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FINANCIAL SCHEMES FOR SMALL AND MEDIUM ENTERPRISES IN MEMBER COUNTRIES OF THE ESCWA REGION

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Preface

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ABBREVIATIONS AND EXPLANATORY NOTES

ABS	asset backed securities
ACSIC	Asian Credit Supplementation Institution Confederation
AIFI	Associazione Italiana degli Investitori Istituzionali nel Capitale di Rischio - Italian Association of Institutional Investors in Risk Capital
APEC	Asia Pacific Economic Cooperation
APROC	Asia Pacific Regional Operations Centre
ASSIFACT	Associazione Italiana de Factoring
ASSILEA	Associazione Italiana Leasing
BFTCD	Bureau of Foreign Trade and Commerce Department
CFI	contracted financial institutions
CGS	credit guarantee schemes
CIC	Credit Insurance Corporation
CITI	Clothing Industry Training Institute
CIPE	Inter-ministerial Committee for Economic Planning
CIRR	Commercial Interest Reference Rate
DLF	Disaster Loan Funds
DoIT	Department of Industrial Technology
EIB	European Investment Bank
EC	European Commission
ECGC	Export Credit Guarantee Corporation
EIF	European Investment Fund
EU	European Union
EUR	euro
EXIM	Export-Import Bank of the Republic of China
FASB	Financial Accounting Standards Board
GDP	gross domestic product
GIN	global information network
IC	Investment Commission
ICE	Istituto Nazionale per il Commercio Estero
IDB	Industrial Development Bureau
IDIC	Industrial Development and Investment Centre
IFC	International Finance Centre
ILO	International Labour Organization
INSME	International Network of SMEs
IP	Intellectual Property
IPI	Institute for Industrial Promotion
IPO	initial public offering
IT	Information Technology
ITRI	Industrial Technology Research Institute
LIT	Italian Lira
MFI	managed financial institution
MGC	mutual guarantee circle
MGS	mutual guarantee schemes
MOEA	Ministry of Economic Affairs, Taiwan
MSI	managed-single institution
NGO	Non-governmental organization
NM	Nuovo Mercato (New Market)
NSC	National Science Council
NT$	New Taiwan dollar
OECD	Organization for Economic and Cooperation Development
PGS	public guarantee schemes
R&D	research and development
SACE	Istituto per i Servizi Assicurativi del Commercio Estero
SBA	Small Business Administration

ABBREVIATIONS AND EXPLANATORY NOTES (*continued*)

SEI	Statute for the Encouragement of Investment
SIG	Società per l'Imprenditorialità Giovanile S.p.a.
SIMEST	Società Italiana per le Imprese Miste all'Estero
SME	small and medium enterprise
SMEA	Small and Medium Enterprise Administration
SMBCGF	Small and Medium Business Credit Guarantee Fund
SMEWG	Small and Medium Enterprises Working Group
SMGF	SME Mutual Guarantee Foundation
SPAN	Integrated Plan of Action for SME Development
SUI	Statute for Upgrading Industries
TAISDAQ	Taiwan Securities Dealers Automated Quotation
TIGER	Taiwan Innovative Growth Entrepreneurs
VAT	value-added Tax
VCF	venture capital firm
WTO	World Trade Organization

The symbol (<) indicates a number less than.
The symbol (>) indicates a number greater than.
The symbol (–) indicates that the amount is nil or negligible.
In reference to laws, the letter c. refers to the Italian word *comma*, meaning paragraph.

INTRODUCTION

This study examines the role of finance in the development and growth of small and medium enterprises (SMEs) in view of the pressures of economic globalisation. SMEs require modest amounts of capital to generate proportionately larger employment opportunities, to stimulate economic activity within a country and to distribute the benefits of economic development. This study reviews how financial schemes enable SMEs to gain better access to sources of finance.

Since the mid-1990s, ESCWA member countries, like other countries in developing regions, have prioritised the promotion of SMEs in the manufacturing sector. However, no member state has yet established a clear or consistent policy with respect to this issue. Whilst some countries, namely, Egypt and Jordan and more recently Lebanon, have focused solely on the provision of financial schemes for SMEs, they have failed to consider the efficiency, effectiveness or sustainability of such projects.

The financing of SMEs is a very broad subject. Therefore this study attempts to present an overview of the current situation. Chapter I is a general analysis of financial schemes for SMEs. The successful financial schemes for SMEs in two countries are examined in chapters II and III. It is recommended that these case studies, which are summarised in chapter IV, be used as examples for ESCWA member countries. Case studies from selected ESCWA member countries will be reported in a future ESCWA publication.

It should be noted that an official definition of SMEs in the ESCWA region does not exist.

I. FINANCIAL SCHEMES FOR SMEs: CONCEPTUAL FRAMEWORK

A. DEVELOPMENT OF SMALL AND MEDIUM ENTERPRISES

1. *Introduction*

SMEs promote sustainable economic growth and generate employment in an era of growing global competition. Nevertheless, the development of small-scale enterprises requires external assistance. Market imperfections and institutional failures are among the most important reasons for increased policy-induced biases that will benefit SMEs and for increased Government intervention.

Governments and international organizations have faced the difficult task of promoting the development of SMEs. A number of SME support programmes—in the form of direct and subsidized financial services—have been initiated with the aim of facilitating access to finance.[1] Yet, despite successes stories in a few countries, the overall results have been poor.[2]

Underlying the search for best practice is a basic question: what form should Government intervention take? There is a need to strengthen local business environments and build local capacity as an effective means of helping SMEs access financial resources.

2. *Improving the local business environment*

A vibrant SME sector is an important reserve of innovation, entrepreneurship and productivity growth. However, SMEs do not operate in a vacuum. They operate in business environments determined by Government policies and affected by social and institutional infrastructures. Owing to their size, SMEs are more vulnerable to business environment weaknesses than large enterprises. If policy-induced biases against SMEs are to be reduced, Government intervention that will ensure a healthy business climate—known as the enabling environment—is vital. The enabling environment encompasses a stable macroeconomic climate, a favourable legal, commercial and regulatory framework, including enforcement of contracts and protection of property rights and physical infrastructure.

In most developing countries, the major obstacles to private sector development relate to implementation and enforcement of policies, rather than the design and parliamentary enactment of those practices. Impediments to the development of SMEs in ESCWA member countries include administrative inefficiency and bureaucratic obstacles, widespread corruption and inadequate enforcement of laws and regulations. In one case, a dispute in one ESCWA member country concerning $1400 took four and half years to be resolved in a court of law, according to an individual interviewed for this study. Large enterprises have the resources to overcome these obstacles: small firms do not.

Establishing an enabling environment is a long-term goal that requires close cooperation amongst Governments, international organizations and other agencies. A strong commitment to this goal by Governments, on the one hand, and technical support and assistance from the international community, on the other hand, is crucial.

3. *Technical assistance and capacity-building*

The creation of a more favourable business climate is not the only criteria that would facilitate the growth of SMEs. If SMES are to develop, they need viable and sustainable financial and technical assistance

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[1] By reducing or completely eliminating market imperfections, governmental financial support policies may help SMEs overcome financing constraints. However, such initiatives may themselves create distortions in financial markets by subsidizing non-viable firms or discouraging firms from using non-credit forms of financing.

[2] Kristin Hallberg, "A Market-oriented strategy for small and medium scale enterprises," International Finance Corporation (IFC), *Discussion Paper No. 40*, World Bank, (Washington D.C., 2000).

programmes that would expand their access to critical resources including capital, skills and industry information.

In many cases, technical support has proven critical to the success of new investments. However, rather than providing such services directly, Governments and international organizations must invest in capacity building of local intermediaries, including amongst others, financial service providers, consulting companies and e-business outlets. These types of services enable SMEs to gain access to new investment, technical assistance and other resources. The International Finance Corporation (IFC) states that aid must be provided to SMEs in the form of capacity-building through equity investment. This encourages SMEs to adopt a transparent financial and accounting system while providing technical support to raise management capacity and competitiveness.

In this respect, some SME loans contain technical assistance components that target specific subsectors. A successful example is the Clothing Industry Training Institute (CITI) in Sri Lanka. In this case, British specialists worked with CITI to upgrade technology, quality control and training of garment producers. Today, CITI is at the forefront of training and innovation in the Sri Lankan garment industry.[3]

4. *Access to information technology*

Information technology (IT) and the Internet have dramatically reduced the cost of generating, processing and transmitting information. SMEs need to utilise the new technologies in several ways. These include building knowledge, gaining access to new markets and selling directly to buyers online. Indeed, small industries can place and fulfil orders, interact with distributors and arrange financing online at a fraction of offline costs. The subsequent increased competition is an incentive for financial intermediaries to introduce e-finance services and lower the cost of financing for SMEs.

With this is mind, a number of developing countries have launched programmes aimed at training SMEs on the use of the Internet as a tool for building new market overseas, namely, the Ghana Export Promotion Council.

Despite increased awareness about the contribution of IT and the Internet to the development of SMEs, the level of e-readiness in many developing countries is still extremely low. Poor telecom infrastructure, low circuit capacity for bandwidth, high tariffs and low PC literacy are still the major obstacles to advancing IT as a tool for the development of SMEs. Unsatisfactory regulatory frameworks and weak core infrastructure are reflected by low IT and Internet penetration rates. The Organization for Economic and Cooperation Development (OECD) countries had 82 Internet hosts per 1000 habitants compared to less than one host per 1000 habitants for non-OECD countries in 2000. Moreover, OECD countries had 80 per cent of total IT related production.[4]

5. *Access to finance*

The financial needs and financing modes of businesses' change and develop over time. Start-ups rely on internal financing, namely, retained earnings, personal savings and contributions from friends, relatives and business associates, in addition to trade credit from financial intermediaries. As a firm starts to establish a track record, it attracts the attention of investors who are willing to inject equity into the company. This facilitates bank loans. By going public, the firm eventually raises funds in the securities markets (see figure 1).[5]

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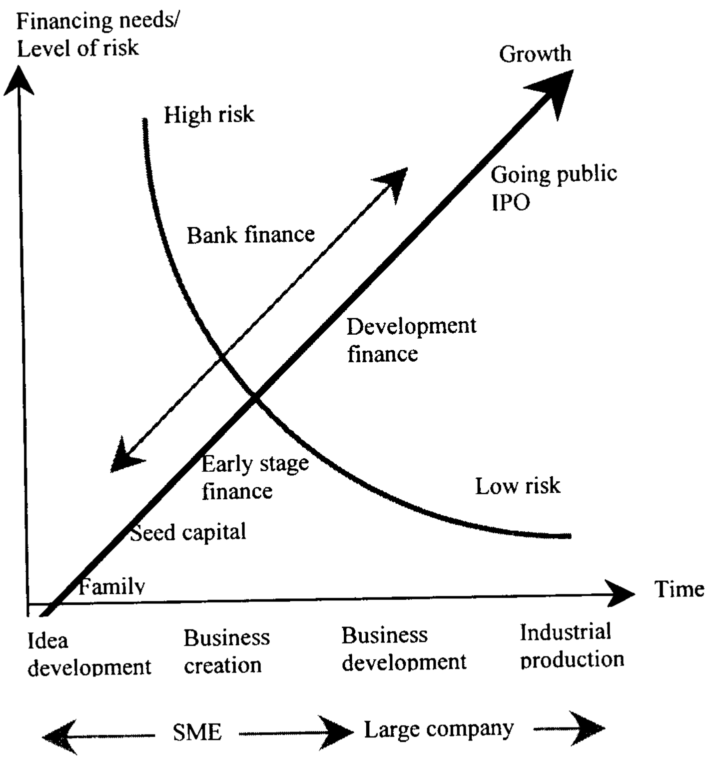
[3] Leila Weber, "World Bank lending for small and medium enterprises", Discussion Paper 113, p. 47.

[4] Rouben Indjikian, "E-Finance for trade: challenges and opportunities for developing economies", *UN Symposium on Government and E-Commerce Development*, UNCTAD, Ningbo, (23-24 April 2001).

[5] *China's emerging private enterprises: prospects for the new century*, IFC 2000.

Figure 1. Financial growth cycle of firms



Source: China's emerging private enterprises: prospects for the new century, IFC, 2000.

Limited access to finance is an important issue for SMEs. While access to capital will not solve all the problems faced by SMEs, it remains a crucial factor in ensuring their competitiveness by enabling them to invest in the latest technologies. However, traditional approaches, in the form of aid programmes, have failed in most cases to facilitate access to resources. Commercial banks and investors have been reluctant to service SMEs for a number of reasons, including high risks and transaction costs. Emphasis must be placed on enabling financial institutions to receive reliable financial information and lower the costs of servicing SMEs. Furthermore, building the capacity of traditional financial intermediaries to serve SMEs is not enough. The need for new and better financial products and initiatives is paramount.

B. FINANCING AND SUPPORT OF SMEs

1. *Access to bank financing*

Banks, like other businesses, concentrate on creating value under controlled risk. When a business applies for a loan, a bank focuses on the risks involved and the methods to mitigate those risks. Therefore, banks are reluctant to lend to SMEs for a number of reasons including the following:

(a) The information asymmetry that arises from small businesses' lack of financial information and standardized financial statements, in addition to the bank's limited knowledge about the borrower's company;

(b) The high risks involved in lending to SMEs as a result of a shortfall of assets that can be used as collateral, high failure rates, low capitalization and vulnerability to market risks;

(c) The higher transaction costs associated with lending to SMEs. SME loans are small and repetitive.

A successful SME financing strategy is one that ensures tailored financial services that meet the specific needs of small industries while coping with the problems of high risks and high transaction costs. In this respect, a number of innovative approaches have been undertaken to overcome barriers to SME financing. These include the use of credit scoring and rating, credit bureaus and training programmes for credit officers. These schemes have been very successful in the United States and Europe.

The problems inherent in receiving a bank loan are examined in box 1.

Box 1. Firm Y's journey to obtain a bank loan

"Firm Y, located in Beijing, specializes in the export of Beijing duck to developed countries. Its owner explains the process of obtaining a bank loan:

1. Find a bank that believes in the firm's repayment capacity. Besides satisfying formal bank requirements, the firm has to rely on an extensive social and information network.

2. Meet with the bank manager, vice manager in charge of the respective industry, vice manager in charge of corporations, and vice manager in charge of lending. This will cost the firm time and money.

3. Convince the lending committee that the firm has the right credentials to qualify for a loan.

4. Meet the lowest-ranking manager in charge of the granting loans in one of the bank's branches. This manager also has the power to kill your loan.

5. Find a firm that is willing to deposit money in the bank. This is required by the bank. However, no firm will do this for free. You have to pay extra interest to the firm which is comparable to the interest it would get from the bank. Of course, to find a firm that is willing to provide the service, you have to spend additional resources.

6. Find another firm that is willing to provide a guarantee because firm Y doesn't have enough collateral. Part of the loan must be leant to the guarantor. It is unlikely that this will be repaid.

7. Firm Y finally obtains a loan. However, a certain amount has already been spent on the formalities described above. In addition, the loan must be repaid in one year."

Source: *China's emerging private enterprises: prospects for the new century*, IFC 2000, p. 56.

2. *Financial growth cycle of SMEs*

Because of lower risks and lower transaction costs, banks' tend to be biased towards large businesses. Unlike SMEs these enterprises usually have an abundance of capital, adequate financial statements, skilled management teams, sufficient assets and a large business volume. What happens when banks fail to appreciate the particular financial needs of small industries is an inappropriate loan structure. Quite often, credit facilities are structured as short-term loans—of one year or less—irrespective of whether what is required is working capital or long-term capital to buy equipment or build a factory.

The following table provides a broad comparison between large and small firms.

TABLE 1. COMPARISON OF LARGE AND SMALL FIRMS

Differences	Large corporations	SMEs
Size	Large	Small to medium
Management	Large team with many levels	One person or small team
Capital sources	Abundant	Limited
Funding sources	Abundant	Limited
Annual reports	Audit by one of the world five banks	Local audit or none
Business evaluation	Through annual reports, analyst's reports and articles, etc.	On the spot and through local networking
Collateral	Local control or through other banks and various institutions	Direct control
Environment	International	Local/regional
Volume US$	Large	Small to medium

Small-scale businesses develop in different ways to large firms. Loans must accommodate this factor. SME development goes through various phases. These include the following:

(a) *The start-up phase*. Bank involvement at this stage is risky. Credit facilities are usually limited to current account transactions. Commercial banks, which pursue justifiable risks and careful stable returns, are reluctant to service start-up businesses because of their vulnerability. A more suitable mode of financing for enterprises at this stage is venture capital;

(b) *The growth phase*. Banks begin to develop a stronger relationship with a firm at this point. Given the slow accumulation of equity and a shortfall of assets that can be used as mortgages, enterprises usually resort to credit guarantee schemes (CGS) to secure bank loans;

(c) *Maturity phase*. Lending risks have been reduced to an acceptable level by this stage. By now bank and firm should have built a solid relationship. The firm is still too small to bank elsewhere. Therefore the bank can sell the company a range of products at good prices.

3. *Banks' innovative approaches to serve SMEs*

Globalisation trends characterized by the disappearance of national borders, worldwide communication and transportation facilities have changed the way companies do business. Furthermore, these trends have shortened the lifecycle of products. Therefore, banks must investigate potential clients more thoroughly.

(a) *Initiatives for information asymmetry reduction*

A standard mechanism to alleviate information asymmetry problems, are guarantees in the form of collateral. However, collateral is only a secondary source of loan repayment for western bankers. Cash flow is considered the primary source of loan repayment—given that the ability of a company to pay back a loan depends on the profits it makes and the cash flows it generates. In contrast, sufficient collateral will guarantee a loan approval for banks in most parts of the developing world. However, the fact that loans need to be repaid out of operating income and not through collateral liquidation is of greater consequence when dealing with SMEs, given that their collateral may be inadequate or not easily available in the event of liquidation. A bank's primary concern must be to find sufficient sources of cash to meet liabilities.

(i) *Financial disclosure*

While information asymmetry is common to companies of all sizes, it has far reaching consequences in the case of SMEs. As a result, well-designed technical assistance would improve the flow of information between borrowers and lenders, thereby ensuring a better appreciation by both of the relevant risks and returns involved.

The financial statements of large corporations usually have standard formats that conform to generally acceptable accounting practices. SMEs however, do not produce comparable financial information. More often, financial statements are locally audited and disclose limited information. The law of incorporation imposes limited financial disclosure requirements, even in developed countries.

Banks usually monitor a client's profit and compare it to the company's peer group to determine market conditions. However, reported profits are paper profits that can easily be manipulated. In fact, in many countries, companies have three "official" accounts, one for the bank, one for the tax authorities, and one for the management.

