefore recommend that economic development policy should not be based on the number of start-ups but on the quality of the start-ups, and that support programs should therefore be concentrated on a small number of companies. The difficulty lies in the selection of beneficiaries, because there are no reliable indicators and no guarantee solution to create growth and jobs. For this reason, funding programs must be subject to constant monitoring and regularly adjusted.[4]

[2] Mueller et al., 2008.

[3] Audretsch, 2003.

[4] Landström, 1998.

2.2 Justification for the use of state resources to promote SMEs

However, even if one assumes positive macroeconomic effects from increased start-up activity, a positive correlation does not yet legitimize any economic policy intervention in the market economy mechanisms.

„Just because entrepreneurship is positively linked to performance does not automatically justify public policy intervention."[5]

A necessary condition for economic policy interventions is the existence of private sector failure in such a way that social benefits and costs deviate from private benefits and costs, i.e. external effects arise.

The sufficient condition is, moreover, that the intervention of economic policy, after deduction of the costs of the intervention, has an overall positive net welfare effect, because paying for the start-up promotion policy from the public budget means less resources for other purposes.

This is all the more true since direct SME support measures also entail the risk of negative effects, above all the risk of distortions of competition, the adverse selection of unsuitable business projects and the misappropriation of subsidies.[6]

For instance, a deadweight effect refers to the situation in which less efficient or less ambitious entrepreneurs are given subsidies, and remain in the market as long as they can use the subsidy; these entrepreneurs do not need such subsidies for improving their business. A substitution effect arises when less efficient entrepreneurs are given an artificial seedbed, while market competition would have induced them to leave the market. These effects advocate a policy oriented towards ambitious entrepreneurs.[7] This is discussed in the next section.

It must be shown that the economy as a whole benefits from SME support measures, both macroeconomically and individually, and that the advantages of the beneficiaries are weighed against the disadvantages of the burdened.

From theoretical and empirical research, there are several approaches to justifying start-up support measures:

The first approach sees evidence of market failure due to the existence of external effects in the form of knowledge spillovers. Start-up and innovation activities produce knowledge that cannot be fully internalized and is partly available as a public good. Abandoned start-up activities and failed companies also produce knowledge and experience for society, especially for the region, because knowledge spillovers require spatial proximity. One can also learn from failure. The experiences from discontinued start-up projects and failed companies have a positive effect on the performance of other companies.[8]

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[5] Audretsch, 2003.

[6] Koch, 2001.

[7] Stam et al., 2006.

[8] Acs/Storey, 2004.

However, private investors cannot appropriate the social benefits of the knowledge spillovers that they produce.[9]

From a macroeconomic point of view, underinvestment will therefore occur. The higher the uncertainty associated with the innovation or start-up, the stronger this effect will be. This is particularly the case for knowledge-based and technology-oriented start-ups and SME: the newer and more innovative the products and services, the more difficult it is to forecast the market potential and the market development.[10]

From a macroeconomic point of view, however, it can make sense to have innovative technologies and business models developed, even if the uncertainty associated with setting up a business is prohibitively high for the private actor. Privately owned academic spin-offs are a particularly effective instrument for the commercialization of uncertain technologies, because they exploit inventions from early-stage technologies that are not licensed by established companies because they are still too far from market maturity from the point of view of the development process, according to the scientific empirical studies.[11]

The second argument for the legitimation of SME promotion refers to a positive contagion effect: The first generations of founders and successful entrepreneurs function as role models and motivate and inspire others.[12]

The third approach relies on a market failure in providing the start-ups with financial capital and financial guarantees through adverse selection due to asymmetric information distribution between SMEs and financial institutions.[13]

The fourth argument is a rather weak argument of the second-best logic and states that the subsidization of jobs through start-up support is superior in efficiency to most other measures of subsidizing jobs.[14]

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[9] Knott/Posen, 2005; Audretsch, 2003.

[10] Eckhardt/Shane, 2003; Storey, 1994.

[11] Shane, 2005.

