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TOO LITTLE OR TOO MUCH CREDIT: SMALL BUSINESS INDEBTEDNESS IN THE EU

Access to finance for small business draws a lot of policy attention based on the premise that small businesses face credit constraints more than larger firms. While this may be true for some types of small businesses, it is also true that small businesses over-borrow and over-invest which may lead to business closures and bankruptcies. So far, this aspect of small business borrowing has attracted little attention. The paper reviews the potential reasons for small business indebtedness and proposes action steps to develop better understanding of the size and scale of this phenomenon in the EU.

SMALL BUSINESS INDEBTEDNESS: A POLICY ISSUE?

Excessive debt by households has attracted a lot attention with the rising consumer borrowing and debt over-hang. Much less attention, if any at all, has been turned to the potential consequences of small businesses over-borrowing. One explanation for that may be the long held belief that small businesses in general have difficulty in accessing funding, in particular credit, therefore the key issue is too little credit rather than too much credit.

It turns out that the reality of small business financing is more complex and that small businesses may also over-borrow. Since small businesses play a very important role in all economies, their ability to survive and thrive is of utmost relevance for policy makers who should monitor the levels of debt incurred by small firms, to ensure that debt levels, for whatever reasons incurred by the firms, do not reach alarming levels that may lead to firm bankruptcies and business closures.

However, the scale of over-indebtedness is not known[1] and there are no accepted measures that could offer guidance as to when a small business has accumulated excessive debt. Establishing such measures and warning signs is complicated by the fact that small businesses often lack formalized financial records and systems that allow the application of standard financial theories.

BORROWING DECISIONS OF SMALL BUSINESSES

To borrow money is not a straightforward decision for most small business owners. What seems trivial and obvious from the point of view of most policy makers – more money is desired as it will help grow the business – is not that simple from the business point of view. Contrary to the common assumptions, a good number of small businesses do not rush to borrow even though a

[1] One study shows that 7% of SMEs in Ireland could be considered over-indebted. See: Fergal McCann, Profiling the indebtedness of Irish SMEs. Central Bank of Ireland. Vol 2014, No. 3

typical survey will likely list lack of money as one of the top reasons why the business does not grow[2].

There are great differences in willingness and ability to borrow among small businesses and self-employed entrepreneurs. In general, less than half of all small businesses ever borrow money and much fewer are looking for external financing at any given point in time. In the UK, for example, about 45% small businesses rely on external financing at least once in their life, and only about 20% seek external financing at any given point in time. In Eastern EU states, the propensity to borrow is even lower, in Poland only 1/3 of all small business are willing to borrow about 15% are actively pursuing financing.

At the same time, there is a segment of small businesses that borrow extensively and borrow more than it may be optimal[3] for their business. Some small businesses are growing and innovating, and they need financing to support the new developments, while others may be over-optimistic and over-confident about the future, especially at the end of the business cycle, and end up investing more than their current cash flow can sustain.

Borrowers may behave irrationally and make sub-optimal decisions, as it is reported by the findings of behavioral economics. Small business owners and managers have their own cognitive biases and prejudices, and may borrow too little or too much irrespective of the actual needs of the business. The attitudes and behaviors of borrowers play a crucial role in borrowing decisions, yet they are often ignored by policy makers who design policies based solely on the rational small business decision maker.

Several competing theories[4] try to explain how small business owners make their financing decisions and there is an on-going debate which theory has a better explanatory value. The fact of the matter remains that some firms may be credit constrained and not have access to adequate amount and type of financing to grow, and others may be borrowing too much leading to overinvestment and financial difficulties. The common feature of these theories is that fact that they largely ignore the small business owner as the decision maker as to how much debt a company accepts.

NOT ALL SMALL BUSINESSES ARE CREDIT CONSTRAINED

The stylized fact of small business financing is that small firms face difficulties in raising funds from the traditional banking market and that size acts as a disadvantage for small businesses to access financing. This difficulty creates a need for corrective policies that can make access more equitable and open to businesses that for various reasons cannot get financing.

There is huge body of literature which tries to prove the existence of credit constraints, and so far there is no consensus or definite answer on the topic. The review of this diverse literature shows that it is impossible to draw generalized conclusion that all small businesses are constrained and that all not require external assistance in getting access to finance. At the same a new string of research is looking at the cases when small businesses over-borrow and try to explain why this is the case. It appears that even when some businesses may be over-borrowing in relation to the current capacity to repay debt, their future growth may ensure the debt repayment from increased future revenues[5].

THE MEANING OF OVER-INDEBTEDNESS OF SMALL BUSINESSES

Over-borrowing and over-indebtedness may have at least two meanings: (1) it may mean borrowing more than a business needs, that is incurring debt beyond what is the optimal financial leverage from the point of

[2] SAFE data, the compilation of data on financing of SMEs in the EU does not, however, put lack of financing and lack of access as the key barriers. Only 22% of small business owners listed it as an obstacle to growth.