However, liquidity and cash flow are less easy to manipulate. Therefore they are a better way to verify a company's ability to repay debts.[6] While verifying liquidity is a paper exercise in large corporations, it can easily be ascertained through a physical examination in the case of SMEs.

[6] Liquidity is defined as liquid assets including cash, bank accounts, marketable securities and receivables minus short-term liabilities.

Cash flow is the other important way a bank can determine whether or not a borrower will default on a loan. In this case, the bank demands that cash flows exclusively pass through the bank. This provides him with a powerful tool to monitor the company by comparing actual cash flows with the projected cash flows agreed upon with the borrower.

(ii) *Credit scoring*

Credit scoring enables banks to alleviate information asymmetry problems with regard to small-scale industries. It is an efficient and cost-effective method of improving risk management in lending to SMEs. Credit scoring systems are better at assessing potential borrowers. However, the success of this mechanism relies on sound financial information.

(b) *Improving the skills and capabilities of credit officers*

Finance for SMEs must be accessible. There is a critical need to devote substantial resources to improve the skills and capabilities of banks' lending officers, especially with regard to the analysis of SMEs financial statements. Understanding the nature of the borrower's business, the specific challenges that he/she faces and the cash flow required is paramount to prevent a non-performing loan scenario.

4. *Credit enhancement*

Credit subsidy schemes were common in the past and continue to be used in many countries. These schemes aim to increase access to capital through a reduction in the cost of borrowing for SMEs. However, these schemes have discouraging results. Moreover, by creating distortions in financial markets, credit subsidies discourage the use of non-credit forms of financing.

Alternatives to credit subsidy schemes include, CGSs, asset securitization, export credit insurance and factoring.

(a) *CGSs*

Lack of collateral and high transactional costs are some of the main obstacles that prevent SMEs from gaining access to credit. Banks are unlikely to lend to SMEs when there are insufficient guarantees. This can hinder a bank's ability to recover loaned funds in the case of default. Moreover, lending to small enterprises is unattractive because high transactional costs result in low profitability.

In response, many Governments and international financial organizations have set up guarantee schemes that facilitate SMEs access to credit by reducing risk.

If properly managed and supervised, CGSs will help to resolve problems arising from information asymmetry and high transaction costs. However, these schemes are not effective substitutes for financial reform. It is important to note that CGSs entail risks when used as a mechanism in credit allocation and as a substitute for policy lending. Nevertheless, CGSs are less damaging than subsidized loans.[7]

This has contributed to their growing popularity. From 1997 to 2000, 2,258 loan guarantee organizations were registered in almost 100 countries. These organizations, which have approximately $45 billion at their disposal and guarantees worth almost $575 billion, provided their services and support to more than 7 million SMEs.[8] The most common types of guarantees are:

(i) Government programmes. These are usually policy-based and subsidized;

(ii) Donor or non-governmental organization (NGO) programmes. These operate under direct donor or NGO control, which is partly linked to micro-finance;

[7] In most developing countries, subsidized credit programmes aim to help the lower income portion of the population to establish small ventures that are sustainable. In theory this benefits the businessman, his family and ultimately creates further employment opportunities beyond the immediate family circle. However, such programmes do not necessarily benefit the poor, since the credit often finds its way to those not classified as poor.

[8] Jacob Levitsky, "SME guarantee schemes", *The Financier*, vol. 4, Nos. 1 and 2, (February/May 1997).

(iii) Mutual fund. This involves membership by a group of SMEs that provide capital with external funding or an aid donor;

(iv) Independent CGS. These have a separate legal status with funding from investors and/or donors.

CGSs are more highly developed in North America, Europe and South East Asia where they are used as a means of increasing access to credit for SMEs. In contrast, credit guarantee programmes are largely designed to deal with market imperfections in developing countries.

Over the last five years, the Small Business Administration (SBA), an American agency for small enterprises, devoted more than $50 billion of its total resources to guarantee credits issued by small financial intermediaries to SMEs, particularly start-ups and expansions.

Approximately 1000 credit guarantee organizations in Europe approve and process guarantee applications from some 3 million SMEs, for a total risk volume of 65 million million euros. CGSs in Europe can be divided into two categories: mutual guarantee systems (MGS) and public guarantee schemes (PGS). MGSs are based on the mutual or self-help concept and they vary from country to country. In France, local SMEs administer guarantees to each other under this system. Whereas in Austria, Denmark and Germany, private societies including chambers and professional associations act as partners in guaranteeing credits issued by lenders.

In contrast, public agencies or administrative bodies, provide a guarantee to the lender under a PGS. In some cases, namely, the Loan Guarantee Scheme in the United Kingdom of Great Britain and Northern Ireland, PGSs operate on a break-even basis.

In South East Asia, CGSs are run by organizations founded through Government initiatives. In Japan, guarantee and re-insurance mechanisms constitute an essential instrument in national economic regeneration policies. A Government-run Credit Insurance Corporation (CIC) reinsures more than 50 credit guarantee corporations, paying them 70 per cent of the guaranteed loss in the case of the default of the borrower. The Asian schemes place great emphasis on loan recovery after banks have been paid out on the guarantees.[9]

Credit guarantee mechanisms are less developed in other parts of the world. With the exception of Latin America where the tendency is to move towards establishing mutual guarantee company systems in which the companies make up the share capital, guarantee systems in developing countries are mainly confined to programmes of multilateral international co-operation organizations. Banks still perceive that lending to SMEs is risky and unprofitable.

The success of CGSs depends on a combination of external and internal factors known as best practices. These include an enabling environment, sound lending practices, viable projects, corporate governance, risk sharing by all parties involved, handling claims without delay or dispute and pursuing loan recovery vigorously even after the guarantee is paid.

(b) *Asset securitization*

Securitization is the process of packaging a set of relatively homogeneous illiquid loans into liquid tradable securities.[10] It is another method that would improve SME access to credit and reduce bankers' risks.

Securitization increases the availability of loan capital for companies with limited access to credit. This is because asset-backed securities are rated on their own merit, independent of the issuing company's financial standing. It also offers advantages to banks in the form of increased liquidity, reduced risk exposure

[9] The Japanese scheme "has kept its default rate low and subsequent loan recovery high compared with the other Asian programmes. This is ascribed to its long history and its highly developed database system". Jacob Levitsky, "SME guarantee schemes", *The Financier*, vol. 4, Nos. 1 and 2, (February/May 1997).

[10] Asset backed securities (ABS) refer to securities backed by instalment loans, leases, receivables, home equity loans and revolving credit.

and enhanced credit; illiquid assets are taken off the book and replaced with highly liquid asset-based securities that are traded in secondary markets (see table 2).

TABLE 2. VALUE-ADDED THROUGH SECURITIZATION

Individual loans	Asset-backed securities
Illiquid	Liquid, active secondary markets for most
Periodical valuation	Pricing efficiency and transparency
Originator assesses risk	Rating agencies and credit enhancers assess risk
Local investor base	National/global markets
Higher cost of funding	Lower costs
Assets remain on balance sheet, additional loan origination requires additional capital	Assets from balance sheets, additional funds available to support more loans

However, securitization, depends amongst other things on the degree of homogeneity of constituent loans and the size of loans. The higher the degree of heterogeneity and the smaller the size of the constituent loans, the less likely asset securitization will succeed. Given the small heterogeneous nature of small business loans, Government support is crucial for the development of SME debt securitization.

The United States of America's Government-supported SBA Loan Guarantee Schemes, led to the successful development of securitized guaranteed loans in the 1980s. According to the American Board Market Association, outstanding asset-backed securities in the United States totalled some $3 million million by the end of 1999; as compared to $374.5 billion in the mid 1980s, when this mechanism was established.

Securitization in this case consists of converting the government guaranteed portion of SME loans of similar structure into tradable bonds. These asset-backed securities, which are effectively default-free, are attractive to investors.

However, securitization is an unattractive option for many countries, with the exception of the United States and the United Kingdom of Great Britain and Northern Ireland, for several reasons including: (a) the heterogeneity and small size of SME loans; (b) the absence of a secondary market for small business loans or at best, the existence of an inefficient one; and (c) the lack of sophisticated legal infrastructure – upon which securitization depends.

If the securitization process is to become more successful and more common in ESCWA member countries, the development of an efficient secondary bonds market and the revision of relevant laws and regulations and the reinforcement of information disclosure is imperative.

Box 2 examines one aspect of securitization.

Box 2. The securitization of intellectual property assets: a new trend

"Lending partly or wholly against intellectual property (IP) assets is a recent phenomenon even in developed countries. Collateralising commercial loans and bank financing by granting a security interest in IP is a growing practice, especially in the music business, Internet-based SMEs and in advanced technology sectors.

Securitization normally refers to the pooling of different financial assets and the issue of new securities backed by those assets. In principle, these assets can be any claims that have reasonably predictable cash flows, or even future receivables that are exclusive. Thus securitization is possible for future royalty payments from licensing a patent, trademark or trade secret, or from musical compositions or recording rights of a musician. In fact, one of the most famous securitizations of recent years involved the royalty payments of a rock musician in the USA, namely, David Bowie.

At present, the markets for intellectual property asset-based securities are small, as the universe of buyers and sellers is limited. But if the recent proliferation of Intellectual Property Exchanges on the Internet is an indication, then it is only a matter of time before all concerned will develop greater interest and capacity to use IP assets for financing business start-ups and expansions. As more cash flows are generated by intellectual property, more opportunities will be created for securitization."

Source: World Intellectual Property Organization.
Available at: http://www.wipo.org/sme/en/ip_business/finance/securitization.htm.

(c) *Export credit insurance*

Export credit insurance provides a guarantee against export-related risks including:

(i) Payment defaults by foreign buyers;
(ii) Cancellation of specific orders by foreign buyers;
(iii) Imposition of restrictions by foreign governments or the cancellation of a valid import license.

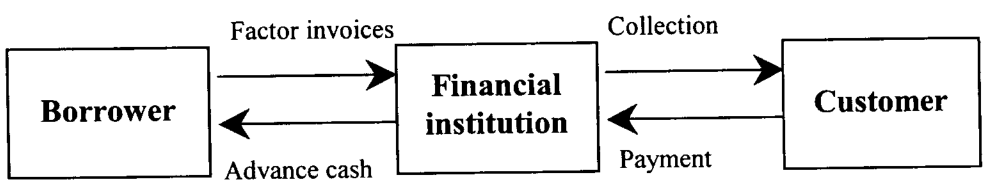
Insurance credit insurance schemes enable SMEs to expand their business activities and obtain better credit facilities from banks and other financial institutions. In most developing countries, public entities accommodate credit insurance schemes. One particularly successful example is the Export Credit Guarantee Corporation of India (ECGC). Established in 1957 by the Government of India, ECGC became the fifth largest credit insurer in the world in terms of coverage of national exports.

(d) *Factoring*

Factoring involves an agreement between the factor, otherwise known as a financial institution and a company. The factor purchases the company's credit-worthy account receivables at a small discount and converts the invoices into immediate cash. However, this traditional form of factoring is usually not available to small industries, which are perceived to be high-risk businesses.

In the case of SMEs, factoring account receivables are usually held as collateral against short-term loans. The borrower provides factor invoices to the lender who shoulders the responsibility of collecting the amount (see figure 2).

Figure 2. Operating procedures for factoring



Factoring can be divided into two categories: domestic and international. International factoring is the method used by exporters who sell on an open account or use documents against acceptance terms. International factoring eases much of the credit and collection burden created by international sales.

5. *Complement to finance: leasing*

Leasing is a rapidly growing alternative to bank loans for SMEs who require new equipment. An asset can be leased in return for a series of specified future rental payments over a definite period.[11]

There are a number of advantages and disadvantages to leasing assets. Leasing enables SMEs to utilise the asset without having to pay for it in advance. Moreover, under a lease agreement, the underlying asset typically acts as collateral. Yet, the cost of a lease is higher than the cost of a direct loan to finance acquisition of an asset. Tax advantages are relatively smaller.

An innovative approach to this problem is the securitization of leased contracts. Asset-based financing firms obtain their capital, in part, by selling bundles of lease obligations to institutional investors. This practice gives them access to large pools of capital at low costs.

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[11] Financial Accounting Standards Board (FASB), Statement No. 13, defines a lease as "an agreement conveying the right to use property, plant, or equipment for a stated period of time." (no date)

Despite its apparent advantages, leasing is difficult to apply in developing countries. The lack of a leasing law that addresses the issues of unclear accounting standards and tax disincentives hinders, the use of leasing for long-term financing of assets.

6. *Equity financing*

SMEs have three main sources of capital; internal financing, loans from financial institutions, and equities. Capital structure decisions, however, depend on market conditions, Government regulations and institutional features. The vast majority of SMEs in developing countries meet their financing needs through internal sources and bank loans. Only a few firms can raise private equity capital and still fewer can obtain financing from institutional investors such as venture capitalists.

Venture capital firms provide equity investment to private SMEs whose ventures are likely to grow rapidly. They tend to favour high-technology industries including biotechnology, telecommunications, computer, Internet and other specialty niche areas. Venture capital investment is perceived as long-term risk finance where the main source of income to the investor is a capital gain from sale of stock of the portfolio companies rather than dividend income. Venture capitalists, through board-level control or representation, are actively involved in the management of the portfolio company on the basis that the success of a venture does not depend solely on supplying capital. Intensive scrutiny of firms prior to providing capital and close monitoring afterwards, alleviates a certain lack of information and reduces capital constraints.

A distinction is usually made between formal and informal markets. Venture capitalists refrain from financing start-ups and very small businesses, which they consider to be risky. Uncertainty and lack of information often characterize these firms, particularly those within high-technology industries. As a result, many small businesses and start-ups resort to bodies within the informal venture capital market, known as business angels. They usually inject small amounts of finance compared to formal venture capital industry standards and provide considerable technical expertise and general management advice.

A private venture capital enterprise typically raises its capital from a limited number of sophisticated investors in a private placement. These operations have a life of some three to five years after which the venture capitalist exits by selling the shares. The investor base consists of wealthy individuals, pension plans, endowments, insurance companies, bank holding companies and foreign investors.

To date, the United States has had the most-developed venture capital market in the world. Venture capital markets in developing countries, however, are at an embryonic stage of development. The lack of developed organized private equity markets prevents SMEs from obtaining long-term capital. Efforts to stimulate the development of these markets must include the establishment of a legal framework for private equity funds; the introduction of preferred stocks; relaxing listing requirements and strengthening the incentive to list on domestic exchanges and boosting the range of exit mechanisms available to investors. Efficient exit mechanisms are vital for the existence of the venture capital industry. Exit mechanisms offer the means for investors to recoup their capital investments and to realise profits. A new exit approach involves the securitization of portfolios.

Box 3 presents a history of private equity investment.

Box 3. History of private equity investment

"Private equity investment has existed in every commercial society. One historical example was documented by Levin (1994). It involved the financing of a private fire department by Marcus Licinius Crassus in Julius Caesar's Rome. His business agents and fire fighters would be at the scene of any fire. If the building was worth saving, the agents would offer to buy it for cash at a substantial discount. If the owner of the property turned down the offer, they would leave without rescuing the building. If accepted, Crassus' fire fighters would attempt to save the building. Crassus made substantial profits."

Source: Thomas Liaw, *The Business of Investment Banking*, 1999, p. 11.

7. *Internet-mediated electronic financial services*

The dramatic reduction in the cost of generating, processing and transmitting information brought about by IT and the Internet has transformed the finance industry. E-finance—defined mainly as electronic financial services—is becoming an increasingly popular phenomenon. However, while penetration rates are high in industrial countries, e-finance is in its infancy in most developing countries. The share of online banking is expected to rise from 8.5 per cent to 50 per cent by 2005 in industrial countries, compared to a rise from 1 to 10 per cent for the same period in developing countries.[12]

E-finance, lowering the costs of providing financial services and increasing the speed at which these services can be delivered, is likely to lead to greater access to financial services. This will benefit a large proportion of SMEs in countries with underdeveloped financial systems characterized by a limited number of financial services provided to a small group of high net worth individuals and large firms. Smart cards, which offer financial services in the form of savings and electronic payments to individuals who often do not have bank accounts, are providing an opportunity for technological leapfrogging in many African countries where the financial infrastructure is weak. In addition, smart cards provide SMEs with a relatively easy and inexpensive way of building a credit track record.

Developing countries have translated an interest in e-finance into an increasing number of initiatives, many of which are specifically geared to serving the small business market. These include, SMEloan of Hong Kong, Pride Africa, and CitiBusiness (see box 4). However, although these initiatives have managed to overcome obstacles, e-finance is not a panacea. The benefits of e-finance can only be achieved by creating an enabling environment. This will involve the establishment of regulatory and other frameworks for telecommunications infrastructure, security and public infrastructure, information and privacy, contract enforcement and corporate governance.

Box 4. E-finance for SMEs

"SMEloan Hong Kong Limited (SMEloan) has reengineered the commercial lending process using the Internet and has become the leading provider of online financing for SMEs in Hong Kong, China. SMEloan conducts most of its business on the Internet and manages credit risk using a Web-based risk management model. In October 2000 SMEloan closed a HK$600 million (about US$75 million) financing facility with a group of banks. This was a first for a startup e-finance company in Asia. The facility will enable SMEloan to expand its current customer base of 200 SMEs to well over 1,000 by mid-2002.

Pride Africa is a financial institution that provides access to credit to more than 80,000 small-scale entrepreneurs in Kenya, Malawi, United Republic of Tanzania, Uganda, and Zambia. Pride Africa has created DrumNet, a virtual information and service network linking clients to markets, information, and services. Through its network of microlending branches and information kiosks, Pride Africa's clients can access wholesale supplies and services, advertising, and partnership and association building opportunities. To integrate microentrepreneurs into the formal financial sector, Pride Africa has created Sunlink Cashpoints. Sunlink clients have smart cards that provide teller access, loan authorization, and client identification, helping to establish credit ratings and so facilitating access by SMEs to other financial services.

Major financial conglomerates with worldwide operations are also entering the SME market. In April 1999 Citigroup created CitiBusiness, a new business group that specializes in financial services for SMEs. In May 2000 it launched the CitiBusiness Platinum Select Master Card, which in addition to providing credit gives access to various services -- including information on building a Web site, setting up an employee benefits programme, and so on. In early 2001 Citigroup offered CitiBusiness Direct, a comprehensive Internet banking program, to SMEs in the Czech Republic, Hungary, and India. In India CitiBusiness accounts for 15 per cent of Citigroup's corporate bank business, and counts 5,000 SMEs among its clients."

Source: Stijn Claessens, Thomas Glaessner, and Daniela Klingebiel, "Emerging markets: is leapfrogging possible?", *Financial Sector Discussion Paper No.7*, World Bank, (June 2001), p. 39.