[12] Greve, 1995; Shane, 2005.

[13] Storey, 1994; Murray, 1998; Koch, 2003; Wagner/Knuth, 2007.

[14] For example, each job created by an academic start-up in the GET UP start-up support network in Thuringia cost an average of around 16,500 euros in subsidies, which is quite low compared to other job subsidies: Lautenschläger/Haase, 2006.

3 Effectiveness of grants as a means of SME support

3.1 Deutschland: start-up grant "Gründungzuschuss"

The objective of the start-up subsidy *"Gründungzuschuss"* was explicitly not to encourage people to set up a business, but to increase the probability of their start-up survival. Start-ups that are started exclusively on the basis of a grant are much more likely to fail.

The start-up grant was introduced in the summer of 2006. According to this, people who are entitled to unemployment benefit and want to start a business, receive a subsidy for the first nine months of their business amounting to the last unemployment benefit they had received. The subsidy can only granted if an experienced independent private business consultant confirms the viability of the planned enterprise on the basis of the business plan drawn up.

The short-term objective of the start-up subsidy was to provide these founders with a living during the start-up phase. Between 2006 and 2010, more than 100,000 people were supported each year.

Five years after starting a business, 70 per cent of the subsidized business were still alive and viable, 20 per cent found another regular employment, and less than 10 per cent registered as unemployed again.

In particular, the long-term survival rates (five years after the start of funding) are far above expectations. Previous studies on the general situation of start-ups observe survival rates of only 50 per cent after five years.

In addition, many of the beneficiaries of the *"Gründungszuschuss"* generate a higher income than before in dependent employment.

In order to prevent deadweight effects, the review of the business plan by a an experienced independent private business consultant was meant to ensure that only serious start-up projects with sufficient financial prospects are financed.

The deadweight effects can primarily be demonstrated if during the funding period itself or shortly thereafter there are high interruptions in self-employment and a return to dependent employment or unemployment. During this period, however, retention rates of 95 per cent and more were observed after one year. In this respect, deadweight effects were neglectable in this program.

Conclusion 2: The start-up subsidy program *„Gründungszuschuss"* was successful mainly because it focused on serious and promising start-ups with long-term growth potential. The projects were selected by self-selection and expert selection.

3.2 Deutschland: Start-up grant "EXIST-Gründerstipendium"

Since the spring of 2007, the EXIST Start-up Scholarship program *"EXIST-Gründerstipendium"* has been supporting the maturation of a business idea into a business plan, the development of marketable products and services and the targeted preparation of a business start-up in order to stimulate the number of demanding innovative academic spinoffs. In addition to providing financial security for

founders in the pre-start-up phase, the goals also include guiding students, graduates and scientists towards entrepreneurial independence and founding their own company, as well as qualifying them to think and act entrepreneurially.

The start-up projects are supported in the form of personal scholarships for a maximum of three persons per project. The amount depends on the status (graduation) of the nascent entrepreneurs: Graduates with a university degree receive a scholarship of € 2,000, while those with a doctorate receive a scholarship of € 2,500. In addition to the personal scholarship, material expenses of up to 17,000 € can be reimbursed, and an additional 5,000 € can be granted for start-up-related coaching and start-up counselling. The maximum duration of the scholarships is one year.

The scholarship is intended to enable those interested in setting up a business to work out the planned business model without major personal risks, to examine its feasibility and viability and to implement key implementation steps.

The target group are scientists universities as well as university graduates and former scientific employees.

Between 2007 and the end of 2012, a total of € 70.6 million in subsidies was committed for 875 start-up projects. The majority of the funded start-up projects are in the range of €70 to €100,000.

The support offered is aimed at start-up projects whose business idea is based on technical product or process innovations.

In order to prevent deadweight effects, very high demands were placed on the application documents.

Firstly, the grant application must contain a draft business plan of approx. 20 pages as well as a project-related work plan with a detailed description of tasks and milestones and deadlines.

