A mechanism to support SMEs in the COVID 19

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GROWINPRO COVID Workshop – 2 December 2020
17.11.2020

Background

- The **COVID-19 shock**
  - affects primarily service sectors with many small enterprises (hospitality, retail trade, marketing and advertising)
  - SMES are more affected
  - Bankruptcy cascades are feared

- ***Table 1*** *How long do you estimate your liquidity reserves will be sufficient if your business situation remains at the level currently expected? lease also take into account possible state aid (short-time working, liquidity support, loan guarantees, etc.).*

	0-2 months	2-4 months	4-6 months	more than 6 months	no liquidity bottlenecks expected
Total Sample	7%	23%	19%	20%	32%
Services (up to 50 employees)	7%	30%	20%	16%	27%
Construction (up to 50 employees)	11%	29%	15%	18%	27%
Manufacturing (up to 50 employees)	12%	22%	24%	17%	24%

Q: WIFO Konjunkturtest, COVID special survey May 2020.

Background II

Traditional stabilization policies are less appropriate to counter the **COVID-19 crisis**:

- Many support schemes had to redesigned (short time work) to fit smaller enterprises, they were focussed on large manufacturing enterprises.
- Support for consumption can be counter-productive to fight the spread of COVID (gastronomy, tourism), but most importantly.
- They are not oriented towards the challenge to keep many small firms without capital market access on life support during the crisis.

- So we started thinking how a support mechanism (or better a **repayment mechanism**) could look like that could keep in place the productive potential and employment of SMEs and that fulfills some criteria ….

Criteria

- The challenge is to provide support in a way that it supports firms fast and does not work havoc on public finances. This may be important if the COVID shock turns into a demand-induced recession.

- The following criteria should be met to ensure that resources are channelled into rescuing enterprises:

  - The support is targeted to the enterprises without major deadweight effects (incentives)
  - Can be implemented quickly & works fast (no overly bureaucratic)
  - Does not endanger the financial stability of the SME sector (overindebtedness),
  - Is fiscally appropriate (conservative) and can be provided
  - with low administrative effort/cost.

The mechanism: Profit-contingent repayable grants

a) **Profit-contingent repayment**: Repayment is suspended if companies remain below an ex-ante specified profit threshold.

b) **Limited repayment period:** The grant should changes into a non-repayable subsidy after a certain period of time.

c) **The support bears and interest at the market rate and premium:** this ensures that the support is used by comanies that need it (incentives).

d) **The support should be administered by the tax authorities**: becomes available fast (tax account) and causes low administrative costs.

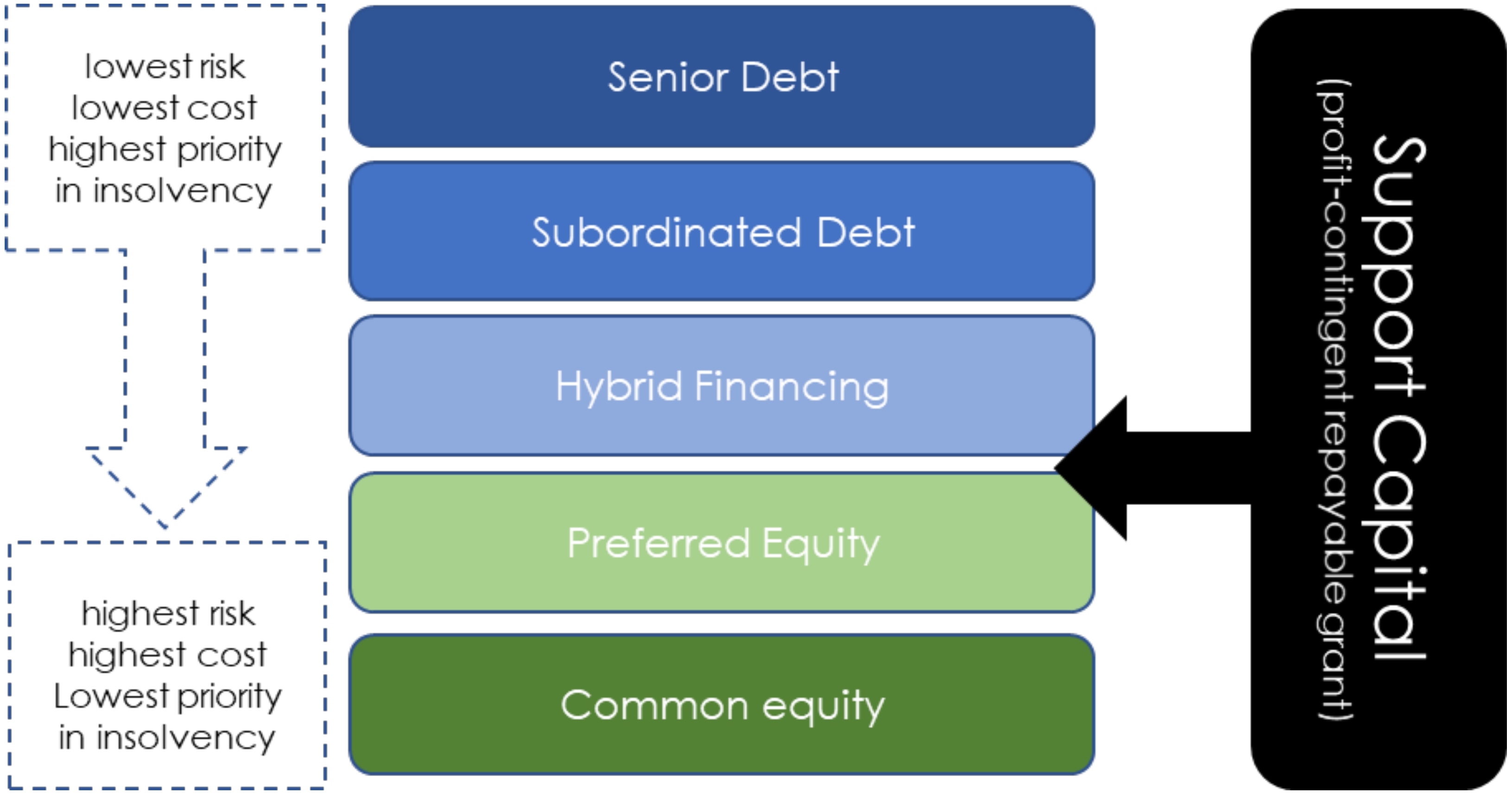
The mechanism can be understood as **reverse insurance**:

The payment due to the claim is at the beginning of the insurance, the premium payment is conditional on success afterwards.

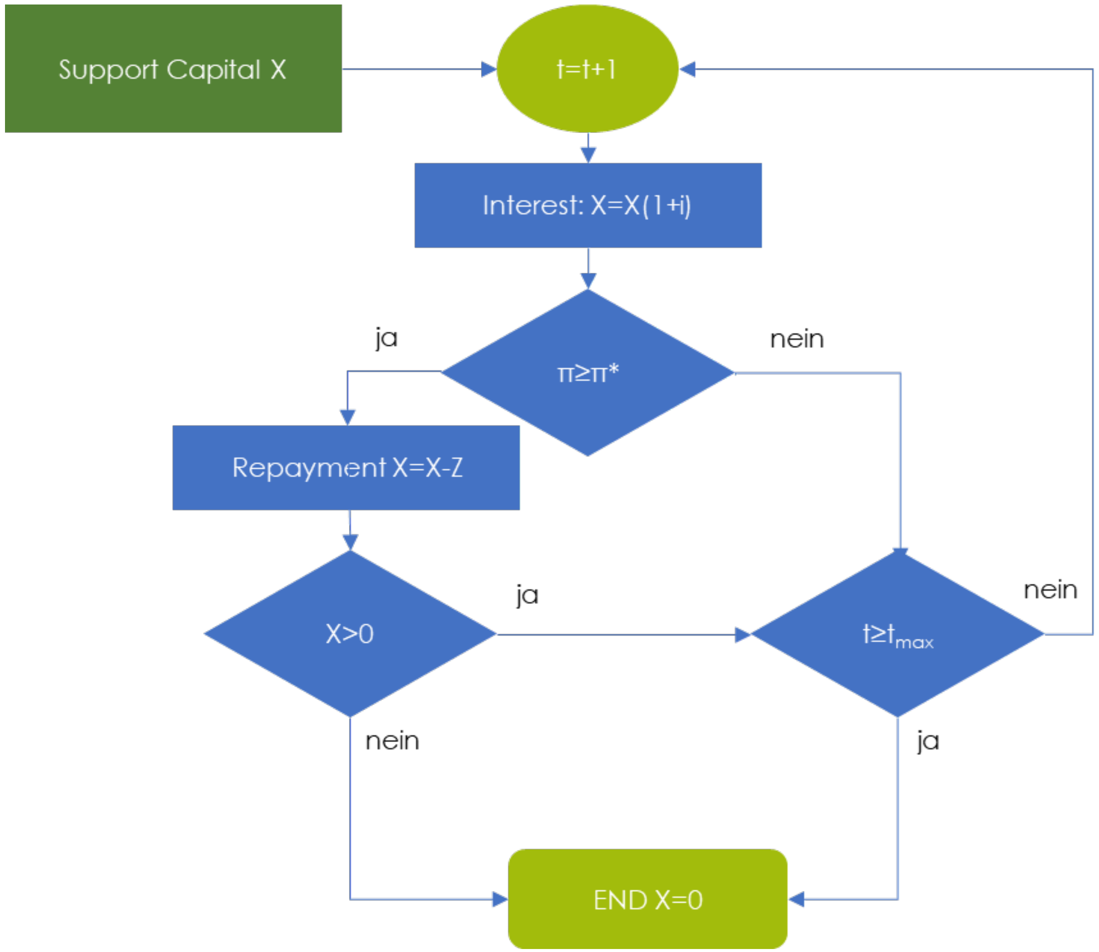
& **low priority** of the claim ensures that it implicitly has the character of participation captial (for SMES without capital market access).