[12] Stijn Claessens, Thomas Glaessner, and Daniela Klingebiel, "Emerging markets: is leapfrogging possible?", *Financial Sector Discussion Paper No.7*, World Bank, (June 2001), p. 7.

8. *Micro-finance*

SMEs operate in the formal sector of the economy. They have access to bank finance, even if it is limited and have the potential to grow into large corporations. In contrast, micro-enterprises are family businesses or self-employed persons operating in the semi-formal or informal sector with little opportunity of nurturing or accessing bank credit.

Micro-finance institutions combine the social mission of providing financial services to the lowest-income population possible, with the financial objective of achieving profits with the help of private financial institutions, or self-sufficiency through NGOs.

Despite their apparent comparative advantage over non-bank micro-lending NGOs, the participation of commercial banks in micro-finance has been rare. Banks have been reluctant to extend credit to micro-enterprises for a number of reasons, including high risks and transaction costs and the socio-economic and cultural barriers between bankers and micro-entrepreneurs. Therefore, the best way to initiate or upscale existing micro-finance activities is through capacity building of local banks.

However, to compete successfully in the micro-finance market, banks must create independent micro-finance programmes and insert them into the larger bank structure. They must acquire an appropriate financial methodology that permits a cost-effective analysis of creditworthiness. Finally they must recruit and retain specialized staff to manage these programmes.

Clarifying the functions of boards of directors is essential for effective governance in the case of micro-finance institutions as an increasing number of micro-finance NGOs become regulated entities that are able to attract deposits. Good governance in this case is the ability of the board to fulfil the dual mission of balancing social impact with financial objectives while protecting the institution's assets. Examples of failed governance in non-profit NGOs include Corposol in Colombia where the concentration of power in the hands of an executive who does not receive proper oversight from the board led to its collapse.

Box 5. Disaster loan funds for microfinance institutions

Creative and innovative disaster loan funds (DLFs) are examples of how micro-finance institutions cope natural disasters. DLFs are financial reserves, usually established by an initial donor grant, held against the occurrence of a disaster such as floods, hurricanes, or earthquakes. In times of crisis DLFs provide money to micro-finance institutions which then make loans to those who have been affected.

"DLFs are structured as follows:

(a) *Managed-single institution (MFI):* A donor provides the MFI with an initial injection of funds to be lent out to affected households and maintains some level of responsibility for monitoring the results of the fund; however, the MFI is essentially responsible for all of the remaining activities. BRAC's planned fund and those developed by BURO Tangail and Fundusz Mikro are all examples of this;

(b) *Separate DLF management-multiple institutions:* The Cooperative for Relief and Assistance Everywhere (CARE) and Inter –American Development Bank (IADB) funds serve multiple MFIs and have each created a separate organization to handle the management of the DLF. This separate entity is responsible for the management of most of the activities of the fund. After a disaster occurs, these entities assess applications for funds from affected MFIs and disburse loans to affected MFIs, which then on-lend these funds to affected clients. Likewise, in the repayment of loans, clients repay their loans to the MFI, and the MFI subsequently repays its loan to the DLF;

(c) *MFI Managed-Multiple Institutions:* A third variety, best illustrated by PKSF in Bangladesh, falls somewhere in the middle. It serves multiple MFIs, but rather than creating a central entity to manage the DLF (or managing it itself), it provides the initial funds to each participating MFI as a one-time grant, giving the MFI responsibility for managing the funds on an ongoing basis."

Source: Warren Brown and Geetha Nagarajan, "Disaster loan funds for microfinance institutions: a look at emerging experience", Calmeadow, October 2000 and DLF "Structures", *Microenterprise Best Practices*, Development Alternatives Inc. Available at: www.mip.org/pubs/mbp-res.htm.

II. DIFFERENT MODES OF FINANCING SMALL AND MEDIUM ENTERPRISES: THE ITALIAN EXPERIENCE

Since the early 1990s, Italian policies and laws have favoured SMEs through a series of financial incentives and products. Whether direct or indirect, these procedures have attempted to foster innovation, research and development (R&D) and the promotion of women and young entrepreneurs. Furthermore, their aim is to upgrade production methods, support exports and improve the internationalisation process. Recent European legislation and framework programmes complement these procedures by incorporating a series of measures that support European integration and foster European joint ventures and export oriented investments.

SMEs are the backbone of the Italian economy. Small-scale industries employed 73.6 per cent of the population, including self-employed individuals in 1997.[13] Clusters, defined as sectoral and geographical concentrations of firms, industrial districts—a cluster of small firms—and network organizations that result in collective efficiency and mutual benefits through active cooperation, characterise the structure of Italian SMEs. Government policies, the regulatory framework and reliable support services have contributed to the development of a business environment that sustains the active role of local SMEs, especially in the face of economic globalisation. The Government of Italy has devised an integrated package approach whereby financial schemes and incentives are accompanied by non-financial support measures provided by specialized support institutions.

There are four major challenges for the financing of Italian SMEs.[14] These include the following:

(a) The European single currency, the euro;
(b) Globalisation. This weakens the flexibility and adaptability of industrial clusters and districts;
(c) Technological changes. These necessitate the adaptation of industrial and business processes;
(d) Family-ownership of SMEs. This common practice inhibits growth by raising equity finance.

In view of the changes taking place in regional and international markets, public and private sector institutions have attempted to address these challenges. Financial schemes will play an essential role in achieving this goal.

A. THE ENABLING ENVIRONMENT

1. *The macro-economic environment*

(a) *Manufacturing sector*

Most Italian SMEs operate in the manufacturing sector. (Table 1 in the appendix contains a definition of SMEs). The manufacturing sector is facing increased competition as a result of globalisation, rapid advances in new technologies and from competition Eastern European countries, which have relatively recently entered the market economy.

According to a census conducted at the end of 1996,[15] manufacturing enterprises represented 15.7 per cent of a total of 3,521,754 companies in Italy and 35.4 per cent of a total of 13.8 million employees.[16] At the

[13] Ministero del Tesoro, del Bilancio e della Programmazione Economica, *Italy's report on economic reform*, (Rome, November 2000), p. 68. Available at: http://www.tesoro.it.

[14] Paul Betts, "SMES: still the backbone to its industrial base", *Financial Times Survey*, Italy: Banking Finance and Industry, (December 13, 1999). Available at: http://www.ft.com.

[15] The National Statistics Institute (Istituto Nazionale di Statistica) (ISTAT), conducted a census of all enterprises in Italy as of 31 December 1996 and as at 31 December 1997. This survey was based on an in-depth analysis of 412,224 enterprises, amounting to 15 per cent of all enterprise in Italy. Available at: http://www.istat.it.

[16] ISTAT, *Censimento intermedio dell'industria e dei servizi*, "Note Rapide", Anno 3 Numero 6, (18 dicembre 1998). Available at: http://www.istat.it.

end of 1997, the total number of companies in Italy amounted to 3,539,820 of which 542,653 where located in the manufacturing sector, excluding construction, mining and energy. Approximately 100 per cent of those in the manufacturing sector, that is 541,223 enterprises, employed less than 250 people. In fact, 97.8 per cent, 531,012 enterprises employed less than 50 people.[17] This highlights the increasing importance of SMEs in the manufacturing sector. Furthermore, the share of the manufacturing value-added (MVA) in GDP at constant 1990 prices was 23.3 per cent in 1997.[18]

At the end of 1997, 2.9 per cent of SMEs had R&D programmes and only 7.5 per cent had signed partnership agreements (see annex, table 2). Of the latter, 59.3 per cent had agreements with local partners, 31 per cent with Italian partners and 5.5 per cent and 4.2 per cent with European Union (EU) and other European partners, respectively.[19] In terms of the objectives of these agreements, 71.4 per cent are related to production and 10.1 per cent were development agreements. These figures indicate that by the end of 1997 the finance facilities and support measures that were launched in the 1990s had not produced adequate results. Innovation, e-commerce and partnerships are key to the competitiveness of SMEs.[20] If the Government of Italy increases support measures for SMEs, it will increase their access to finance and therefore their viability in a highly competitive environment.

(b) *Financial sector*

SME access to finance has improved since 1990. This can be attributed to several developments. One of these is the consolidation of the banking sector in anticipation of European integration and the advent of the European single currency. The other is intensified competition that has led to better access to available funds and loans at a lower cost for SMEs.[21] Over the last decade, there were 508 mergers in Italy's banking and financial sector according to the Bank of Italy and the number of banks declined from 1,176 in 1990 to 862 at the end of September 2000.[22] The market share by total assets of the five major Italian banks increased from 35 per cent in 1996, to 41.8 per cent in 1998 to reach 51 per cent in 1999.[23] In 2000 Italy's five leading banks accounted for 54 per cent of the total assets of all banks.[24]

During that period, other developments that facilitated SME access to equity finance took place in the non-banking financial sector. One of these was the creation of the Nuovo Mercato (New Market) (NM) in 1999. This caters to high growth and high technology companies and aims to facilitate access to equity financing. "NM is the Italian arm of the Euro. NM market—the exchange for growth stocks—also operates in Amsterdam, Brussels, Frankfurt and Paris".[25] Furthermore, STAR was launched in June 2001. It operates within the Main Exchange and comprises SMEs with market capitalization below 800 million euros (see appendix, table 3).

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[17] ISTAT, *Censimento intermedio dell'industria e dei servizi*, "Note Rapide", Anno 5 Numero 2, (21 aprile 2000). Available at: http://www.istat.it.

[18] United Nations Industrial Development Organization (UNIDO), *International Yearbook of Industrial Statistics 2001*, p. 39.

[19] ISTAT, *Censimento intermedio dell'industria e dei serviz*, "Note Rapide", Anno 5 Numero 6, (22 dicembre 2000). Available at: http://www.istat.it.

[20] OECD and the Ministry of Industry of Italy, *Enhancing the Competitiveness of SMEs in the Global Economy: Strategies and Policies*, Bologna, 13-14 June, 2000.

[21] The Amato law No. 218/1990 initiated the restructuring process, followed by the European Union (EU) Second Banking Directive in 1992 and the Consolidated Banking Law in 1994.

[22] Paul Betts, "More mergers to come", *Financial Times Survey*, Italian Banking Finance and Investment, (December 11, 2000).

[23] Ministero del Tesoro, del Bilancio e della Programmazione Economica, *Italy's report on economic reform*, (November 2000), p. 76. Available at: http://www.tesoro.it.

[24] Banca d'Italia, "The Governor's concluding remarks", *Ordinary General Meeting of Shareholders*, (Rome, 31 May 2001), p. 12. Available at: http://www.bancaditalia.it.

[25] The Economist Intelligence Unit Ltd (EIU), *Country Finance Italy*, New York, (September 2000), p. 32.

A privatisation programme, launched in July 1992, generated proceeds of up to Lit 194,992 billion by the end of 1999, equivalent to 12.9 per cent of GDP in 1992 and 9.2 per cent in 1999.[26] These proceeds combined with the European convergence requirements resulted in a reduction of public debt and increased financing to firms.

SMEs are expected to gain increased access to finance as liberalization of the financial sector continues. Particular attention must be drawn to draft legislation, provisionally approved in March 2001, concerning the banking activities of the Post Office, Bancaposta. As a result, Bancaposta will be able to compete with commercial banks on an equal basis, particularly those offering services, namely loans, to individuals and SMEs.[27]

2. *Support institutions*

(a) *Italian support institutions*

Italian SME support institutions enable SMEs to take advantage of Government policies. They represent a major component of an integrated package approach to the development of SMEs and their accessibility to sources of finance.

Public, semi-public, local and private bodies provide various kinds of support, including specific policies, regulatory frameworks and laws, technical assistance for training, marketing and promotion, incentives for innovations, feasibility studies, partner-finding, facilitation of export and accessibility to finance.

Several ministries are involved in this package approach. These include:

(i) The Ministry of Industry, which is responsible for central Government measures aimed at developing economic activities in the industrial sector, namely laws, decrees and circulars. Furthermore, it coordinates policies concerning the Mezzogiorno—the south of Italy and the islands;

(ii) The Ministry of University and of Scientific and Technological Research which is in charge of R&D laws and incentives;

(iii) The Ministry of Foreign Trade whose main objectives is to promote information about export consortiums, export financing, insurance and guarantee schemes in addition to soft loans for southern Italian export firms.

In addition, two public institutions provide financial support to industries.[28]

(i) Mediocredito Centrale was created in 1952 as a medium term finance institution targeting the reinforcement, development and export orientation of industrial SMEs. Owned by the Ministry of Treasury, it was sold to Banca di Roma in December 1999;[29]

(ii) Società Italiana per le Imprese Miste all'Estero (SIMEST), the financial institution for the development and promotion of Italian businesses abroad was created in 1991 as a joint stock company controlled by the Ministry of Foreign Trade and other shareholders including banks,

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[26] The fixed exchange rate: Lit 1,936.27 = 1 euro.

[27] EIU, *Country Finance Italy*, New York, (March 2001), p. 3.

[28] UNIDO, "A comparative analysis of SME strategies, policies and programmes in Central European initiative countries – part three: Italy", *SME Policy Framework*. http://www.unido.org/doc/331152.htmls to 331156 htmls.

[29] Ministero del Tesoro, del Bilancio e della Programmazione Economica, *La relazione sulle privatizzazioni*, (Giugno 2000), p. 11. Available at: http://www.tesoro.it.

firms and professional associations. Its aim is to support entrepreneurs with regard to exports, foreign investments, participation in international tenders, feasibility studies and technical assistance.

Semi-public institutions that provide assistance include:

(i) The Institute for Industrial Promotion (IPI), which assists SMEs technically, namely, by providing them with information on financial incentives;

(ii) The Istituto Nazionale per il Commercio Estero (ICE). It promotes the internationalisation of trade and investments.

Professional associations also play an essential role in supporting SMEs.

(i) Confederazione Generale dell'Industria Italiana (CONFINDUSTRIA) is the largest organization. It comprises 111,000 firms employing 4.2 million people in total;

(ii) Confederazione Italiana della Piccola e Media Industria (CONFAPI) is the confederation of SMEs which promotes the interests of SMEs and comprises more than 60,000 SMEs. It employs 1.2 million people;

(iii) Federazione tra i consorzi di garanzia collettiva dei fidi (FEDERCONFIDI) is the federation of consortiums for credit guarantees in the industrial sector. Its objective is to facilitate access to credit for industrial SMEs, especially bank loans.

In addition to these are the following:

(i) The Italian Chambers of Commerce;

(ii) Unioncamere, whose objective is to provide comprehensive services to SMEs namely administrative, information, assistance and promotion. Unioncamere is a decentralized network with specialized agencies;

(iii) Sviluppo Italia, a development agency, was launched in 1999 to manage the promotion of investments and incentives.

(b) *European support institutions*

The main European SME financing institution is the European Investment Fund (EIF). It "acts as a public-private partnership set up by the European Investment Bank (EIB), the European Community (EC) and public and private institutions from all 15 member states".[30] It supports the creation, growth and development of SMEs through venture capital and guarantees means to facilitate their access to debt finance. Since its inception in 1994 and up to the end of 1999, it has signed guarantees for 2.8 billion euros and committed 195.2 million euros to 51 venture capital operations.[31]

Other important institutions are the Euro Info Centres created in 1987 which to date have 284 offices in 37 countries. They act as a relay between the EC Enterprise Directorate General and local organizations. Their role is to inform, advise and assist SMEs. The Innovation Relay Centres network, launched in 1995, comprises 68 centres and addresses the needs of SMEs for innovative technology.[32]

[30] European Investment Fund, *Annual report 1999*, "Key facts and figures", 1999.

[31] Ibid.

[32] European Commission Community Research (CORDIS). Available at: http://www.cordis.lu.

3. *Business environment and culture*

The business framework of Italian SMEs, which is based on personal, family and institutional networking, helps firms to obtain debt financing or guaranteed loans, whether individually or in consortiums.

(a) *Italian industrial districts*

The core business environment of Italy comprises some 200 industrial districts, employing approximately 2.2 million people or some 43 per cent of the manufacturing sector. These contribute to one third of Italian exports and have been described as the country's "largest reservoir of resources and know-how".[33] These districts are characterised by a high concentration of specialized SMEs, with a high division of labour amongst companies, an efficient network of public and private services and an economic and social life regulated in a non-conflicting manner by trade associations and labour organizations. Furthermore, they are based on strong relationships within communities, namely, schools, training centres and industrial museums.[34]

(b) *Italian territorial pacts*

Territorial pacts are agreements among various private and public local entities, enterprises, industrial and work associations. They aim to build specific development programmes for the local production sector or infrastructure projects that would improve the business environment. Such pacts span all socio-economic sectors. They have developed in depressed areas. In April 2001, there were 109 approved territorial pacts, 71 of which were in southern Italy. These covered 2,281 municipalities with 18.6 million inhabitants. Investment amounted to Lit 14.6 million million of which Lit 7.1 million million derived from public contributions.[35]

B. FINANCING SCHEMES AND SUPPORT SERVICES

1. *Italian policies and incentives: laws in favour of SMEs*

Before reviewing and analysing the major financing and support schemes available to SMEs in Italy, it is important to outline the main policies they serve.

The majority of the schemes are biased in favour of SMEs and the internationalisation of Italian companies in line with specific objectives recognized by the EU as priority. These objectives are defined by the EU Structural Funds. These constitute the framework within which Italian legislators have elaborated their policies. These objectives are as follows:

(a) Objective 1: To promote the development and structural adjustment of less developed regions;[36]

(b) Objective 2: To support the economic and social conversion of areas facing structural difficulties;

(c) Objective 3: To support the adaptation and modernization of policies and systems of education, training and employment and provide equal employment opportunities for men and women;

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[33] Andrea Balestri, "I distretti industriali: la via italiana al lavoro e allo sviluppo", CD-ROM, Istituto Nazionale per il Commercio Estero (ICE) and Club distretti, 1999.

[34] Ibid.

[35] Ministero della Industria, del Commercio e del Artigianato, Direzione Coordinamento Incentivi Imprese, *Relazione sugli interventi di sostegno alle attività economiche e produttive*, "I Patti Territoriali", (Rome, 2001), table A-1, p. 3. Available at: http://www.minindustria.it.

[36] In Italy, this area covers the south and the isalands: Mezzogiorno: Campania, Puglia, Basilicata, Calabria, Sicilia, Sardegna and Molise.

