# Cohesion Policy and SMEs : Boosting the absorption of EU Cohesion Policy Funds through Financial Engineering Instruments

*Georgios Papapastamatiou[1], Lefteris Podimatas[2], Vassiliki Delitheou[3]*

The reinforcement of Financial Engineering Instruments' (FEIs hereafter) usage contributed significantly to the effectiveness and efficiency of the available EU Cohesion Policy Budget (CPB hereafter). As a result, the advancement of FEIs' sustainability has been accomplished by recycling Structural Funds' (SFs hereafter) resources and so have the stimulation of additional funds, the allocation of the experience and expertise amongst regional and national authorities, financial intermediaries and final beneficiaries by the mutual collaboration between the two parties of public and private sector.

Furthermore, compared to traditional grants, FEIs resulted in a more efficient use of public resources and into the shrinkage of the dependence from final beneficiaries' side on the public support. This is due to the mandatory fund repayment and guarantee release; otherwise, in case of Investments on Equity, the mandatory fund return holds having impact, amongst others, on the behaviour of the final consignees.

Taking into account the projection for reduction of the existing CPB from 2020 onwards due to the upcoming exercise of the EU Withdrawal Act from the UK, the further utilisation and exploitation of the FEIs is appropriate actions to hedge the limited CPB's resource availability through leveraging and stimulating additional public or private sponsorships.

Aside from the necessity for fewer, shorter and more concrete regulations prior to the new framework of the 2021-2027 Cohesion Policy, the further enrichment and adjustment of the FEIs in accordance with the needs of the firms and the financial intermediaries is a prerequisite as well. In that manner, a faster and more effective Cohesion Policy resource allocation can be achieved. As per the OECD's reports, the range of the funding means arriving at SMEs and entrepreneurs needs to be broadened in order to be able to play a major role in investments, in the growth, in innovation and in employment.

The purpose of this article is to give prominence to FEIs as well as flesh FEIs out with more business-friendly and agile procedures and tools, such as factoring, and with tools oriented to investment needs of smaller scale, such as leasing, aiming to encourage the flexibility and accessibility of the SMEs to EU's resources for the Cohesion Policy as well as the faster absorption.

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[1] *Phd Student at Panteion University of Social and Political Sciences. Department of Economic and Regional Development. Email : g.papastamatiou@panteion.gr*

[2] *Phd Student at Panteion University of Social and Political Sciences. Department of Economic and Regional Development. Email : Email : lpodimatas@hotmail.com*

[3] *Permanent Assistant Professor at Panteion University of Social and Political Sciences. Department of Economic and Regional Development. Email : v.delitheou@panteion.gr*

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## Introduction

Cohesion Policy is the main EU investment policy and one of the most solid expression of solidarity for bridging the continual inequalities observed amongst the member states and simultaneously supports the opening of new job vacancies, the firm competitiveness, the economic growth, the sustainable growth and the improvement of quality of living of the citizens.

EU issued 351,8 billion EUR, one third of its total budget for 2014-2020 Cohesion Policy, to achieve the aforementioned goals and address various development needs across the continent. More specifically, EU co-finances - through several Funds, but mainly through European Regional Development Fund (ERDF), European Social Fund (ESF) and the Cohesion Fund - a series of projects permitting less developed regions and countries to fulfil their future financial prospects as the majority of available resources is aimed, first, at "less developed regions" having GDP less than 75% of the average EU GDP and second, at "transition regions" having GDP ranging between 75% and 90% of the average EU GDP.

The Multi-annual Financial Framework (MFF hereafter) for 2014-2020 was agreed in 2013 due to the economic crisis and the strained financial situation of many member states. Consequently, MFF focused to a great extent on investing in EU's value-added sectors for the invigoration of the employment and growth. MFF did also boost the relationship between EU budget and essential administrative and structural reforms in the member states introducing stricter terms. MFF introduced an approach based on the budget performance and the simplified delivery mechanisms in order to deliver quickly whilst innovative techniques amplified the EU's capability of dealing with the new challenges and utilise public and private resources.

However, MFF provides essential mid-term projections for encouraging investments in accordance with EU's priorities. During the 2014-2020 period EU was summoned to deal with a broad framework of multiple crises and to adapt rapidly to the floating priorities and unexpected events such as defence, immigration flows and structural reforms. Support for these urgent cases was achieved by creating the European Fund for Strategic Investments (EFSI hereafter) under the Investment Plan for Europe (IPE hereafter) and by issuing grants for countermeasures due to immigration challenges and safety issues.

Nevertheless, the investment gap having been left behind by the economic crisis, the need for promoting employment and of young people particularly, the political pressure to focus on funding the new priorities (defence, immigration, structural reforms), the impending EU Withdrawal Act exercised by the UK and its impact on EU budget, foreshadowed that Cohesion Policy which accounts for about 34% of the EU budget (67% including Common Agricultural Policy), would face the risk of limited available resources for the post-2020 period in the forthcoming launch of negotiation for its completion.