[3] The best debt-to-equity ratio for a firm that maximizes its value. The optimal capital structure for a company is one which offers a balance between the ideal debt-to-equity ratio and which minimizes the firm's cost of capital. In theory, debt financing generally offers the lowest cost of capital due to its tax deductibility. However, it is rarely the optimal structure since a company's risk generally increases as debt increases.

[4] See Berger and Udel, The Economics of Small Business Finance, 1998, for a review of literature on small business financing theories.

[5] The study of over-indebtedness of Italian SMEs shows that the growth-oriented business with excessive debt are able to repay loans with future earnings, which is not the case for businesses which are not growth-oriented and operating in the more traditional sectors. See: Damiana G. Costanzo, Damiano B. Silipo, Marianna Succurro, Over-Indebtedness and Innovation: Some Preliminary Results February 2013 (draft)

view of the company's profitability and cash flow management, and (2) it may also mean over-extending debt beyond an unsustainable level resulting in potential insolvency and bankruptcy.

The first situation may harm the profitability of the business and it may not necessarily lead to serious financial problems. However, the second option is often dangerous for the survival of the business. These two options may be considered as two theoretical markers for business over-indebtedness that may show the varying degree of debt and the severity of indebtedness for the proper functioning and survival of a business. In all likelihood a small business operates between these two scenarios.

While these markers offer a simple framework for understanding excessive indebtedness, the precise measurement of over-indebtedness remains a challenge.

MEASURING BUSINESS OVER-INDEBTEDNESS

Measuring the level of debt that a company has is fairly straightforward, however, finding a precise measure of over-indebtedness is not an easy task. The challenge is to develop an ex-ante predictive measure, ideally fairly uncomplicated that would provide unbiased information about the level of debt and severity of indebtedness as a warning sign for the businesses and the lenders. The current efforts in developing the over-indebtedness measures show that there is still much to be done in this area, and no single approach has emerged as a frontrunner candidate.

One over-indebtedness study of Irish SMEs[6] used a debt to turnover ratio to measure the levels of debt. Based on the data from an SME survey the authors showed that about 7% of SMEs in Ireland could be considered over-indebtedness. This single measure of indebtedness offers a simple method of measuring debt overhang but this measure may be too limiting in presenting the complex financial structure of a business.

A different study of Italian innovative companies[7] attempted to construct a fairly sophisticated measure to capture the firm's financial fragility by considering a set of variables including several aspects of the indebtedness phenomenon such as leverage, indebtedness capacity, form of the financial debt, net financial position, etc. While the proposed financial variables are able to provide a better understanding of the firm's financial condition than a single ratio of indebtedness, they require more data and they are less intuitive in application, therefore may not be best suited as a policy guidance.

BETWEEN GOOD DEBT AND BAD DEBT: WHY DO SMALL BUSINESSES OVER-BORROW?

There are different reasons for over-borrowing by small businesses: over- optimism, availability of finance, stage of the business cycle in addition to simple business reasons such as misguided business decision or new market development. In general, these factors can be shown to be both on the supply side and demand side:

Supply Side

- *Availability of financing*: there are many programs offering access to finance for small businesses, aiming at reducing the barriers to access to finance. Many of such programs are not able to distinguish between the credit constrained business and an opportunistic borrower who may be induced to take on unnecessary debt only because it is available at a favorable rate.
- *Unfair lending practices*: similarly to households, small businesses may face unscrupulous lenders selling too much debt or inappropriate toxic products which may cause the borrowers to experience financial difficulties.

Demand Side

- *Over-confidence*: many entrepreneurs exhibit over-confidence and will borrow beyond their needs only because they believe that they will be successful.

[6] Fergal McCann, Profiling the indebtedness of Irish SMEs. Central Bank of Ireland. Vol 2014, No. 3

[7] Ibid.

While optimism plays an important role in entrepreneurial success, it may also lead to over-indebtedness.

- *Myopic decision-making*: as already mentioned, small business owners may not always act rationally and in their best interest, they may accumulate too much debt based on their biased assessment of the market potential or become a victim of a herding behavior of other small businesses which are borrowing money. Financial skills of borrowers may play an important role as well.
- *Innovation and growth*: many business borrow funds to finance growth and expansion of their operations, and borrowing is highly correlated with high growth if the expected growth is realized. If not, the excessive borrowing based on faulty expectations may lead to over-indebtedness of the business.

The interplay between the supply and demand factors determines the actual borrowing behavior of businesses, and its potential for indebtedness. Therefore, it is critical to analyze both types of reasons for indebtedness.

INCENTIVES TO BORROW

Incentives to borrow merit a special attention. There are solid reasons for governments to remove unnecessary obstacles to borrowing for companies and consumers alike. But offering additional incentives raise questions whether such policies create an environment in which small businesses access the needed levels of financing or over-borrow beyond their capacity to repay and sustain the business.