(d) Objective 4: To facilitate the adaptation of workers to industrial and production systems changes;

(e) Objective 5: To promote rural development by speeding up adjustments of agriculture structures in the framework of the reform of the common agricultural policy and the development of rural areas.[37]

Government ministries and agencies in addition to regional, local, public and private bodies provide support measures that help to finance SMEs. These support measures are translated into numerous laws, decrees and circulars. However, this generates an excessive amount of bureaucracy that is detrimental to the effectiveness of these schemes. Another problem is that European directives and laws—designed to achieve social cohesion and integration among member states—are often limited in terms of national incentives.

Italian policymakers have certain priorities. These include tackling unemployment, increasing GDP and attempting to reduce the economic disparity between the north and south of the country. These objectives are translated into macro objectives that incorporate sound financial management and internationalisation in addition to productive development, R&D and the streamlining of economic sectors.[38] The Government is attempting to counterbalance and minimize the negative impact of small-scale production on the competitiveness of SMEs.

These efforts are enshrined within laws and incentives that aim to promote and support the following: investments for the purchase or lease of machinery and for upgrading of productive and technological means,[39] financing of applied R&D and innovation,[40] export and internationalisation process,[41] women entrepreneurs,[42] financial intervention in under developed areas,[43] young entrepreneurs[44] and electronic commerce.[45] Other financial support includes automatic incentives in the form of tax credits that can be wholly or partially used as tax payments.[46]

There is an overabundance of national incentive measures.[47] The number of intermediary bodies that overlap in terms of target sector or firms complicates this situation.

On the national level, 93 incentives cover all sectors and businesses. Fifty-two of these refer to grants, 18 concern facilitated loans, five deal with guarantees and five with tax credits. EU co-financing exists in some cases. However, budget problems have meant that 23 incentives remained idle in the last four years. From 1997 to 2000, 15 of the 93 incentives amounted to 96.4 per cent of the majority of requests presented and approved and 79.7 per cent of approved grants. Industrial firms can only benefit from two thirds of these

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[37] *Official Journal of the European Communities*, Council Regulation (EC) No. 1260/1999, chapter I, article 1, 21 June 1999; the EU Structural Funds, http://www.cordis.lu/finance/src/s-funds.htm and UNIDO, *SME Policy Framework*, "A comparative analysis of SME strategies, policies and programmes in Central European initiative countries – part three: Italy". Available at: http://www.unido.org/doc/331152.htmls.

[38] Ministero dell' Industria, del Commercio e del Artigianato, Direzione Coordinamento Incentivi Imprese, "Relazione generale", *Relazione sugli interventi di sostegno alle attività economiche e produttive*, (Rome, 2001), p. 30. Available at: http://www.minindustria.it.

[39] Law No. 1329/65 (Sabatini).

[40] Laws Nos. 297/99 (ex 46/82), 598/94, 346/88, 317/91, 140/97.

[41] Laws Nos. 143/98 (ex 227/77-Ossola), 394/81, 49/87, 83/89, 100/90, 304/90.

[42] Law Nos. 215/92.

[43] Laws Nos. 488/92 and 341/95 art.1.

[44] Law No. 95/95 (ex. 44/86).

[45] Law No. 388/2000.

[46] Laws Nos. 341/95 and 266/97.

[47] The decentralization Legislative Decree, D.Lgs 112/98 transferred competence and management of national firms' incentives to regions of Italy. In addition to the national measures, there are 422 regional incentives, of which only 135 were active in 2000.

15 incentives.[48] For the same period, SMEs of all sectors were the primary beneficiaries of the total approved grants. Therefore, small enterprises received 44 per cent of grants and medium-sized enterprises 21.5 per cent of the total.[49]

2. *Italian financing schemes for SMEs*

Financing schemes for SMEs are instigated, financed, monitored and controlled by public, semi-public, professional and private institutions. Deregulation and recent developments in the financial sector have made new sources of financing available to Italian SMEs in the 1990s.

The financing possibilities for SMEs reviewed in this study are not exhaustive but they are relevant to member countries in the ESCWA region. They include direct means, namely, factoring, equipment and machinery purchase or leasing, facilitated loans, export credit and guarantees and international joint ventures support and venture capital. They also include indirect financing, namely, guarantees, tax credits and automatic incentives.

(a) *Direct means of financing SMEs*

(i) *Factoring*

This is a common short-term form of financing. It accounted for Lit 55.75 million million in 1999, a 19.9 per cent increase from 1998.[50] Factoring is the sale of account receivables by a company or client, to a factor or bank or financial company.[51] This method has various advantages, including the fact that cash is available within a few days after invoicing, no debt increases are incurred because the transaction is classified as a sale of receivables and there is a reduction or elimination of collection monitoring or management since these functions are borne by the factor. The downside is the high cost for the client.

There are two types of factoring. The first is recourse, whereby the client remains responsible for any amount the factor cannot collect. The second is without recourse. In this case the client transfers the risk to the factor. In the case of factoring with recourse, the client receives 80 per cent as an advance and the remaining 20 per cent when the operation has been completed. In the case of factoring without recourse the client receives 100 per cent. As compensation for the service rendered, the factor usually charges an additional set of fees on the interest on the amount advanced. This is approximately 1 to 2 per cent above the prime rate. This includes a commission of 0.5 to 1.5 per cent on the nominal value credit negotiation fees, credit-check charges of Lit 150,000, legal fees on late payments and management fees varying from 0.7 to 2 per cent for factoring with recourse and 1.5 per cent for factoring without recourse. These charges are tax deductible. However, they are subject to value-added tax.[52]

By the end of 2000, there were 211 financial companies, including 24 banks in Italy. Of these companies, 42 listed factoring as their main activity.[53] According to a survey, 64 per cent of these firms used factoring. Of this number, 60 per cent used factoring for less than five years while only 9 per cent have used

[48] Ministero della Industria, del Commercio e del Artigianato, "Relazione generale", *Relazione sugli interventi di sostegno alle attività economiche e produttive*, Direzione Coordinamento Incentivi Imprese, (Rome, 2001), tables A1, A2 and A3, pp. 8-9. Available at: http://www.minindustria.it.

[49] Ibid. p. 21.

[50] EIU, *Country Finance Italy*, New York, September 2000, p. 43.

[51] Factoring is regulated by Legislative Decree No. 385/93.

[52] EIU, *Country Finance Italy*, New York, September 2000, p. 43.

[53] Associazione Italiana per il Factoring (ASSIFACT), *Fact & News*, numero 3 – anno 3, luglio 2001. Available at: http://www.assifact.it.

this procedure for more than 10 years. Furthermore, two-thirds of firms questioned, considered factoring as an alternative, 23 per cent or complement to bank loans and 43 per cent.[54]

(ii) *Equipment and machinery purchase or lease financing*

The purchase or lease of equipment and machinery by SMEs can be classified as medium to long term financing. The Sabatini law of 1965 permits a discount on the interest rate charged for the financed amount, namely, the investment amount including machine cost and auxiliary costs. These include, packing, assembly and testing costs ranging between Lit 1 million without VAT and Lit 3 billion including interest costs. The financing period is a maximum of five years including a pre-redemption period of one year. The interest rate is:

a. A figure of 0 per cent for acquiring firms in the objective 1 areas, with a maximum discount of 8 per cent, (see section B, part 1);

b. A figure of 40 per cent of the reference rate for firms located in the area excluded in article 87.3 of the Rome Treaty, with a maximum discount of 6 per cent;

c. A figure of 50 per cent of the reference rate, with a ceiling of 200,000 euros for medium-sized enterprises, for firms in the rest of Italy, with a maximum discount of 5 per cent.

The machinery or equipment is used as collateral for the loan. This facility cannot be cumulated with other Italian incentives for the same investment. However, it does not exclude European incentives and guarantees. In 1998 and 1999, leasing facilities represented some 11 per cent of facilities worth Lit 500 billion out of a total of Lit 4,611 billion under the Sabatini law and in terms of number of operations, 6.4 per cent.[55]

Financial leasing has become increasingly popular as it has several advantages over regular leases or purchases.[56] After a 35 per cent increase in 1998, the amount of leasing contract reached 21.9 billion euros in 1999, a 27 per cent increase compared to the previous year of which 8.4 billion euros, a 15 per cent increase in annual growth, was accounted for by the lease of office and industrial equipment.[57] Furthermore, operational leases are available, usually for short-term periods. Financial leasing, as a means to acquire assets, is the most popular form of leasing. Furthermore, leaseback is becoming increasingly popular after it was legalised in 1998. Therefore, lease charges are considered tax deductible and VAT refundable.[58]

(iii) *Facilitated loans*

This form of financing is medium to long term. Several major facilitated loan schemes are available to SMEs in Italy. These relate to the following: R&D and innovation, upgrading of productive means, export and internationalisation and women and young entrepreneurs. A high proportion of the investments and/or costs of these schemes have lower interest rates than market rates and long maturities. In some cases these provide for pre-redemption periods. These facilities are regulated by and operated under specific laws that

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[54] ASSIFACT, "La domanda di factoring". Available at : http://www.assifact.it. All firms were located in the industrial regions of Lombardia, Veneto, Emilia Romagna Lazio and Campania. Of the firms surveyed, 80 per cent were SMEs with a maximum of 250 employees.

[55] Associazione Italian Leasing, (ASSILEA), *Rapporto sull'activitá associative e sul mercato del leasing 1999*, 22 Maggio 2000, p. 32.

[56] The main advantages include the following: a possible discount by the supplier who is paid upfront by the leasing company, better balance sheet ratios because the asset amounts do not include the cost of the equipment, flexibility of financing terms, namely, duration, reimbursement schedule and amounts, an option to buy the equipment at the end of the contract and tax deductible leasing charges.

[57] ASSILEA, *Report on leasing 1999*, (Maggio 2000). Available at: http://www.assilea.it/creazine.asp.

[58] EIU, *Country Finance Italy*, New York, (September 2000), p. 46.

are monitored by the concerned ministries, namely Industry, Foreign Trade, Scientific and Technological Research and Foreign Affairs and appointed banks. The most important among these banks is Mediocredito Centrale. It was privatised in 1999 and is now a subsidiary of the Banca di Roma Group.

Loans conditions depend on the purpose of the loan and the time frame needed to accomplish the project. Pre-redemption periods are possible for long projects. The interest rate is usually expressed as a percentage of the "reference rate" which is the "market-rate for government-backed transactions".[59] There are approximately 10 reference rates depending on the duration and nature of the loan. These are set monthly, or bi-monthly by the Ministry of Treasury.[60]

(iv) *Export credit guarantees and international joint venture support*

Two public institutions control export insurance and export credit facilities in Italy: Istituto per i Servizi Assicurativi del Commercio Estero (SACE) and Società Italiana per le Imprese Miste all'Estero (SIMEST). They provide the main support for Italian companies including SMEs operating in foreign markets. The support provided by these bodies covers investments, market penetration, participation in international tenders and feasibility studies and technical assistance.

As part of the dynamic policy approach of the Government of Italy, functional adjustments of institutions take place on a regular basis. In this context, SACE, the only official export insurer, was recently restructured according to Legislative Decree 143/98. It now runs along private sector lines and is under the aegis of the Ministry of Treasury. It is governed by "the resolutions on internationalisation adopted by the Interministerial Committee for Economic Planning (CIPE)".[61] SACE provides "guarantees and insurance cover for political, catastrophic, economic, commercial and exchange rate risks" to which Italian companies are exposed in their export and foreign activities. This cover may also be applied to Italian and foreign banks with regard to loans for Italian activities abroad.[62] SACE's insurance and guarantees are guaranteed by the Italian State based on a proposal by the Ministry of Treasury and the Ministry of Foreign Trade.

SMEs are exempted from the insurance coverage application fee. The insurable amount at risk covers the commercial contract amount, the performance bond or machinery value, if it is not covered in the loan, the capital amount of credit lines and financial loans. The maximum loan maturity is subject to two rules: the Bern Union rule (EIC/1214 of November 13, 1996) for loans less than or equal to two years and the international rule, known as the Export Credit Consensus, for loans exceeding two years. The length of the loan depends on the type of goods and services. For loans subject to the consensus rule, the following terms must be fulfilled: minimum cash payment of 15 per cent, maximum loan five years, up to 8.5 years in specific cases. This is reimbursed in equal instalments at least semi-annually and at a minimum interest rate equal to the Commercial Interest Reference Rate (CIRR) set monthly by the OECD.[63] The difference between market rates and CIRR is covered by SIMEST. The cost of export credit coverage is a premium that varies according to the buyer's country and its nature, namely, public or private and the duration. The premium fee is a percentage of the loan amount and is usually charged on the amounts covered. It is determined at the loan agreement signature. The minimum premium on interest rates, are governed by a set of rules.[64]

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[59] EIU, *Country Finance Italy*, New York, September 2000, p. 19.

[60] Ibid. p. 19.

[61] Legislative Decree No. 143, 31 March, 1998. Amended by Legislative Decree No. 170, chapter I, Article 1, 27 May, 1999. Unofficial translation is available on the SACE web site, http://www.isace.it.

[62] Ibid. Chapter I, article 2.

[63] OECD, *Arrangement on guidelines for officially supported export credits*, chapter II, article 16, 1978. Available at: http://www.oecd.org. CIRR is set 100 basis point above the base rate which is initially determined according to one of two methods: five-year government bond yields for maturities and repayment terms of up to and including five years and three-year government bond yields; for repayment terms of up to and including 8.5 years, five-year government bond yields; for repayment terms above 8.5 years, seven-year government bond yields.

[64] Ibid. chapter II, article 20.

SIMEST, a joint stock company controlled by the Ministry of Foreign Trade, whose shareholders include banks, firms and business associations, provides financial support for the internationalisation of Italian businesses. SIMEST, in addition to providing export credit support through interest rate subsidies covers the difference between market rates and CIRR and provides firms and consortiums with various types of financial support. It is permitted to take minority stakes of up to 15 per cent in Italian joint ventures and to facilitate Italian investments in non-EU countries. Furthermore, SIMEST will cover 85 per cent of costs up to Lit 4 billion or Lit 6 billion for consortiums to establish branches in non-EU countries or specific promotions, for a maximum of seven years including a pre-redemption period of two years.

(v) *Venture capital*

This type of equity financing is most suitable for innovative and new technology-based SMEs where the level of risk and the possibility of important returns on investments are high. Furthermore, it can be used to finance the restructuring of existing firms. Venture capital financing caters to the various financial needs of firms throughout their development. These include the following:

a. Early stage: seed and start-up capital;

b. Expansion stage: second and third stage financing through investments to increase production capacity and market or product development;

c. Later-stage: bridge financing to prepare firms to go public, replacement capital and refinancing of bank debt;

d. Acquisition/buy out or buy in: for diversification or management buy out or buy in.

Venture capital is a relatively new concept in Italy. However, according to Associazione Italiana degli Investitori Istituzionali nel Capitale di Rischio (AIFI), the number of companies financed by this method grew by 97 per cent from 1996 to 1999. Furthermore, there was a 245 per cent increase in investment for the same period. In 1999, 50 per cent of investments were related to buy outs and 8 per cent and 20 per cent respectively, pertained to seed/start-up and expansion investments.[65] As a percentage of GDP, venture capital investments doubled in Italy between 1989 and 1999, an increase of 0.02 to 0.05 per cent. This is low compared to the United States, where venture capital accounted for 0.11 per cent of GDP in 1989 and 0.59 per cent in 1999.[66]

Venture capital encourages job creation, the development of new technologies, a rise in exports and local and regional development. Therefore, more and better support agencies and policies would improve the business environment for venture capital operation. Regarding supply, these measures must address the issue of tax incentives, mainly the reduction of tax on capital gains for venture capitalists and funds, the facilitation of the role of business angels and exit schemes from funds. In relation to demand, measures fostering entrepreneurship, innovation and R&D and training are in place. Nevertheless, additional measures for business incubators and science and technology parks must be considered.

(b) *Indirect methods of financing SMEs*

(i) *Guarantees*

Guarantees are an indirect means of facilitating access to finance for SMEs. Guarantees eliminate or reduce the need for collateral that is usually required by banks or financial companies as insurance against default on reimbursement. Various guarantees are available through the Central Guarantee Fund (Fondo

[65] Associazione Italiana degli Investitori Istituzionali nel Capitale di Rischio (Italian Association of Institutional Investors in Risk Capital) (AIFI), *Venture Capital and Private Equity in Italy*, 1999. Available at: http://www.aifi.it.

[66] C. Christofidis and O. Debande, *Financing Innovative Firms through Venture Capital*, European Investment Bank, PJ/ Industry & Services, (February 2001), p. 20. Available at: http://www.eif.org.

Centrale di Garanzia).[67] These include: direct guarantees in favour of financing entities, namely, banks, financial institutions and financial companies related to innovation and development; counter-guarantees in favour of other guarantee funds and co-guarantees that finance entities and other guarantee funds simultaneously.

Guarantees are priced according to type, size of firm and location of the operation. The cost varies between 0.125 per cent and 1 per cent of the guaranteed amount. The financial resources of this Central Fund are from four different sources. These include: the State; the interest revenue on loans provided by the Fund; the contribution of financial companies determined annually by the inter-ministerial committee for credit and savings and from withholding financial companies.

(ii) *Tax incentives*

In the past, this form of indirect financing favoured economic activity in less developed areas. More recently tax incentives have been widely used to facilitate employment and economic development and growth. Tax incentives comprise tax holidays or credits, social security reduction and wage subsidies, the majority of which are specifically geared towards SMEs. Tax incentives are incorporated within various laws. However, some incentives are automatic and only require formal approval. This complicates the management and monitoring of incentives. For investments, tax credits reach a maximum of 65 per cent and vary according to the size of the firm size and its location.[68]

(c) *Facilities for specific target groups*

Specific incentives to foster the creation of new enterprises by young entrepreneurs and to promote equal opportunities for men and women were introduced in 1992 and 1995.

(i) *Facilities for women entrepreneurship*

Law No. 215/92 promotes various aspects of women entrepreneurship, including management training, facilitated access to financing for small enterprises, cooperatives and associations—as defined in the 1997 Ministry of Industry decree (see appendix, table 1)—at least 60 per cent owned and managed by women. These financial facilities include grants or the equivalent amount in tax-credits and soft loans. Grants are calculated within EU limits for state aid expressed in equivalent gross and/or net subsidy. The amount depends on the location of the firm or the EU *de minimis* rule.[69] In the case of soft loans, this amount could reach up to 80 per cent of the admitted investment costs with a maximum of LIT300 million and with an interest rate equal to 40 or 50 per cent of the reference rate determined by the Ministry of Treasury, depending on the location of the firm. The incentives under this law are limited to grants. Furthermore, incentives are provided for management training and consultancy. The amounts allocated to these facilities have been steadily increasing and reached a cumulative Lit 551.2 billion in February 2001.[70]

(ii) *Facilities for youth entrepreneurship*

Law No. 95/95, previously known as Law 44/86 De Vito, promotes youth entrepreneurship and supports young entrepreneurs with grants, facilitated loans, loan guarantees, technical assistance and

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[67] Law 662/96, article 2, c. 100.