Secondly, the applicants must give up their previous activities for the funding period of one year, which implies that the applicants already have a pronounced intention and vision to found a company.

Due to these prerequisites, the commitment of the applicants is proven. In other words, a self-selection mechanism ensures that only highly convinced and highly committed nascent entrepreneurs apply for the grant.

Thirdly, applicants must be supported by universities or research institutions and be integrated into a start-up support network. The university or research institution must provide a mentor and a workplace to the grant recipients, as well as a guaranteed free use of its infrastructure. The university or research institution must be able to draw on a broad and interlinked range of services for start-up support and coaching.

The applications get reviewed by a board and several market experts and technology experts. Despite the high prerequisites, the experts and the board reject quite a number of applications. Between 2007 and 2011

- 73% of the start-up projects based on internet technologies were rejected,
- 31% of the start-up projects based on biotechnologies were rejected,
- 37% of the start-up projects from the area of software solutions were rejected.

The key figures on the effectiveness of the program in the period 2007-2011:

- 78% of the granted projects led to the foundation of a company.
- 84% of the founded companies survived the first 5 years.

Conclusion 3: The start-up subsidy program *„EXIST Gründerstipendium"* was successful, because it focused on serious and promising start-ups with long-term growth potential, targeted high-educated people und made use of a multi-tier selection process combining self-selection mechanism and selection by market experts and technology experts.

3.3 USA: R&D grants for entrepreneurs

The largest single grant provider for high-tech entrepreneurs in the United States is the SBIR (Small Business Innovations Research) grants program, which provides about $2.2 billion annually. The U.S. Congress first authorized the SBIR program in 1982 to strengthen the U.S. high-tech sector and support small firms. While the SBIR program is important in itself, it also provides many targeted programs to subsidize new high-tech businesses, both nationally and globally.

The SBIR program consists of two phases. The first phase grants of $150,000 are intended to finance the concept validation work for nine months. Phase 2 grants amounting to $1 million will be used to finance the validation work over a period of nine months. Phase 2 grants of $1 million, provided approximately two years after the first phase, are intended to finance demonstrations at later stages. The application process is time-consuming and takes between one and two months on a full-time basis.

In its application, the firm proposes to use the grant for research and development, but once the firm receives the lump sum payment, it will not be monitored or enforced to do so. However, to apply for Phase 2, the firm must demonstrate progress in Phase 1 of the project. No sharing of private costs is required, the state does not require any share capital and does not claim any intellectual property rights.

An evaluation study of 7,436 applicants from small high-tech firms with budgets in excess of $884 million between 1983 and 2013 found that early-stage grants had a strong positive impact on patent issuance, finance, revenue, survival and successful completion of urban activities. The grant is useful because it allows the firm to invest in reducing technological uncertainty, making it more viable for investment.

Conclusion 4: To the extent public funds are used to subsidize applied private sector R&D, the authors of the evaluation of the SBIR program suggest that more grants to small, young firms on a one-time basis may be more effective in stimulating innovation than fewer larger grants that follow firms through multiple stages of technology development.

4 Coordination of SME promotion: the example of financing start-up centers

As mentioned in the introductory chapter "Fundamentals of SME support", the selection of projects to be supported plays an essential role for the effectiveness of the measures.

The successful practical examples from section 3 have in common that they use a mature selection mechanism.

A selection mechanism that combines self- and external selection and best uses multi-level filters must be taken into account in the design and coordination of the funding programs.

Using the example of start-up support in the form of advice and coaching in start-up centers, the following section will briefly explain how an efficient selection of projects is promoted or hindered by the way in which start-up centers are financed.

There are basically four types of founders:

1. Fast-Track
2. Stay-Short
3. Stay-Long
4. Stop

1. Fast-track-founders are people who have a sufficient level of ability and need little additional knowledge. They can also successfully set up a business without the support of a start-up center or a business incubator.

2. Stay-short-founders are people who already have the necessary skills and knowledge for a successful start-up. With little, but targeted support, they can soon reach the stage of start-up maturity.