Support capital & corporate finance

Figure 1 *Positioning the support capital in the hierarchy of corporate financing*



How would the mechanism work?



The support capital **X** is subject to interest every year.

Every year there is a repayment dependent on reaching the profit threshold (**π≥π***).

Das Unterstützungskapital ceases to exist after repayment (**X=0**) or at the end of the planned duration (**$t \geq t_{max}$**)

X … support capital
i … interest rate
Z … repayment
π … profit
π* ... profit threshold
t …. time
t_{max}.. maximum repayment period
e

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Possible problems ...

- Incentives are highest for „zombie companies“
  - Balancing of errors: Saving of zombies vs. saving of enterprises that need it.
  - Can be cushioned by criteria, but needs to be accepted to some extend.

- Increased incentives not to report income to tax authorities.
- Increased incentives for (inefficient) legal tax optimisation: e.g. excessive investments, excessive salaries fo managers, outsourcing of profits, taking out of loans
- Complex design – many parameters – could induce inefficient behaviour/ dilution of the mechanism.

- These problems show that the design is essential for the effectivity of support measures.

Some addititonal comments

- The proposal was not taken up …
  - Some did not like the part with the administration of repayments.
  - Other did not like the possible negative effects on a the recovery (it is still debt)
  - Nothing is said about how to support the firms (it is only about repayment)
- … but the mechanism is flexible:
  - parametrization allows for more or less generous support schemes
  - can be mixed (only part of the grant is repayable)
  - could be used also for specific support measures targeted at specific firms e.g. compensation for lockdown losses, only for firms with high turnover losses and high fixed costs

Summary and conclusions

- We propose a mechanism "profit-contingent repayable grant" to support SMEs in the COVID 19 crisis.
- The four central aspects of out proposal are
  a) profit-contingent repayments ,
  b) limited repayment period,
  c) market interest plus premium, and
  d) administration by tax authorities.
- This could make it possible to provide public "support capital" for many SMEs in an responsible manner to counteract insolvency cascades and the destruction of production capacities and employment.
- … but it might be also relevant to look at bankruptcy procedures to sustain efficient debt restructuring.

Thank you for your attention

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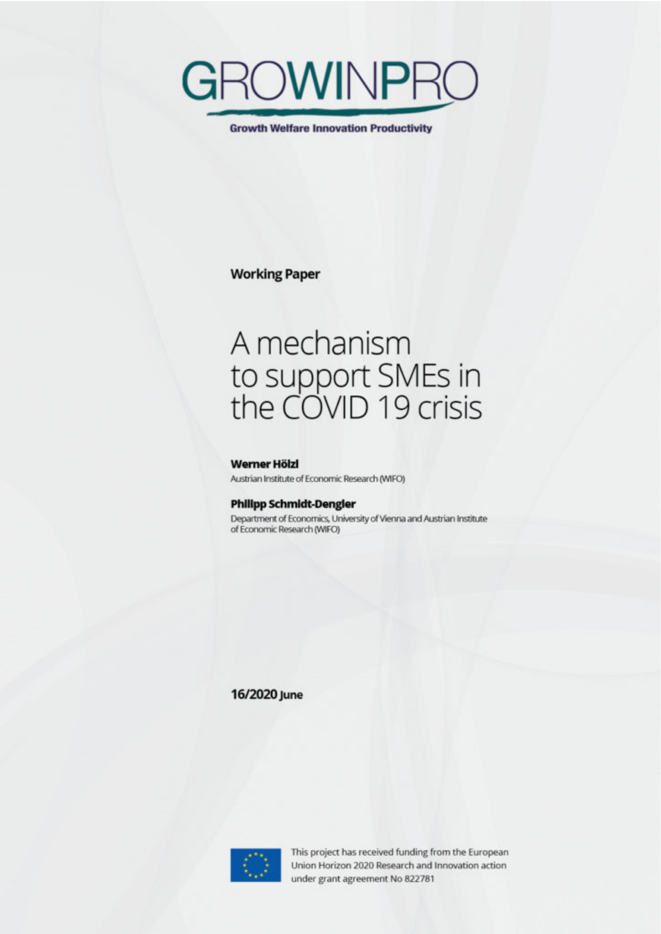
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Working Paper

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16/2020 June

This project has received funding from the European Union Horizon 2020 Research and Innovation action under grant agreement No 822781