[68] EIU, *Country Finance Italy*, New York, (September 2000), p. 28.

[69] *De minimis* is a European Union rule governing member state aid. The amount of aid subject to this rule cannot exceed 100,000 euros over a period of three years. This concerns all aid, regardless of its source. However, this does not exclude other aid accepted by the EU (Official Journal No. C68/96).

[70] Ministero della Industria, del Commercio e del Artigianato, "Indagine sulla legge", *Relazione sugli interventi di sostegno alle attività economiche e produttive*, Direzione Coordinamento Incentivi Imprese, 215/92, 2001, p. 14. Available at: http://www.minindustria.it.

training.[71] Grants cover fixed assets, excluding land, running costs and personnel, in varying proportions. Compared to other facilitated loan measures, this law provides a loan guarantee of up to 20 per cent of investments through a guarantee fund established by Società per l'Imprenditorialità Giovanile (SIG), now part of Sviluppo Italia.

Furthermore, there are various support measures related to the different stages of a firm's development. These include pre-launch support, project development and business plan elaboration assistance and post-launch support services for enterprises involved in management training. Four years after launching, the survival rate of firms who received this form of incentive was 81.5 per cent according to a study by Sviluppo Italia, in 2000.[72]

Table 3 summarises the major financing schemes in Italy according to support targets.

3. *Italian SMEs support services and programmes*

There are a number of support services in Italy. The Ministry of Industry and Unioncamere have listed and grouped these services under the following headings:[73]

(a) Reception, facilities and basic information, namely, distribution of publications, meeting facilities and videoconferencing and promotional activities;

(b) Professional information services, namely legislation, market information, technical standards and certification, patent and technical namely, environment;

(c) Advice and direct support, namely, business planning and development of business contacts;

(d) SME specific training, namely, management and targeting, namely, women entrepreneurs or start-ups;

(e) Finance, namely, equity, research activity for grants and subsidies;

(f) Premises, namely, incubation units and technology centres;

(g) SME specific strategic measures, namely, seminars, trade fairs and missions, promotion of networking and cluster promotion.

The Chambers of Commerce, specialized service centres, which function at a local level and business associations, largely provides these services.

New support services and facilitating measures are expected related to taxation and networking possibilities for SMEs.

The changes of the 1990s had a positive affect on SMEs in general and their access to finance in particular. Furthermore, Italy's numerous incentive programmes and measures should become more streamlined over the next few years and there should be some growth in the number of measures aimed at encouraging new financing possibilities, namely, venture capital. This process may include the overhaul of

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[71] All shareholders must be between 18 to 35 years old or the majority must be between 18 to 29 years old. This age range remains valid for least 10 years or the grant/aid is cancelled.

[72] Sviluppo Italia S.p.a., *Tasso di Sopravvivenza delle Imprese "44"*, Divisione Servizi allo Sviluppo, (Rome, 30 settembre 2000), p. 3.

[73] Ministero della Industria, del Commercio e del Artigianato and Unioncamere, *Support services to SMEs in Italy*, 2000, pp. 36-38. Available at: http://www.minindustria.it.

the complicated taxation system. The Prime Minister of Italy wants to reduce the country's 100 tax headings to eight.[74]

The Ministry of Industry recently proposed the creation of an International Network of SMEs (INSME). "INSME would be aimed at offering a framework to boost the process of information dissemination, partnership implementation and service delivering for SMEs".[75]

4. *European SME support services and programmes*

There are a wide variety of support services and programmes available to European SMEs. The main promoters of schemes aimed at improving the supply of capital are the EC, the EIB and the EIF.

In 1997, the EC approved the Growth and Employment Initiative, which includes three complementary programmes. It is managed by the EIF and aims to provide SMEs with easier access to finance and to stimulate job creation, namely, the EIF Start-up for risk capital for firms in their early development stage, the Joint European Venture for SMEs in member states and the SME Guarantee Facility providing SMEs with loan guarantees to facilitate their access to loan financing.

Furthermore, a series of specific measures for SMEs support innovation, namely, the Finance, Innovation and Technology (FIT) programme, coordinated by the EIB, the EIF and other financial institutions hopes to facilitate the creation of innovative firms by promoting trans-national networking of financiers, investment banks and technology sources including research institutes and science parks.

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[74] James Blitz, "Tax-cutting zeal of richest power broker", *Financial Times Survey*, Italian Banking Finance and Investment, December 11, 2000. Available at: http://www.ft.com.

[75] Ministero della Industria, del Commercio e del Artigianato and OECD conference, *Enhancing the competitiveness of SMEs in the global economy: Strategies and Policies, Italian proposal for the International Network of SMEs (INSME)*, (Bologna, 13-15 June 2000).

TABLE 3. SUMMARY OF MAJOR FINANCING SCHEMES ACCORDING TO SUPPORT TARGET

	Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
1	Purchase or lease of machines and equipment	MICA[a]	SMEs	Law No. 1329/65 (Sabatini)	Facilitated loans	New Italian machines and equipment	Minimum Lit 1 million and maximum Lit 3 billion, excluding VAT and including interest costs	Up to 5 years	0 per cent to 50 per cent of reference rate[(1)] determined by the MTB	Duration includes a maximum of 1 year of pre-redemption	Mediocredito Centrale	The equipment must be used as collateral. This cannot be cumulated with other incentives for the same investment. Can be cumulated with guarantees
2	Innovation and research	MTB[b]	SMEs	Law No. 598/94, article 11	Facilitated loans	Investment in land, machinery allowing for substantial improvement in technology, environment protection, patents, consultancy	70 per cent of investments costs depending on location. Up to Lit 3 billion	Up to 7 years	20 per cent to 78 per cent of reference rate determined by the MTB	Duration includes a maximum of 2 years of pre-redemption	Mediocredito Centrale	Cannot be cumulated with other national, regional or local incentives
		MICA	All firms	D. Lgs 297/99 (ex Law No. 46/82)	Facilitated loans and grants	Personnel, equipment and consulting, expenses directly related to research undertaken autonomously	Grants of up to 65 per cent of admitted project costs depending on location with a maximum Lit 10 billion. Loans of up to 35 per cent to 55 per cent of project costs	Loans up to 15 years	25 per cent or 50 per cent of reference rate determined by the MTB	Duration includes a maximum of 5 years of pre-redemption	MURST, IMI[d] and MICA	Grants for particularly innovative projects and those at high industrial risk

TABLE 3 (*continued*)

Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
	MURST[a]	All firms	Law No. 346/88	Grants and facilitated loans	Personnel, equipment, consulting, expenses directly related to research undertaken autonomously	Up to 70 per cent of admitted project costs worth a minimum of Lit 10 billion	Up to 10 years	85 per cent of reference rate determined by the MTB	Duration includes a maximum of 4 years of pre-redemption	MURST and Appointed bank	Grants for particularly innovative projects and those at high industrial risk (10 per cent to 25 per cent of admitted costs)
	MICA	SMEs	Law 317/91 article 5, 6, 12	Grant or tax-credit	Innovative investments in machines and equipment such as hardware, software, and networks	15 per cent to 37.5 per cent of admitted costs up to Lit 675 million depending on location	-	-	-	MICA	The two types of facilities, grant and tax-credit, cannot be cumulated
	MICA	Industry and services SMEs created before 25/10/91	Law 317/91 article 8	Tax-credit	Research expenses, laboratories equipment, databases	Up to 50 per cent of admitted costs with a maximum amount of Lit 750 million depending on location	-	-	-	MICA	Can only be cumulated with European incentives
	MTB	SMEs and SME Consortiums	Law 317/91 article 17-25	Facilitated loans	Investment costs after 25/10/9: personnel, training, software development, technical assistance, marketing and consultancy	60 per cent to 80 per cent of admitted costs up to Lit 2 billion depending on location	Up to 10 years	30 per cent or 60 per cent of reference rate determined by the MTB depending on location	For duration	MICA	-

TABLE 3 (*continued*)

	Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
		MICA	Industrial firms	Law No. 140/97	Tax-credit	Research personnel, know-how for new products and new productive processes, equipment, overheads up to 40 per cent of admitted personnel costs and technological consulting	Varies according to size and location of firm	-	-	-	Banca Roma branches	Facility decentralized in all regions. All costs capitalized and shown in balance sheet
3	Exports and Internatio-nalisation process	MCE[g]	All exporting firms and consortiums	Law No. 143/98 (ex. Law No. 227/77 Ossola)	Export guarantee and credits	Credit and/or insurance for coverage of country political risks, catastrophes and commercial risks for goods and services sold to non-EU countries	Up to 90 per cent of supplier's credit and up to 95 per cent purchaser's financial credits of insurable amount determined after deduction of 15 per cent downpayment.	Varies according to country. Usually between 2 and 5 years	Premium and interests vary according to country. Minimum interest rates are determined monthly by OECD.		SACE[f], SIMEST[h] and Mediocredito Centrale	100 per cent coverage for specific operations
		MCE and Mediocred ito Centrale	All industry and service firms and consortiums	Law No. 394/81, article 2	Facilitated loans	Costs and expenses incurred after approval for foreign market penetration outside the EU	Up to 85 per cent of admitted costs with maximum of Lit 4 billion (Lit 6 billion for consortiums). Advance maximum of 30 per cent of admitted costs	Up to 7 years	40 per cent of reference rate determined by the MTB	Duration includes a maximum of 2 years of pre-redemption	MAE and Mediocredito Centrale	MAE (legal conformity and market penetration programme) and Mediocredito Centrale (technical conformity)

TABLE 3 (*continued*)

Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
	MAE[g]	All firms	Law No. 49/87, article 7	Facilitated loans and participation in capital	Italian partner share in joint ventures with private or public investors	70 per cent of Italian partner share for first Lit 10 billion and up to 50 per cent of exceeding amount with a maximum of Lit 20 billion	Up to 10 years after starting production or contract signature	30 per cent of reference rate determined by the MTB	In 16 instalments; duration includes a maximum 2 years grace period	Directorate General for Cooperation development in MAE	To promote and support the creation of Joint ventures in developing countries with less than US$ 3,250 annual income per capita
	MCE	Consortiums of exporting SMEs	Law No. 83/89	Support for SME export activity	Management and promotional expenses	40 per cent (60 per cent for consortiums in southern Italy) of admitted expenses in the year preceding application with a maximum amount of Lit 150 million	-	-	-	MCE	Not excluding other financing facilities. Consortiums should comprise at least 8 SMEs
	SIMEST and Mediocredito Centrale	All firms and consortiums to set up joint ventures in non-EU countries	Law No. 100/90	Shareholding and facilitated loans	Joint-venture share	Loan of up to 70 per cent of Italian partner share with a maximum Lit 5 billion for a single joint venture, Lit 10 billion for a single Italian SME or Lit 15 billion for a group of SMEs	Loan up to 8 years	50 per cent of reference rate determined by the MTB	In 10 weekly instalments to start after pre-redemption period of 3 years maximum	Mediocredito Centrale	SIMEST can hold up to 15 per cent of the joint venture but has to sell shares within 8 years. Loans can benefit from SACE coverage

TABLE 3 (*continued*)

	Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
		MCE and Mediocredito Centrale	All firms, consortiums and associations	Law No. 304/90	Facilitated loans	Expenses incurred for international bids and tenders in non-EU countries	Up to Lit 2 billion per firm and up to Lit 5 billion per bid	Up to 4 years	40 per cent of rate set according to Ossola law	Within 4 years	MCE and Mediocredito Centrale	
4	Women entrepre-neurship	MICA	Small firms, consortiums, associations run by a majority of 60 per cent women according to company type; created after 22/3/95	Law No. 215/92	Grants, facilitated loans and tax-credit.	Launching or acquisition of new activities, product innovation costs (feasibility, software, patent) technology transfer costs and entrepreneurship courses for women	Grants: for projects subject to *de minimis* rule [2], 50 per cent to 60 per cent of admitted costs depending on location (30 per cent for services costs); otherwise varies according to location and type. Facilitated loans up to Lit 300 million	Up to 5 years	40 per cent to 50 per cent of reference rate determined by the MTB depending on location	Up to 5 years	MICA	Facilities can be cumulated with other national or European benefits within 80 per cent of admitted costs. Tax-credits equal to the grant
5	Productive development in depressed areas	MICA	Industry and service firms in depressed areas	Law No. 488/92	Grants, contribution to interest payments on investment loans, leasing rents, social tax and payments	Industry: land, buildings, new machinery and equipment, vehicles, financial leasing, software, patents, feasibility studies, undertaken in previous year of demand; maximum 3 per cent of total cost	Industry: amount varies depending on location and size of enterprise and is paid in 2 or 3 equal annual amounts; the first as an advance and the rest based on incurred costs	-	-	-	Authorized bank transmits approval by decree to MICA	Grant cannot be cumulated with any other regional, national or European facility. Guarantee for realisation of project: bank security or insurance policy. Goods should remain in the firm for at least 5 years

TABLE 3 (*continued*)

	Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
		MICA	Industry firms in depressed areas	Law No. 341/95, article 1	Automatic incentive: tax-credit	Installations, new machinery and equipment, licenses, patents, environmental certification and installation and testing costs (10 per cent total costs)	Tax credit of 7.5 per cent to 65 per cent of admitted costs for SMEs depending on size and location with a maximum of Lit 10 billion per year	-	-	-	MICA	Tax credit cannot be cumulated with any other regional, national or European facility. Investment to be completed within 30 months
6	Young entrepreneurship[3]	MTB and Sviluppo Italia S.p.a.	SMEs in depressed areas. Exclusions: projects that do not increase production and employment and those which are not innovative.	Law No. 95/95(ex. Law No. 44/86)	Grant, facilitated loans with partial guarantee of up to 20 per cent of investment. In addition, technical assistance and management training limited to the first 2 years of activity	Fixed assets (buildings, machinery and equipment), studies, consultancy. Total investment should not exceed Lit 5 billion, excluding personnel costs	Up to Lit 5 billion depending on nature of cost: feasibility studies, fixed assets, management costs, subject to *de minimis* rule in some areas, raw material, products, leases, financial payments and fees; technical assistance and training	Up to 6 years	Reference rate determined by the MTB	If facilitated loan is awarded, reimbursement period starts 1 January of the year following the last payment of the facility amount. Reimbursements are paid annually	Sviluppo Italia S.p.a.	Facilities cannot be cumulated with any other regional, national or European incentives. Operations should not have started before the request is presented

TABLE 3 (*continued*)

	Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
7	Territorial pacts	MTB	Members of the pact (local firms, local authorities, professional associations, Chambers of Commerce) represented by an appointed promoter	Law No. 662/96, article 2, c.3 and Law No. 341/95, article 8	Grant and Tax-credit	Infrastructures and productive investment costs (land, buildings, machinery and equipment, studies and consultancy)	Up to Lit 100 billion. Only 30 per cent of grant can be used for infrastructures	-	-	-	MTB	Cannot be cumulated with other incentives
8	Guarantee	MTB and MICA	SMEs and consortiums	Law No. 675/77, article 20 (MTB) for manufacturing and Law No. 662/96, article 2, c.100 for industry and commerce	Direct guarantee, counter-guarantee, co-guarantee	Medium and long term loans, minority shareholding	Direct guarantee of up to 80 per cent of loan or operation amount. Counter-guarantee: up to 90 per cent of original guarantee which cannot exceed 60 per cent or 80 per cent depending on location	Up to 10 years	Central Guarantee fund cost: varies with type of guarantee, location and size of firm, from 0.125 per cent to 1 per cent of guarantee amount	-	Mediocredito Centrale	Can be cumulated with any other regional, national or European incentives
9	Automatic incentives on all the territory	MICA	Industry and Services SMEs	Law No. 266/97	Automatic incentive: tax-credit	Machinery and equipment, studies and consultancy	Depending on size and location of SME (7.5 per cent to 65 per cent with a maximum of Lit 10 billion per year)	-	-	-	MICA	Tax credit cannot be cumulated with any other regional, national or European facility. Investment to be completed within 30 months

TABLE 3 (*continued*)

	Support target	Authority	Beneficiaries	Legislative framework	Nature of facility	Costs admitted	Maximum amount	Duration	Interest rate (per cent)	Reimbursement	Application sent to	Comments
10	Electronic commerce	MF[i]	All firms, except transport, export, construction, distribution management. For sensitive sectors and projects for more than Lit 50 million, EU approval is a pre-requisite. priority is given to SMEs in consortiums	Law No. 388/2000	Tax-credit	Hardware, software, specialist consultancy, electronic directories and personnel training (up to 30 per cent of total cost)	60 per cent of admitted costs subject to the *de minimis* rule (100,000 euros over 3 years)	-	-	-	Not defined	Project has to be managed by a promoter for the benefit of at least 20 SMEs. Project has to be completed within 2 years

Source: ESCWA. Data collected and compiled mainly from (a) Ministero della Industria, del Commercio e del Artigianato, Direzione Coordinamento Incentivi Imprese web site: http://www.minindustria.it/Dgcii/Relazione/RELAZIONE, (b) from UNIDO, *SME Policy Framework*, "A comparative analysis of SME strategies, policies and programmes in Central European initiative countries – part three: Italy", http://www.unido.org/doc/331152 to 331156.htmls, and (c) http://www.contributi.it.

Notes:

a/ Ministero della Industria, del Commercio e del Artigianato (Ministry of Industry, Commerce and Craft).

b/ Ministero del Tesoro e del Bilancio (Ministry of Treasury).

c/ Ministero dell'Università e della Ricerca Scientifica e Technologica (Ministry of University and Scientific and Technological Research).

d/ Istituto Mobiliare Italiano.

e/ Ministero del Commercio con l'Estero (Ministry of Foreign Trade).

f/ Istituto per i Servizi Assicurativi del Commercio con l'Estero (Foreign trade insurance).

g/ Ministero dei Affari all'Estero (Ministry of Foreign Affairs).

h/ Società Italiana per le Imprese Miste all'Estero: A public-private financial institution to support joint-ventures development abroad. The major shareholders are Ministry of Foreign Trade and Mediocredito Centrale.

i/ Ministero delle Finanze (Ministry of Finance).

(1) 0 per cent of reference rate for SMEs in objective 1 areas (see section B, part I) A maximum discount of 8 per cent, 40 per cent in area of article 87.3 (see section B, part I) maximum discount of 6 per cent, 50 per cent in rest of Italy (maximum discount of 5 per cent) with capital of 200,000 euros for medium enterprises.

(2) *De minimus* is a European rule governing member State aid.