There are two main ways how credit is made more available to small businesses: (1) by making it easier to access funds, for example by offering government credit guarantees that eliminate some of the barriers such as collateral requirements and lack of business experience of the borrowers, and (2) by making credit affordable (cheaper) either by explicitly lowering interest rates through subsidies or indirectly by allowing interest payments on debt to be deducted from taxes. In fact, a business paying taxes may benefit from the discounted interest rate loans and tax deductions, which would make debt even more affordable, and potentially reducing the effective cost of debt to zero.

Credit guarantees are very popular among the policy makers who see this as a simple and effective tool for making funds more accessible for the target borrowers who are presumed to experience undue difficulties, and which the guarantees purport to correct. The evidence of the effectiveness of guarantees funded through public sources is inconclusive at best. Credit guarantee schemes are difficult to design to correctly align the barriers they are supposed to remove with incentives to borrow by the credit constrained borrowers. While some studies show additionality from credit guarantee schemes, most point to pervasive use of the subsidies by borrowers who may not need to be subsidized, and who may as a result over-borrow because cheap funds are available.

Tax policy allowing interest deductions introduce a heavy bias in favor of debt over equity: it distorts financial decisions and can lead to excessive risk-taking by borrowers. Attempts to correct this often face strong political opposition arguing that eliminating or reducing the tax deductibility of interest will raise the cost of funds and may reduce investments.

Belgium is one of the few countries that attempted to correct the bias. It did not reduce the tax break for interest payments. Instead, it enacted a new tax deduction, based on a company's equity, that helps neutralize the tax benefit of borrowing. The principle is very simple: allowing firms to deduct from their tax liabilities an interest charge that is proportional to the value of their equity. With this reform, new investments receive a tax deduction regardless of whether the source of the financing is debt or equity. As the recent research[8] studying the Belgium experience showed, businesses increased equity and reduced leverage ratios, reducing the risk of over-borrowing and over-indebtedness.

Since borrowers strongly react to incentives, policy makers should pay careful attention to the proper design and application of incentives which are meant to improve access to finance, and which may have perverse outcomes on the capital structure of small businesses, leading to over-leveraging and over-borrowing.

[8] Frédéric Panier, Francisco Pérez-González, and Pablo Villanueva, Capital Structure and Taxes: What Happens When You (Also) Subsidize Equity? October 2012.

POLICY IMPLICATIONS

As the above discussion shows, access to finance has two equally important dimensions: too little and too much credit. Designing corrective actions and policies to equalize access and use of finance for small business should take into account the following points:

- Not all small business are credit constrained, uniform policies that promote more access to finance may be misguided and may lead some firms to over-borrow, and accumulate unsustainable levels of debt
- Some small businesses over-borrow, and may end up with debt overhang that may reduce employment and further investments
- Reasons for over-borrowing and over-indebtedness of firms are many, with factors both on the demand and supply side
- Small businesses in the West and in the East appear to have different leverage ratios and different propensities to borrow, which needs to be taken into account when designing supportive policies. The concept of over-indebtedness for firms needs to be better elaborated and better measures are needed to allow policy makers to understand and monitor the scale and scope of indebtedness of small businesses in the EU.

RECOMMENDATIONS

As shown in the paper, over-indebtedness among small firms is not a well explored topic and there is both little data and empirical research to help the policy makers design appropriate access to finance policies that on the one hand allow businesses to get the needed financing, and on the other hand prevent from over-borrowing. Some of the actions that could be undertaken include the following:

Data

- There is little if any at all data that would allow to assess the level of indebtedness in small businesses. This data should allow the lenders and the policy makers to have a better evidence-based understanding of the size and levels of small business over-borrowing, and its potential impact on economic growth and employment.

Research

- Methods for assessing over-indebtedness need to be developed and measures need to be adopted to appropriately measure business over-indebtedness that take into account the stage of the business development, industry and its growth potential.
- There is a need to better understand the borrowing decision making process by small businesses that takes into account the behaviors and biases of the owners and managers when it comes to making money-related decisions.

Policy

- Country level and EU-wide policies on small business financing should be reviewed from the point of view of effectiveness to reach the credit constrained borrowers to ensure that they indeed serve the marginal clients and do not lead to over-borrowing due to the existence of subsidized funding.
- Special attention should be paid to the credit guarantee schemes and tax treatment of interest deductions to ensure that such policies do not encourage excessive borrowing.
- EU could conduct an annual review of small business lending practices survey which would bring to light the issues and challenges faced by small business borrowers, with a particular attention to unfair practices of lenders.

Advocacy

- A small business lending coalition similar to the Responsible Business Lending Coalition in the US[9] should be created to promote responsible borrowing among small businesses in the EU. The coalition could engage lenders – banks and non-banks – in adopting appropriate standards and ethical behaviors towards small business borrowers which will ensure borrowing on terms and conditions that do not harm the borrowers.

[9] http://www.responsiblebusinesslending.org

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