3. Stay-long-founders are people with promising business ideas whose level of knowledge and ability is very low but basically capable of development. They can only successfully set up a business with prolonged process-oriented support.

4. Stop-founders are persons without an viable business idea or with a low, non-developable level of ability. In spite of flanking support, they will not be able to create a business in the foreseeable future, or at best one with little prospect of success. This group of people should be advised not to set up a business.

An economically sensible allocation of subsidies as well as human capital requires the correct identification of the appropriate types of start-ups, the precise management of these types of start-ups and the discouragement of *Stop-Founders* from starting a business. This can only succeed if intermediaries are active on a broad basis who, unlike in pure seminar operations, not only transfer knowledge, but also train the skills of the founders at the same time. An efficient support consists of giving the young entrepreneurs targeted feedback on their decisions in the founding process and enabling them to think through their planning steps to the end. As a result, the internal risk of founding a company is minimized and with it the fear of failure.

In order to achieve a skillful interlocking of self- and external selection, multi-stage selection filters are important: An unfiltered offer from the start-up-centers or incubators would lead to deadweight

effects with *Fast-track-founders* and would go up in smoke with *Stop-founders*. An early identification of the individual profile ensures that first and foremost the developable and thus worthy *Stay-short-Founder* and *Stay-long-founder* receive support.

In order to do so, the financing structures of the start-up centers and/or business incubators must take into account the need and effort for differentiation and multiple filters. The prerequisite for maintaining the necessary multiple filters is the appropriate allocation of public financial resources to the start-up centers and/or business incubators.

Disadvantages of vouchers or consulting cheques

A participant related billing of coaches, consultants and trainers via vouchers or consulting cheques would not take into account the different types of the founders and would set false incentives: The start-up centers and business incubators would then generally look after the participants once they have been won until the end of the measure, longer and more cost-intensively than actually necessary.

Also *Stop-founders*, which should be advised against a establishment already for their own protection, would run through the promotion programs to the end.

Disadvantages of target agreements for incubators

With target agreements as the basis for financing the start-up centers and incubators, a concentration on *Fast-track-founders* and *Stay-short-founders* would be likely (creaming effect). These are the ones that require the least amount of support, since they already have almost all the prerequisites for a successful start-up.

Such a procedure can be fatal from a funding perspective. This is because start-up centers would then no longer encourage Fast-track-founder to set up immediately and would not advise Stop-founder to immediately advise against setting up. The incentive for differentiated support and activation of different types of founders can thus be lost.

Disadvantages of competitive tendering for the operation and financing of incubators

A similar effect is to be feared if, in competitive tenders, decisions are based exclusively on price and the respective target groups are disregarded. The awards would go to the cheapest carriers with the most *Fast-track-founders* or *Stay-short-founders* requiring the least support. Start-up support would thus have led itself ad absurdum.

Conclusion 5: The best solution for all would be basic financing of the start-up centers and incubators, taking due account of fixed costs in conjunction with a target agreement that differentiates according to the types of founders.

5 Summary and implications for Belarus

Firstly, the large number of relevant studies quoted in section 2 is intended to underline that, after almost forty years of international experience in supporting SMEs in industrialized countries, scientists and politicians agree that SME support with financial grants and monetary assistance must concentrate on a few, growth-oriented companies.

The broad support with a watering can for all types of start-ups and SMEs produces little effect. The state funds spent on watering cans of financial subsidies and monetary measures are not in reasonable proportion to the economic effects and welfare effects achieved.

Secondly, against the background of international experience, a linking of SME promotion and the promotion of regional economic development must be regarded as very ambitious.

Thirdly, the outlined examples of successful support programs have one decisive success feature in common: they use an effective selection mechanism that combines self-selection and external selection, each in different ways. Since Belarus has the opportunity to completely redesign its support programs, we recommend learning from these successful selection mechanisms. Distribution mechanisms such as vouchers and tenders for funding non-financial support can lead to misguided incentives and can lead to distortions.

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