(3) All shareholders should be between the ages of 18 and 35 years or with the absolute majority of shareholders should be between 18 and 29 years old. These proportions must remain valid for at least 10 years after the facilities are granted, otherwise, they are cancelled.

(-) A hyphen indicates the amount is not applicable.

III. FINANCING SMEs THROUGH CREDIT GUARANTEE SCHEMES: THE EXPERIENCE OF TAIWAN

The economy of Taiwan relies heavily on SMEs. However, industrial SMEs face two challenges, membership of the World Trade Organization (WTO), achieved at the end of 2001 and the realisation of Taiwan's desire to head the Asia Pacific Regional Operations Centre (APROC), primarily for manufacturing and telecommunications.[76] The Government of Taiwan has several aims. It would like Taiwan to become a specialized manufacturing centre for high value-added products, a gateway to East Asian markets for other countries of the Asia-Pacific region and Europe and to transform Taiwan into an "island of technology".[77] These challenges require deregulation, market-opening measures and removal of restrictions regarding foreign ownership. This would increase the competitiveness of the Taiwanese economy and turn it into a more attractive manufacturing centre.

A. THE ENABLING ENVIRONMENT

1. *The macro-economic environment*

(a) *Manufacturing sector*

SMEs (see appendix, table 4 for definition of SMEs) represent the majority of enterprises in Taiwan. The number of SMEs increased from 992,000 in 1995 to 1,061,000 in 1999. They represented 97.96 per cent of all enterprises in 1995 and 97.73 per cent in 1999. Furthermore SMEs employed 79.75 per cent of the workforce in 1995 and 78.25 per cent in 1999.[78] Despite the fact that the number of SMEs in the manufacturing sector steadily decreased from 154,400 in 1995 to 142,700 in 1999, representing respectively 15 per cent and 13 per cent of all SMEs, they contributed to 28.35 per cent and 28.49 per cent of SMEs employment in 1995 and 1999 respectively.[79]

Moreover, the share in direct export value of manufacturing SMEs reached NT$ 507.8 billion[80] or 42.4 per cent in 1999.[81] In fact, the actual share may be higher. According to a study by the Chung-Hua Institution for Economic Research, 70 per cent of the leading trade companies declared that their products were derived from SMEs. Furthermore, the share of the MVA in GDP at constant 1990 prices was 30 per cent in 1997.[82]

These figures reflect the results of policies implemented since the 1950s. These were aimed at decreasing the dependence on imports of finished products by encouraging private enterprises to produce consumer goods locally and to increase exports, thereby achieving a trade surplus and earning foreign exchange reserves. In the 1970s, the manufacturing structure evolved towards more capital and technology-intensive industries. Industrial output grew by an average of 14.1 per cent annually in that period.[83] The 1980s witnessed the development of high-tech and high value-added industries that accounted for 40.2 per cent of total exports by 1990.[84] In the 1990s, the IT industry dominated the manufacturing sector, with IT

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[76] EIU, *Country Profile 2001 Taiwan*, London, 2001, pp. 28 and 29.

[77] Industrial Development and Investment Centre of the Ministry of Economic Affairs (MOEA), Asia-Pacific Regional Operations Centre, Taiwan, January 2001, http://www.idic.gov.tw/html/epatc.html.

[78] Small and Medium Enterprise Administration (SMEA) of the MOEA, *White Paper on Small and Medium Enterprises in Taiwan, 2000*, (September 2000), pp. 28 and 38.

[79] Ibid., pp. 29 and 40.

[80] US$ 1 equivalent to NT$ 31.2. This is based on an average for 2000. Source: EIU, *Country Profile 2001 Taiwan*, (2001, London), p. 26 and SMEA of the MOEA, *White Paper on Small and Medium Enterprises in Taiwan, 2000*, (Taiwan, September 2000), p. 46.

[82] UNIDO, *International Yearbook of Industrial Statistics 2001*, p. 40.

[83] MOEA, Industrial Development Bureau, "Course of Industrial Development", *Development of Industries in Taiwan, ROC*, 2000. Available at: http://www.moeaidb.gov.tw/idb/indintro/etext/1.htm.

[84] Ibid.

hardware growing by 27.5 per cent per year from 1995 to 1997. The electronic and information industry output growth averaged approximately 15 per cent per year from 1996 to 2000.[85]

The competitive advantage of the Taiwanese products has decreased over the last decade as a result of a shift in economic conditions related to the appreciation of the New Taiwan dollar, an increase in wages and stiffer competition from other developing countries. To restore competitiveness and attract private investments, the Government introduced policies aimed at accelerating the industrial upgrading process by encouraging automation, R&D activities, training, pollution control and high-tech projects.[86] At the forefront of this drive was the Statute for Upgrading Industries (SUI) of December 1990, amended in December 1999 and extended until the end of 2009.

(b) *Financial sector*

In 1989, the New Banking Law signalled the advent of financial sector reforms and paved the way for the ongoing liberalization process. Prior to 1989, the banking sector, capital flows and foreign exchange were tightly regulated and controlled. In fact, most banks were state-owned. The new law led to a "significant share of financial sector activity in the informal market and as result, the formal intermediated market and securities market were both underdeveloped".[87] The licensing of 15 new commercial banks and the conversion of an Investment and Trust Company into a bank in 1991 initiated the liberalization of the banking sector.[88] The privatisation process that began in 1997 is scheduled for completion by 2002.

The top three out of a total of 48 general domestic banks[89] dominate the market in terms of deposits and loans with a share of 60 per cent.[90] The amount of outstanding loans of these general domestic banks was NT$ 11.62 million million as of August 2000. Of this amount, 41.06 per cent accounted for private enterprises and 67.10 per cent for medium- and long-term loans.[91] Furthermore, co-operative banks channel funds to small enterprises and local entrepreneurs. According to SMEA, 50 to 60 per cent of the loans provided by the top five banks with the highest market shares, are loans to SMEs. In addition, Taiwan has five medium-sized business banks that were previously private mutual savings and loan companies. According to the 1975 Banking Law, these medium-sized business banks had to "specialize in extending medium and long-term credit to small and medium-sized enterprises".[92] In August 2000, their outstanding loans amounted to NT$ 793 billion of which 92.5 per cent was accounted for by private enterprises.[93] The large number of domestic banks and a rise in the number of financial institutions as a result of the liberalization process has increased competition and squeezed profits. Government and market forces have encouraged mergers to streamline this sector and re-establish profitability margins.

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[85] EIU, *Country Profile 2001 Taiwan*, London, pp. 37-38.

[86] MOEA, Industrial Development Bureau, "Course of Industrial Development", *Development of Industries in Taiwan, ROC*, 2000. Available at: http://www.moeaidb.gov.tw/idb/indintro/etext/1.htm.

[87] Institute for International Economics, "Financial services liberalization in the WTO: case studies – Taiwan", 2001. Available at: http://www.iie.com/CATALOG/Case Studies/DOBSON/dobtaiwa.htm.

[88] EIU, *Country Profile 2001 Taiwan*, London, p. 39.

[89] Excluding the five medium-sized banks that theoretically operate in a limited geographic area and therefore do not compete with general banks.

[90] EIU, *Country Finance Taiwan*, New York, (November 2000), p. 10.

[91] Ibid., p. 11.

[92] Institute for International Economics, "Financial services liberalization in the WTO: case studies – Taiwan", 2001. Available at: http://www.iie.com/CATALOG/Case Studies/DOBSON/dobtaiwa.htm.

[93] EIU, *Country Finance Taiwan*, London, (November 2000), p. 11.

Delinquent loans are one of the major problems for financial institutions.[94] "The average non-performing loan ratio in the banking system as a whole has risen in recent years, reaching a record high of 6.25 per cent at the end of September 2000".[95] This phenomenon may be related to the Asian financial crisis of 1997 and the major earthquake of Taiwan in 21 September 1999. On a structural level, it may relate to lending habits and policies based on personal relationships rather than on creditworthiness and solvability, in addition to the high level of enterprise interdependence. In this case, liquidity or a default in one enterprise could trigger chain reactions in others.

The solution may be the privatisation of banks and the liberalization of the financial sector. This would facilitate access to equity financing, the development of financial markets and venture capital. Financial markets are becoming more accessible to SMEs that require equity financing. Besides the Taiwan Stock Exchange (TSE), there is an over-the-counter (OTC) securities exchange for shares and bonds for smaller stocks. In May 2000 the OTC market was renamed Taisdaq "to emphasize its high-technology stocks".[96] By the end September 2000, Taisdaq comprised 263 listed companies. In April 2000, a new stock exchange division of the Taisdaq, Taiwan Innovative Growth Entrepreneurs (TIGER) was launched. It is primarily intended for technology companies.[97]

2. *Support institutions*

(a) *Taiwanese support institutions*

Several governmental and institutional bodies provide control, support and guidance to SMEs in general and to industrial SMEs in particular. The structure, framework and policies within which these institutions are highly centralized, controlled and monitored by governmental bodies.

The most prominent of these is the Ministry of Economic Affairs (MOEA). It is in charge of all matters concerning national economy including industry, trade, international cooperation and SMEs. It has specialized administrative agencies and units, of which several concentrate on industry and/or SMEs. These include the following:

(i) *Industrial Development Bureau*

The Industrial Development Bureau (IDB) is "charge of industrial policy, the formulation and planning of laws and regulations, administration, centralized planning, coordination and development,"[98] including taxation and financial measures favouring industrial development.

(ii) *Department of Industrial Technology*

The Department of Industrial Technology (DoIT) was set up in 1993 after a reorganization of the Office of Science and Technology Advisors. Its main objective is to "upgrade the technological level and operation strategies of local industries"[99] through policy planning, development of key industrial technologies and promotion of international cooperation with Asia Pacific Economic Cooperation (APEC) countries and exchanges with mainland China.

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[94] The overdue loans of the seven leading banks reached NT$ 349.4 billion at the end of August 2000. Source: EIU, *Country Finance Taiwan*, New York, November 2000, p. 8.

[95] EIU, *Country Profile 2001*, London, Taiwan, p. 40.

[96] EIU, *Country Finance Taiwan*, New York, November 2000, p. 34.

[97] *Taiwan Headlines*, "Taiwan to Launch TIGER exchange", Taiwan Economic News, Taiwan Headlines, March 1, 2000. Available at: http://www.taiwanheadlines.gov.tw.

[98] MOEA, "An introduction to the MOEA of the Republic of China". Available at: http://www.moea.gov.tw/~meco/cord/HTM/authority_e.htm.

[99] More information concerning the Department of Industrial Technology is available at: http://www.doit.moea.gov.tw/English/push/organization.asp.

(iii) *Investment Commission and Industrial Development and Investment Centre*

The Investment Commission (IC) examines and approves investments in mainland China. The Industrial Development and Investment Centre (IDIC) studies investment environments and promotes technical cooperation between domestic and foreign companies. Furthermore, it facilitates strategic alliances between them.

(iv) *The Small and Medium Enterprise Association*

The Small and Medium Enterprise Association (SMEA) was created in January 1981. It guides and assists SMEs with regard to law and policy-making, studies, improvement of manufacturing technologies, training and better operations. Furthermore it helps SMEs with easier access to finance and advises on development matters related to SMEs. The SMEA has established 22 local SME Service Centres. These disseminate information and increase the efficiency of its operations.

The SME Policy Deliberation Committee comprises representatives of various governmental agencies from various sectors including, economic, finance, interior and labour affairs, industry and academia. It offers advice on policies in addition to devising business environment improvements, financing, taxes and guaranteeing measures for the development of SMEs.

The Small and Medium Business Credit Guarantee Fund (SMBCGF) was established in July 1974. It provides credit guarantees to SMEs that do not have the necessary collateral to obtain finance. The SMBCGF is funded by the central and local governments and from contracted financial institutions (CFI). At the end of 1999, their respective contributions amounted to 84 per cent and 16 per cent of a total amount of NT$ 19.96 billion.

The SME Mutual Guarantee Foundation (SMGF) was established in August 1997.[100] "The Foundation is duly organized for the purpose of concentrating the group strength of SMEs, improving operating mechanisms, building a complete financial structure to meet the change of industrial environment, prevent chain closing and maintain steady growth of enterprises".[101]

(b) *Regional support institutions*

Regional institutions operate on a policy level. They share information and provide indirect support in terms of networking. They do not provide legal or financial assistance. APEC comprises 21 countries. One of its aims is to promote and support SMEs. The Policy Level Group on SMEs was established by APEC in February 1995. It became the SME Working Group (SMEWG) in 2000. The private sector is becoming increasingly involved with SMEWG which is acting positively on their proposals.[102] APEC recently launched a project called Global Information Network (GIN) for SMEs to foster trans-national transactions. If GIN is efficiently implemented, there could be a significant reduction of export networking costs for SMEs. Furthermore, industrial SMEs may be able to export directly without going through export trading channels.

The Asian Credit Supplementation Institution Confederation (ACSIC) was established in October 1988. It promotes the sound development of the credit supplementation system for small businesses through

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[100] In accordance with articles 7 and 23 of the Statute for Development of Medium and Small Business promulgated 4 February, 1991 and revised 21 May, 1997 and 21 January,1998.

[101] Chou Edwards and others, "Study on introducing SME mutual guarantee mechanism to APEC members", SME Development Fund, SME Mutual Guaranty Foundation and Chung-Hua Institution for Economic Research, Taiwan, (September 2000), p. 2.

[102] During the fourth to seventh Asia Pacific Economic Cooperation (APEC) Ministerial Meetings, the following were arranged: the Young Entrepreneurs Organization meeting, the Women Leaders' Network meeting, the Export Credit Agencies meeting and several business forums.

information exchange, discussion and interchange of personnel among small business credit supplementation institutions in Asia.[103]

3. *Business environment and culture*

Business practice of Taiwanese SMEs is based primarily on informal personal relationships. The business organization is characterized by its horizontal networked structure. This has implications for production, human resource, marketing, capital and investment.

(a) *SME business networks in Taiwan*

There are two types of horizontal networks in Taiwan. These include family networks with vertical hierarchical control and *guanxi* networks based on reciprocity between socially or family related bodies with horizontal control.[104] These networks play an essential role in an entrepreneurs' access to all forms of capital.[105] Half the SMEs interviewed by Pascale Güllner declared that their start-up capital was family-funded. The other half stated that they relied on friends, classmates, neighbours or co-workers. In the majority of cases these partners are silent and do not intervene in management issues. In many cases, they are not officially declared as shareholders. This framework developed for cultural and economic reasons in the period between the 1950s and 1980s. At this time there was a great demand for capital and investment. However, there was an acute shortage of finance because banks were reluctant to lend unless potential client's possessed real estate collaterals or guarantees.[106]

(b) *Taiwanese subcontracting*

The industry structure of Taiwan is heavily based on the concept of subcontracting. It follows, therefore, that there is a high dependency on personal networks and *guanxi*. This has pros and cons in terms of mutual support on the one hand and high risks that could trigger chain reactions in case of default, on the other hand. On a financial level, this is where the credit guaranty and mutual credit guarantee institutions play a significant role. Subcontracting in Taiwan can be analysed in terms of incentives and risks.[107] The reasons that force contractors to support sub-contractors or the latter to invest in the operations of the former are protective measures that reduce the business risk for both of them. The incentive mechanisms found in Taiwan's subcontracting networks comprise technical advice, loans, lending of machines, tools or factory space, settlement terms, capital investment into the subcontractor by the contractor or the other way.[108]

B. FINANCING SCHEMES AND SUPPORT SERVICES

1. *Taiwanese policies and incentives: laws in favour of industrial SMEs*

At the end of World War II, Taiwan successfully transformed its agricultural economic structure to an industry-based model. This metamorphosis was facilitated by the long-term policies adopted by the authorities. A series of fundamental laws and decrees reflecting the comprehensive economic policy planning and objectives were promoted.

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[103] Excluding areas to the west and north of Pakistan.

[104] Pascale Güllner, *Small and medium sized enterprises business networks in Taiwan*, Swiss Asia Foundation: Asia Field Research Scholarship Programme, Report No. 17, edited version is available at the Swiss Asia Foundation web site, July 1999, p. 25. (web site not included).

[105] Ibid., p. 26.

[106] Ibid., p. 27.

[107] Ibid., p. 41.

[108] Ibid.

The major framework laws or decrees and committees relevant to SMEs in the industrial sector include the following:

(a) SUI and the subsequent enforcement rules.[109] These cover various issues, namely, tax benefits, the establishment of industrial districts and their development;

(b) The Statute for the Development of SMEs;[110]

(c) The establishment of the SME Policy Deliberation Committee in 1994.[111] It comprises public, private and academic representatives and aims to build consensus among concerned parties in addition to playing a consultative role to the executive authorities;

(d) The establishment of the SME Development Fund with a budget of NT$ 12 billion under the direct authority of the MOEA and the Ministry of Finance;[112]

(e) The constitutional protection of SMEs in an amendment of 1997.[113]

With the aim of transforming the country into an technology leader, Taiwan has developed mid- and long-term plans that aim to raise industrial standards and promote quality, upgrade product design capabilities and improve the competitiveness of SMEs. These plans aim to encourage individual or joint R&D to develop new products and cooperation among industries, professional associations, public agencies, colleges and universities. In this regard, the Government of Taiwan has allocated a budget to create research centres specialized according to the industry to complement existing bodies, namely, the Industrial Technology Research Institute (ITRI).[114]

2. *Taiwanese financing schemes for SMEs*

Financing schemes for Taiwanese SMEs are institutionalised in the sense that they are developed, financed, monitored and controlled by public, semi-public and private institutions. Furthermore, they are centralized in their policy design and cover the island in terms of beneficiaries and applicable conditions.

The financing possibilities for SMEs reviewed in this study are not exhaustive. However important schemes for industrial SMEs that could be helpful in planning and implementing SMEs incentives in the ESCWA member states are included in this analysis. They include direct means, namely start-up loans to the specific target group of young entrepreneurs, venture capital and export credit and indirect financing, for example, credit guarantees, mutual credit guarantees, tax and investment incentives and re-lending facilities. Furthermore, incentive packages that promote science-based industrial parks will be reviewed.

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[109] Promulgated on December 29, 1990 and amended on December 31, 1999.

[110] Promulgated on February 4, 1991 and amended on January 21, 1998.

[111] Preceded by the *SME Policy Deliberation Committee organizational Guidelines* promulgated by the Taiwanese Cabinet, known as Executive Yuan in Taiwan on April 28, 1994.

[112] Created according to Article 9 of the Statute for the Development of SMEs and the Budget Law. The fund provides loans and guarantee financing to SMEs through financial institutions and is authorised to invest directly in promising and innovation/R&D oriented SMEs.

[113] MOEA, Small and Medium Enterprise Association (SMEA), *China's SMEs ready for the next millennium*, 2001. Available at SMEA web site: http://www.moeasmea.gov.tw/english/html.

[114] MOEA, SMEA, *The experience and achievements in providing guidance and assistance to small and medium enterprises*. Available at SMEA web site: http://moeasmea.gov.tw/english/html.

(a) *Direct means of financing SMEs*

(i) *Start-up loans for young entrepreneurs*

Young Taiwanese entrepreneurs have received significant support for more than 30 years on the basis that this approach will create job opportunities, accelerate economic development and improve social stability by allowing young people to undertake creative projects and increase their wealth.[115]

The beneficiaries of this type of support are manufacturing and non-manufacturing young entrepreneurs between 23 to 45 years old, who completed or are exempted from military service, who have at least three years of experience in the field of the proposed enterprise and who are graduates or developed their own inventions. These entrepreneurs must be managers of the enterprise or actively involved in it.[116]

Applications with a business plan are sent to the Youth Assistance Commission for evaluation. When a project is approved, the commission sends the young entrepreneur to a bank participating in the youth entrepreneurship fund to obtain a start-up loan.

Terms and conditions of start-up loans for manufacturing projects are as follows:

a. Maximum loan amount: NT$ 4 million for individuals, NT$ 600,000 for unsecured loans and NT$ 12 million for partnerships not exceeding 10 people, NT$ 3 million for unsecured loans;

b. Loan duration: six years for unsecured loans and 10 years for loans with collateral. For loans lacking collateral, a guarantee must be obtained from SMBCGF;

c. Repayment conditions: for the first 12 months for unsecured loans or the first 24 months in the case of secured loans, only the interest is payable. Starting from the thirteenth or twenty-fifth month, the principal and the remaining interest amounts are averaged and paid monthly over five or eight years;

d. Interest rate: fixed at nine-tenths of the basic interest rate of the Bank of Taiwan, which is adjusted every three months.

Non-financial assistance includes a number of support activities that are offered to young entrepreneurs before and after a firm is established. These include assistance in obtaining relevant information on starting-up a new business and on related procedures and applications, training programmes, assistance in preparing a business plan, technical advice, appointment of a start-up coordinator with a mission to promote cooperation among young entrepreneurs, assistance in improving operations and management methods, organizing seminars with experts and publishing guides, directories and catalogues for product promotion.

These programmes are funded by a number of institutions and banks including the Taiwanese Cabinet, known as the Executive Yuan and the Bank of Taiwan. The amount it raised reached NT$ 3.2 billion in September 2000.[117]

Since the launch of the Youth Entrepreneurial Fund in 1968 and up till end of 1999, the Youth Assistance Commission "helped 19,468 young people found 13,668 businesses, creating 107,277 jobs in total. Loans amounted to NT$ 17.7 billion, investment by young people totalled NT$ 47.3 billion, production

[115] Chuen Chang, "The mechanism and practice of Youth Entrepreneurial Fund", Small and Medium Business Credit Fund, Taipei, (September 2000), p. 4.

[116] Ibid., p. 5.

[117] Ibid., p. 6.

output reached NT$ 68.98 billion".[118] The proportion of manufacturing businesses assisted, reached 20 per cent.

(ii) *Venture capital*

Another source of funds for SMEs are venture capital firms (VCFs). Government encouragement of VCFs indirectly helps SMEs access equity finance more easily.

The Government of Taiwan established a set of rules entitled Regulations Governing Venture Capital Investment Enterprises, in 1983. These regulations were designed to upgrade the country's industrial structure by enhancing the development of technology-intensive industries. Any company with a minimum paid-in capital of NT$ 200 million can submit an application to the Ministry of Finance for assessment prior to the establishment of a VCF. Banks may hold up to 5 per cent stake in such a firm. Foreign and capital investment enterprises are permitted to establish or invest in VCFs. However, the total capital investment in the domestic manufacturing industry must not exceed 30 per cent of the paid-in capital of a VCF.[119]

As an incentive for the creation of VCFs, the Government provides a tax exemption for participating individuals of up to 20 per cent of the investment if shares are held for a minimum of two years. This exemption applies to companies for up to 80 per cent of earnings. In addition, since there is no capital gain tax in Taiwan, there is no tax exit cost for investors in VCFs. Furthermore, to set an example for investors and to boost the venture capital industry, the Development Fund of the Executive Yuan and Chiao Tung Bank established a NT$ 800 million venture capital seeds fund in 1985 and in 1991, the amount was increased to NT$ 2.4 billion.[120] Banks, insurance companies and various pension funds were recently encouraged to participate in new VCFs.

The number of VCFs has steadily increased over the last few years. By September 2000, there were 162 registered VCFs in Taiwan, worth a total of NT$ 100 billion in capital.[121] In April 2000, the Government permitted venture capitalists to invest in Internet-service companies and high-tech holdings. Previously this facility was limited to manufacturing and high-tech enterprises, mainly firms that manufacture semiconductors. However, shareholders involved in venture capital investments in high-tech companies no longer benefit from a 20 per cent investment tax-credit.[122]

(iii) *Export credit*[123]

The main provider of export credit is the state-owned Export-Import Bank of China (EXIM).[124] It covers various forms of risk including political, namely, war, revolution, civil disturbances, expropriation, import bans or transfer restrictions in the buyer's country and commercial, namely buyer insolvency, unilateral cancellation by public buyers and contract nullification in certain circumstances.

In most cases, coverage is up to 90 per cent of the insurable amount for commercial risks and up to 100 per cent for political risk, with a standard two-month waiting period for payment of losses. The premium amount, a percentage of the amount insured, varies depending on the policy type, risk classification, payment

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[118] Ibid., p. 8.

[119] Susan S. Chang, "The role of government funding for start-up companies and SMEs: the case of Chinese Taipei", presented at the *APEC Seminar on Securing Initial Funding for Start-up Companies – The Birth and Growth of SMEs in a Knowledge-based Economy*, Taipei, 16-18 May 2000, pp. 3-5.

[120] Ibid., p. 5.

[121] EIU, *Country Finance Taiwan*, New York, (November 2000), p. 21

[122] Ibid.

[123] The information in this section is from the Export-Import Bank of China web site available at: http://www.eximbank.com.tw and the EIU, *Country Finance Taiwan*, New York, (November 2000).

[124] Established in 1979 with a fully paid-in capital of NT$ 10 billion and assets of NT$ 119 billion as 31 December 2000.

terms, the importers' country and the duration of the insurance period. There are no application fees, credit limit commitment fees or unused credit fees. However, costs related to a credit investigation and correspondence, are charged to the insured party.

EXIM offers six types of policies that could benefit exporting manufacturing SMEs. These include the following:

a. *Short-term credit sales on documents against payment and documents against acceptance terms*

This provides coverage of up to 90 per cent of the gross value of exported goods or of the export bill amount, which is the lesser amount. This type of insurance constitutes 85 per cent of EXIM bank coverage. This type of insurance does not cover China.

b. *Letter of credit*

Political risk coverage is up to 100 per cent and commercial risk coverage ranges between 85 to 90 per cent of the insurable amount.

c. *Comprehensive open account*

Political risk coverage is up to 90 per cent and commercial risk coverage ranges between 70 to 85 per cent of the insurable amount.

d. *Medium and long-term export credit insurance*

This provides specific coverage for machinery, equipment, capital goods and turn-key plants. The insurable amount is up to 90 per cent of the gross invoice value after deduction of a 20 per cent down payment.

e. *Safety export credit insurance for SMEs*

Political risk coverage is up to 100 per cent and commercial risk coverage ranges between 85 to 90 per cent of the insurable amount including the invoice amount, gross value of exported goods or an irrevocable letter of credit amount.

f. *Comprehensive general export credit insurance*

Political risk coverage is up to 90 per cent and commercial risk coverage is 60 per cent of the insurable amount. This policy covers pre-shipment only and includes the manufacturing costs incurred before the irrevocable letter of credit arrives.

(b) *Indirect means of financing SMEs*

(i) *Credit guarantees*[125]

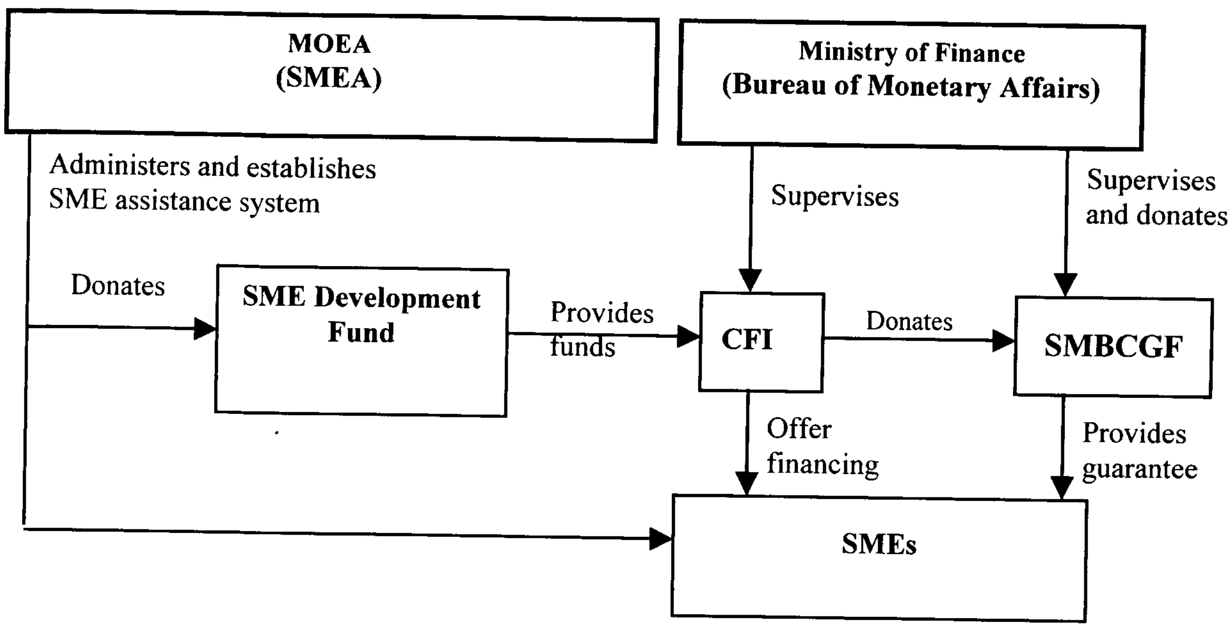
Credit guarantee schemes must play a complementary role to the operations of commercial banks who must screen and monitor accepted loan applications according to a principle known as the 5-Ps, namely, people, purpose, perspective, payment and protection or collateral. SMEs have serious problems obtaining bank loans because they are often required to offer collateral they do not possess. To combat this problem, the Executive Yuan established a non-profit legal entity, the SMBCGF in July 1974. Its mission is "to provide credit guarantee to SMEs which are promising but short of collateral necessary to obtain finance

[125] The information in this section is from the SMBCGF web site available at: http://www.smbcgf.org.tw and Chuen Chang, "The Role of Credit Guarantee for SMEs", Taipei, (February 2001).

from CFIs".[126] The SMBCGF signed Entrustment Contracts with 49 CFI that are classified as domestic financial institutions, namely, banks, investment and trust companies with 2,500 branches across the island. The principle behind the credit guarantee scheme is the "partial risk-assuming basis".[127] In Taiwan, SMBCGF covers 50 to 90 per cent of the risk depending on the type of credit guarantee, the enterprise's credit record and performance.

The scheme below outlines the mechanism adopted to provide credit guarantees.

Figure 3. Credit guarantee scheme in Taiwan



Source: SMBCF web site. Available at: http://www.smbcgf.org.tw.

The paid-in capital of SMBCGF comprises donations from central and local Governments and CFIs. By the end of 1999, these donations amounted to NT$ 19,958 million, of which 83.78 per cent was from the central and local governments and 16.22 per cent from CFIs.[128] The SMBCGF has guaranteed 1,894,669 cases, 134,870 enterprises for an amount of NT$ 2,251.98 billion since its establishment in 1974 up until end of June 2001.[129]

(ii) *Beneficiaries*

These include manufacturing and non-manufacturing SMEs, small-scale businesses, prospective young entrepreneurs aged between 23 to 45 years old, enterprises promoting their own brand name internationally.[130] SMEs that obtained guarantees from SMBCGF are eligible for assistance for up to eight years, even if the size of the company exceeds the definition of a SME. Once the manufacturing, non-manufacturing SMEs and those companies who have expanded beyond the SME limits are listed on the stock market or the OTC market, they are no longer eligible for credit guarantee.

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[126] Small and Medium Business Credit Guarantee Fund, "Objective". Available at: http://www.smbcgf.org.tw.

[127] Chuen Chang, "The Role of Credit Guarantee for SMEs", Tapei, (February 2001), p. 5.

[128] SMBCGF, "Capital", available at: http://www.smbcgf.org.tw.

[129] SMBCGF, "Performance", available at: http://www.smbcgf.org.tw.

[130] These enterprises, including large firms, must obtain approval for their promotion campaigns from the Ministry of Foreign Trade.

a. *Application procedure for SMEs*

SME applications for a loan guarantee from the SMBCGF fall into two categories. The first is the simplified approach. In this case a SME applies to a CFI who verifies that the SME lacks collateral and meets the conditions for this approach. The CFI contacts the SMBCGF, which issues a letter of registration. If the CFI approves the application, it grants the loan to the client. The CFI sends a notification of guaranteed credit and the guarantee fee to the SMBCGF as confirmation.

The second method is known as the normal approach. In this case the CFI, after verifying that the application does not meet the simplified requirements, refers the case to the SMBCGF. It cannot extend the credit facility until it receives formal approval from the SMBCGF through a letter of guarantee. This is sent to the CFI and to the client. It stipulates the conditions of credit and that the guarantee coverage ranges between 50 to 90 per cent. The CFI must notify the SMBCGF within seven days after the loan is extended. In this case, what is taken into consideration is not lack of collateral, it is the "operating performance, financial status, the proposed use of the loan and payment plan and the credit records of the enterprise and those who operate it".[131] Manufacturing firms with short and medium term working capital loans are only eligible for the normal approach guarantee application procedure. As of May 2000, 65 per cent of the guarantee amounts were processed using the simplified approach.

b. *Control of credit defaults*

When a firm defaults on payment, the CFI must notify the SMBCGF within two months. The case is put under SMBCGF control. Then the SMBCGF and the relevant CFI then devise a collection plan. The latter launches a legal action. If successful, the CFI applies to the SMBCGF for a prepayment. A payment is made when the prepayment has been approved. The allowance for bad debt is written off in the CFI's books. If any amount is later recovered by the CFI, the SMBCGF is paid according to its share in the covered amount.

c. *Maximum amount*

For each enterprise the maximum amount of guaranteed loan is NT$ 100 million. Another NT$ 100 million can be guaranteed for enterprises applying for the international promotion of own brand loans.

d. *Collateral and guarantors*

There are no collateral requirements for guaranteed loans. However, if the loan is intended for the purchase of land, factories or equipment, the CFI is required as collateral. Furthermore, those in charge and the firm's legal representatives are considered liable. Therefore, the CFI may require additional guarantors.

e. *Guarantee fees*

The regular fee is 0.75 per cent per annum of the credit coverage. However, for some types of loans the fee is lower, namely, guarantees on contract performance are approximately 0.5 per cent per annum.

(iii) *Mutual guarantees*

A new form of credit guarantee has been available to SMEs since 1997 through the SME Mutual Guarantee Foundation (SMGF). It operates as a non-profit legal entity under the authority of the MOEA. The basic principles governing the operations are mutual help and risk sharing.[132]

The various participants in the mutual guarantee scheme include the following:

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[131] Chuen Chang, "The role of credit guarantee for SMEs", Taipei, (February 2001), p. 6.

[132] Manufacturing SMEs must have been established for more than two years. The SMGF only admits applications from enterprises it considers eligible for guidance and support.

a. The SMGF arranges the Mutual Guarantee Circle (MGC), appoints a convener, signs a contract and provides the guarantee after a credit investigation is undertaken jointly with the bank(s);

b. The convener is a Taiwanese citizen of good reputation, a corporate entity or its representative with a sound credit record for at least five successive years and an established work record for at least seven years. The convener may or may not be paid for his services. His responsibilities include the selection of the MGC members and the organization of the MGC;

c. A financial institution provides a loan after a credit investigation. The amount approved may be different from the amount applied for;

d. MGC members are SMEs that would like to obtain a loan.

In addition to the entrustment contract with the convener, there are a number of bi-lateral contracts among the various participants of the mutual guarantee scheme. The SMGF signs a guarantee contract with the banks and a "trusted guaranty contract"[133] with the MGC members to act as their limited liability guarantor vis à vis the financial institutions. Furthermore, the SMGF, the convener and the circle members sign a "loss share contract"[134] to determine the fixed share that each party would bear in case of default.

The risk sharing among the different parties is fixed as illustrated in table 4.

TABLE 4. RISK SHARING AMONG VARIOUS PARTIES
(Percentage)

Default rate	Convener	MGC members	Financial institution	SMGF
Below 5	10	60	20	10
5 to under 10	–	60	25	15
10 to under 15	–	60	30	10
15 to under 20	–	60	35	5
20 to under 25	–	60	35	5
25 and over	–	–	35	65

Source: SME Mutual Guarantee Foundation web site. Available at: http://www.mugrnty.org.tw.

SMGF liability is limited to a maximum amount not exceeding four times the paid-in capital of the borrowing circle member or half of the previous year's turnover of the SME. The maximum loan period that can be guaranteed cannot exceed three years. The repayment conditions take one of the following forms:[135] One-year loans can be repaid by monthly annuities. Otherwise they can be repaid by circulating appropriation This must not exceed 50 per cent of the amount of the loan and can be paid by monthly annuities.

Three-year loans can be repaid by monthly annuities or by principal reimbursements in quarterly instalments with monthly interest.

Other repayment forms can be negotiated with financial institutions.

[133] Chou Edwards and others, "Study on introducing SME mutual guarantee mechanism to APEC members", SME Development Fund, SME Mutual Guaranty Foundation and Chung-Hua Institution for Economic Research, Taiwan, (September 2000), chapter II, p. 4.

[134] Ibid.

[135] Chou Edwards and others, "Study on introducing SME mutual guarantee mechanism to APEC members", SME Development Fund, SME Mutual Guaranty Foundation, and Chung-Hua Institution for Economic Research, Taiwan, (September 2000), p. 10.

Depending on the loan duration and the repayment conditions, the circle members deposit a percentage of the loan amount ranging between 15 to 22 per cent in a deposit fund in the lending financial institution under the custody of the SMGF.[136] The guarantee rate charged to the borrower varies between 1 to 2.375 per cent while the annual interest rate is some 8.25 per cent, approximately 2.5 per cent lower than the interest charged to non mutually guaranteed loans, regardless of the loan period.[137]

The SMGF charges each circle member NT$ 3,000 for participation in the credit investigation and management fees.

Since its establishment in February 1999 and up till January 2001, the SMGF has received applications for NT$ 6,987 million and approved guarantees for NT$ 1,748 million. There are 547 MGC members and 28 conveners have been contracted since the fund's establishment.[138]

There are advantages for every party in this type of scheme. Banks reduce or eliminate the risk of default, SMEs access finance more easily and at a lower cost compared to unsecured loans and the Government is not required to provide budgetary contributions because the deposit of 15 to 22 per cent of the loan amount of the circle members in a fund under the SMGF custody usually cover costs in case of default. However, this scheme has some problems because banks would rather not share risks and thus are more inclined to make use of the credit guarantee scheme. Furthermore, the Ministry of Finance is opposed to additional coverage provided by insurance companies and therefore, the risk is borne entirely by the circle members, banks, conveners and the SMGF.[139]

(iv) *Tax and investment incentives*

Taiwan has used tax incentives as a means to implement its economic policies, mainly on the taxable income level for half a century.

In the 1950s, when the trend was for import substitution and export promotion, tariff rates for imported manufacturing products were raised and those applied on material used in the industries of exportable goods were decreased. Furthermore, new firms were granted a three-year income tax holiday.[140]

This trend continued for the next 30 years. During that period, the Statute for the Encouragement of Investment (SEI) was promulgated. It promoted exports and stimulated investment in productive spheres by increasing tax holidays to five years and tax benefits to include expanding firms. Furthermore, accelerated depreciation on machines and equipment was introduced to encourage capital-intensive activities in addition to reduction or exemption of various taxes and duties, namely, reduction on land value tax, exemption of duties for material imported to be used in export-processing zones. In the 1980s, the SEI provided investment tax credits of 10 to 15 per cent on specific productive equipment against business income tax.

Furthermore, R&D was given priority because it stimulates competitiveness. The Government aims to increase R&D from approximately 2 per cent of GDP in 1998 to 3 per cent by 2010.[141] Therefore, firms that are eligible for tax holidays or accelerated depreciation have had to allocate a certain percentage of their annual sales to R&D, or pay the equivalent amount to the Government. If the amount allocated to R&D in

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136 Ibid.

137 Ibid., pp. 10 and 11.

138 The Foundation in Brief at the SME Mutual Guarantee Foundation web site. Available at: http://www.mugrnty.org.tw.

139 SMEA of the MOEA, *White Paper on Small and Medium Enterprises in Taiwan, 2000*, September 2000, Taiwan, p. 246.

140 Glenn P. Jenkins and Chun-Yan Kuo, "Which policies are important for industrialization: the case of Taiwan", *Development Discussion Papers Taxation Research Series*, No. 594, Harvard Institute for International Development, Harvard University, (July 1997), p. 2.

141 United States Department of Commerce, Office of Technology Policy, *International science and technology: policies, programs and investments*, December 2000, p. 28.

any year during the preceding five years was higher than the required amount, the firm is entitled to a 20 per cent tax credit against its business tax.[142]

The SUI promulgated at the end of 1990 and extended 10 years from January 2000 replaced the SEI. However, it includes a chapter on tax benefits similar to the conditions provided for in the SEI. Nevertheless, it does not specify the types of industries or firms benefiting from these preferential incentives.

The case study of Taiwan shows that income tax policies based on tax holidays, investment tax credits, export sales-based income tax credit and accelerated depreciation are the most important for firms operating in the domestic market but not for export-oriented firms. Therefore, this tax policy is not necessarily the most suitable system for Taiwan where economic policies have encouraged export-oriented production since the 1950s.[143]

(v) *Relending facilities*[144]

To promote exports, the EXIM bank offers credit to foreign banks. This must be lent to buyers of Taiwanese goods. These loans ultimately benefit Taiwanese SMEs indirectly because they are used to buy Taiwanese products. These loans are in United States dollars or in other major currencies. The financed amount is up to 85 per cent of the gross cost with a ceiling of US$2 million. The duration is usually six months to three years. For amounts exceeding US$1million, the duration is five years. The repayment period is in equal semi-annual instalments, effective one year after disbursement. For loans less than one year, the repayment comprises one lump sum to be paid on the agreed maturity date. There are no prepayment penalties. The interest rate is fixed or variable. The fixed interest rate is 5.25 per cent per annum for loans between six months and three years inclusive and 5.5 per cent per annum for loans between three and five years. The variable interest rate is calculated according to the six-month London Inter-Bank Offered Rate (LIBOR). The foreign bank is permitted to charge an additional 2.5 per cent interest.

(vi) *Incentives for SMEs located in science-based industrial parks*

Taiwan started designing and implementing a policy favouring the creation of science-based industrial parks to improve its science and technology status, in the 1980s. The first project, the Hsinchu Science-based Industrial Park in the north west of Taiwan, was launched by the National Science Council (NSC), the Science Park Administration and various high-tech industries. It covers 2,100 hectares and aims to attract high-tech industries. It includes integrated circuits, computers and peripherals, communications, photo-electronics, precision machinery and biotechnology. The preliminary studies for a second science-based industrial park in the south west of the country were initiated in 1994 and the construction of the Tainan Science-based Industrial Park that began in 1998, is expected to last five years.[145]

A wide variety of incentives encourage companies to operate in science-based industrial parks. These incentives include rent exemption for up to five years; possible use of patent rights or special technology as investments up to 25 per cent of the total investment amount; low-interest loans for the purchase of machinery or plant construction, up to 80 per cent of the total cost or 65 per cent of the total investment amount and up to 10 years including a one to three year grace period, with an interest rate 2 per cent lower

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[142] Glenn P. Jenkins and Chun-Yan Kuo, "Which policies are important for industrialization: the case of Taiwan", *Development Discussion Papers Taxation Research Series*, No. 594, Harvard Institute for International Development, Harvard University, (July 1997), pp. 3-5.

[143] Ibid. p. 44.

[144] The information in this section is based on the Export-Import Bank of the Republic of China web site, available at: http://www.eximbank.com.tw.

[145] EIU, *Country Finance Taiwan*, New York, (November 2000), p. 33.

than the regular loans from banks. In addition the Government can provide up to 49 per cent of the capital for an investment.[146]

(c) *Taiwanese SMEs support services and programmes*

There are numerous support and assistance programmes for SMEs in Taiwan. These cover a wide spectrum of services, financial and non-financial, ranging from information, training programmes, technical assistance to guidance systems on specific issues. These support systems complement each other and form a comprehensive integrated assistance system that allows SMEs to flourish.

SME support services and programmes are largely supervised by the MOEA. One of its most comprehensive services is entitled the Ten Guidance Services for SMEs.[147] This service operates in conjunction with the SMEA, the Bureau of Foreign Trade and Commerce Department (BFTCD) and the IDB. This guidance system covers the following aspects:

(i) SMEA: management, finance and credit, information management and quality improvement;
(ii) BFTCD: marketing;
(iii) IDB: R&D, production technology, industrial safety and pollution control.

The Government launched the Science and Technology R&D Project, with an allocated budget of NT$ 22.7 billion for the second half of 1999 until the end of 2000[148] as part of its ongoing policy to shift Taiwan towards an economy relying more on science and technology.

The committee of the SME Development Fund promoted a project called Guidelines for Encouraging the Establishment of Small and Medium Enterprise Incubator Centres by Public and Private Sector. As of February 2001, 600 firms were involved in the project and 52 centres were established.[149]

(d) *Regional SME support services and programmes*

Recognizing that SMES are key driving forces of growth, APEC regularly publishes a *Guide for SMEs in the APEC region*. It aims to help SMES have "good access to markets, information, technology, human resources and financing".[150]

The fifth meeting of APEC ministers responsible for SMEs in 1998, set the guidelines for an Integrated Plan of Action for SME Development (SPAN). Recognizing the necessity for a "comprehensive approach" and for "initiatives to create a conducive enabling environment to provide the requisite economic infrastructure and support services"[151] SPAN identified six issues and impediments to SME development, namely, policy environment, human resources development, financing, technology, market and information access. Furthermore SPAN devises guidelines to address each of these impediments. In the case of financing, it stresses the need to set up specialized financial institutions, credit guarantee corporations, export credit refinancing schemes and equity financing and venture capital, especially in the high-technology industries.

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[146] MOEA, Industrial Development and Investment Center (IDIC), "The investment environment of the R.O.C. in Taiwan". Available on the IDIC web site at: http://www.idic.gov.tw/html.

[147] SMEA of MOEA, R.O.C.'s "SMEs ready for the next millennium". Available on the SMEA web site at: http://www.moeasmea.gov.tw/english/html.

[148] Industrial Development Bureau (IDB) of the MOEA, Promotional Strategies and Measures, available on the IDB web site at: http://www.moeaidb.gov.tw/idb.

[149] MOEA, SMEA, " An overview of the SMEA". Available at: http://www.moea.gov.tw/english/eindex.html.

[150] John Manley, "Message from the APEC 1997 SME chair," *Guide for SMEs in the APEC region*, APEC, 1997. Available at: http://www.strategis.ic.gc.ca/SSG/ae00028e.html.

[151] Fifth meeting of APEC ministers responsible for SMEs, "Integrated plan of action for SME development (SPAN)", Kuala Lumpur, (7-8 September 1998), paragraph 4.4.

IV. LESSONS LEARNT

The following summary must serve as a model for setting up financial schemes for SMEs in member countries of the ESCWA region.

A. THE EXPERIENCE OF ITALY

Since the early 1990s, Italian policies and laws have favoured SMEs through a series of direct and indirect financial incentives and products. These aim to foster innovation, R&D, the promotion of women and young entrepreneurs in addition to upgrading productivity methods, supporting exports and the internationalisation process.

Several developments have taken place regarding the supply aspect of the financial sector, since Italy started to facilitate the ability of SMEs to access finance in 1990. One of those developments is the consolidation of the banking sector and increased competition. This generates more funds and loans to SMEs at lower costs.

Other developments in the non-banking financial sector have facilitated SME access to equity finance, including the creation of the NM in 1999.

Italian SME support institutions are essential as relays of Government policies. They represent a major component of an integrated package approach to the development of SMEs and their accessibility to sources of finance.

The interaction between public, semi public and local and private bodies is continuous and the support it provides is multi-faceted. This includes specific policies, regulatory frameworks and laws, technical assistance for training, marketing and promotion, incentives for innovations, feasibility studies, assistance in finding a partner, facilitation of export and accessibility to finance.

The business practice of Italian SMEs, which is based on personal, family and institutional networking, is a facilitating factor in obtaining debt financing or guaranteed loans for firms, whether individually or in consortiums.

Support measures for the financing of SMEs in Italy are institutionalised. A number of Government ministries and agencies, regional and local, public and private bodies play an active role in supporting SMEs. Furthermore, measures are translated into laws, decrees and circulars. However, this scenario is made less flexible by the fact that too many institutions are involved.

The general economic objectives of Italian policymakers are employment, increase of GDP and a reduction in the economic disparity between the north and south. These goals are translated into macro objectives of sound financial management and internationalisation, in addition to productive development, R&D and the streamlining of the economic sector.

Furthermore, financing schemes for Italian SMEs are institutionalised in the sense that they are instigated, financed, monitored and controlled by public, semi-public, professional, private institutions. SMEs evolve dynamically because new schemes appear or changes are introduced according to policy needs. Deregulation and recent developments in the financial sector have opened up new sources of finance to Italian SMEs in the 1990s. A number of financing schemes are available for SMEs. These can be accessed more easily by SMEs now, than in the past. Financing possibilities depend upon the needs of SMEs.

The financing schemes reviewed in this study include direct means, namely, factoring, equipment and machinery purchase or leasing, facilitated loans, export credit and guarantees and international joint ventures support and venture capital. They also include indirect financing such as guarantees, tax credits or automatic incentives.

Forthcoming support services and facilitating measures are expected regarding taxation and networking possibilities for SMEs. The numerous incentive programmes and measures and the increase in the number of measures aimed at encouraging new financing possibilities, namely venture capital, should become more streamlined over the next few years. One likely aspect of this process is the overhaul of the complicated taxation system.

To further help SMEs, the Ministry of Industry recently proposed the creation of INSME and is developing a feasibility study for this project.

SMEs in Italy still benefit from a large number of subsidies in the form of grants and subsidized soft loan interest rates. These incentives can subsidize non-viable SMEs. Furthermore, if financial schemes are not accompanied by efficient non-financial measures, the development and growth of SMEs may be jeopardized.

The general trend in Europe is to reduce state aid and to simplify business administrative procedures. The Government of Italy has expressed its commitment to this trend and practical measures are expected in the future.

B. THE EXPERIENCE OF TAIWAN

Taiwan's economy relies heavily on SMEs. Small enterprises play a vital role in the Government's objective of developing Taiwan into a specialized manufacturing centre for high value-added products, transforming it into a gateway to East Asian markets for other countries of the Asia-Pacific and Europe and improving its science and technology.

In the last decade, the competitive advantage of Taiwanese products has decreased as a result of the appreciation of the New Taiwan dollar, the increase in wages and stiffer competition from other developing countries. To restore competitiveness and attract private investment, the Government has introduced policies aimed at accelerating the industrial upgrading process by encouraging automation, R&D, training, pollution control and high-tech projects

The New Banking Law of 1989 signalled the beginning of the financial sector reforms that have paved the way for the ongoing liberalization process. The average non-performing loan ratio in the banking system has risen in recent years. This may be the result of the Asian financial crisis of 1997 and the major earthquake of 21 September 1999. These events should be absorbed by Government measures. On a structural level, this problem may stem from lending habits and policies based on personal relationships and the high level of interdependence of enterprises. In this case, liquidity or a default in one firm could trigger a chain reaction in others.

Several governmental and institutional bodies provide control, support and guidance to SMEs in general and to industrial SMEs in particular. The structure, frameworks and policies of these institutions are highly centralized, controlled and monitored by governmental administrations.

Regional institutions operate on a policy level. They disseminate information and provide indirect support in terms of networking. Legal or financial assistance is not available. APEC, is the main regional institution that endeavours to promote and support SMEs.

The business practice of Taiwanese SMEs is based primarily on informal personal relationships. The business structure is characterized by a horizontal network structure. This affects production, human resources, marketing, capital and investment.

Taiwan's industry structure relies heavily on subcontracting. The consequence is a high dependency on personal relationships and *guanxi*. This has pros and cons in terms of mutual support on the one hand and high risks that could trigger chain reactions in case of default on the other hand.

Financing schemes of Taiwanese SMEs are institutionalised in the sense that they are developed, financed, monitored and controlled by public, semi-public and private institutions. Furthermore, they are centralized in their policy design and cover the entire territory in terms of beneficiaries and applicable conditions. Financing schemes reviewed in this study included direct means, namely start-up loans to the specific target group of young entrepreneurs, venture capital and export credit and indirect financing, namely, credit guarantees, mutual credit guarantees, tax and investment incentives and relending facilities, in addition to incentive packages available to promote science-based industrial parks.

Guarantee schemes and mutual guarantee schemes have played an essential role for the last 25 years in responding to the high ratio of loan defaults in Taiwan. Furthermore, they have encouraged banks to increase loans to SMEs.

There are a number of support and assistance programmes for SMEs in Taiwan. These cover a wide spectrum of services, financial and non-financial, ranging from information, training programmes, technical assistance to guidance systems on specific issues. These support systems complement each other and form a comprehensive integrated assistance system. Ultimately, they allow SMEs to flourish.

Appendix

TABLE 1. DEFINITION OF SMEs IN EUROPE

Definition of an industrial SME in Italy and in Europe	Small enterprise	Medium enterprise
Maximum number of employees	< 50	< 250
Maximum turnover (millions of euros)	7	40
Maximum balance sheet total (millions of euros)	5	27
Control by an enterprise other than SME (percentage)	< 25	< 25

Source: Decreto Minindustria 18/9/97, Official Gazette No. 229/97 and Official Journal, C. 213/96.

TABLE 2. NUMBER OF ENTERPRISES PER CATEGORY OF EMPLOYEES IN MANUFACTURING AND PERCENTAGE OF TOTAL ENTERPRISES IN THE SAME CATEGORY, PER FEATURE AS OF 31 DECEMBER, 1997

	Number of employees						
	1-9	10-19	20-49	50-99	100-249	>= 250	Total
Number of enterprises	448 518	54 592	27 902	10 211		1 430	542 653
Partnerships	5.9	13.1	16.4	21.3	24.3	31.6	7.5
Employee training	6.6	26.6	40.5	58.0	74.7	87.4	11.7
R&D	1.4	4.8	11.3	23.0	36.9	58.3	2.9
Hardware	29.1	76.1	89.0	97.4	99.2	100.0	38.3
Software	18.0	56.4	73.4	87.8	94.4	97.7	26.3

Source: ISTAT: Principali Risultati del Censimento Intermedio dell'Industria e dei Servizi, updated 22 January, 2001. Available at: http://www.istat.it.

TABLE 3. BORSA ITALIANA: LISTED COMPANIES AND CAPITALIZATION BY MARKET

	Number of companies				Domestic capitalization in millions of euros			
	December 1998	December 2000	June 2001	percentage change 2001/1998	December 98	December 2000	June 2001	percentage change 2001/1998
Main exchange[a/]	223	242	240	+7.6	481 065	790 277	660 085	+37.2
NM	0	40	43	–	–	22 166	13 788	–
Parallel market for companies with small capital	20	15	15	-25.0	4 122	5 941	6 153	+49.3
Total	243	297	298	+22.6	485 187	818 384	680 026	+40.2

Source: Borsa Italiana - Monthly Key Figures and Main Indicators. Available at: http://www.borsaitalia.it/.
a/ June 2001, including 22 companies in STAR with a capital of 5,604 million euros.

TABLE 4. DEFINITION OF MANUFACTURING SMES IN TAIWAN

		Small enterprise	Medium enterprise
A	Legally completed registration	Yes	Yes
B	Paid-in capital not exceeding	-	NT$ 80 million
C	Maximum number of regular employees [a/]	20	200

Source: MOEA, SMEA, "Standard for identifying a SME", Taiwan. Approved in accordance with an official letter of the Executive Yuan No. TAI-80-MOEA33054, October 19, 1991. The latest revision is MOEA letter No. MOEC(89) B89340202, May 3,2000.

a/ This is considered by the relevant agencies when B is not applicable. The regular number of employees is the average number of monthly of insured employees declared to the labour authorities.

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