## The Multi-annual Financial Framework (MFF) for the 2021-2027 period

On May 2nd of 2018, the European Commission published its proposals with the title 'A Modern Budget for a Union that Protects, Empowers and Defends. This is the act that officially initiated the negotiations on the Multi-annual Financial Framework (MFF) for the 2021-2027 period.

Prior to the aforementioned act the assessment of the mid-term MFF implementation for the 2014-2020 period as well as the tasks being carried out simultaneously in the context of a Budget Focused on Results (BFOR initiative) had been taken place which were supposed to lead the Commission in order to propose further improvements aiming at: i) turning the budget onto policy priorities and new challenges, ii) the improvement of its efficiency and flexibility with regards to the resource mobilisation and supply for coping with the ever-evolving demands and iii) demonstrating evidence of the improvement of its systems for report submission with regards to performance, accountability and results.

European Commission's suggestions for MFF for the 2021 – 2027 period have been considered ambitious and pragmatic given the straightened budget circumstances associated with Brexit. These proposals forecast a budget of €1,135 billion EUR in commitments (2018 prices) for 2021-27 period, equivalent to 1.11 percent of EU27 GNI of EU 27 compared to the € 1,134 billion of the 2014-20 budget, (2018 prices), which accounted for 1.03%. According to the Commission, these two budget are similar; the new budget also includes European Development Fund (EDF) though which was out of the 2014 – 20 budget.

Direct comparisons between 2014 – 20 and 2021 – 27 are not simple at all. Taking into account that EU budget calculations apply a two percent deflator in the annual adjustments of the MFF, the total amount is actually similar to the 1,134 billion Euros in the 2014-20 period, compared with the 1,135 billion Euros in the period 2021-27. However, it is worth mentioning that the percentage applies to the EU-27, i.e after Brexit. It is also interesting to notice that inflation in the EU27 averaged around 1.1% in the EU27 from 2011 to 2018, significantly below the deflator of two percentage points. As a percentage of GNI, the proposals create increase - from 1.03% (including the EDF) to 1.11% as well as both constant (€ 54.3 billion) and current prices (€ 217 billion) taking into account the inflation. Compared in relative terms to the current EU-27 GNI (i.e. with UK GNI subtracted), to match the 'virtual' current MFF of EU-27, it represents a decrease from 1.16 % to 1.11 % of the EU-27 GNI. Despite the blurred reality, it could be argued that these suggestions bear testament to an increase compared to 2014 – 2020 budget. (Bachtler et al, 2019; Patty et al, 2018).

Regarding their targets, E.U. investments will be leaded by five policy objectives for the 2021 – 2027 period:

1. A smarter Europe by promoting innovative and smart economic transformation;

2. A "greener" with lower carbon dioxide emissions Europe by promoting clean and fair energy transition, green and blue investment, circular economy, climate adaptation and risk prevention and management;

3. An interconnected Europe by enhancing mobility and regional ICT

connectivity;

4. A more social Europe implementing the European Pillar of Social Rights;

5. A Europe closer to citizens by fostering the sustainable and integrated development of urban, rural and coastal areas and local initiatives.

The structure proposed by the Commission differs significantly from the current MFF. It increases the number of headings from five to seven, reduces the number of programmes from 58 to 37, and shifts some programmes amongst headings.

Headings and expenses distribution among them are as follows:

- Heading 1 "Single Market, Innovation and Digital" (€187.4 billion or 14.6%)
- Heading 2 "Cohesion and Values" (€442.4 billions or 34.6%)
- Heading 3 "Natural Resources and Environment" (€378.9 billions or 29.6%)
- Heading 4 "Migration and Border Management" (€34.9 billions or 2.7%)
- Heading 5 "Security and Defence" (€27.5 billions or 2.2%)
- Heading 6 "Neighbourhood and the World" (€123 billions or 9.6%)
- Heading 7 "European Public Administration" (€85,3 billions or 6,7%)

## Cohesion policy in the post-2020 period

In the new MFF, Cohesion Policy accounts for 34.5% of the total EU budget for the 2021-2017 period and continues to invest in all regions, always taking as basis 3 categories (less developed, regions in transition, more developed regions). Regional development investments will strongly focus on objectives 1 and 2. 65% to 85% of ERDF and Cohesion Fund resources will be allocated to these priorities, depending on Member States' relative wealth.

The resource allocation method is still largely based on GDP per capita. New criteria are added (youth unemployment, low education level, climate change, and the reception and integration of immigrants) to better reflect the reality on the ground. Outermost regions will continue to benefit from special EU support.

Turning now on the proposed legislative changes to Cohesion Policy for 2021-2027 period, the Commission identified four main features of its proposal for a modernised Cohesion policy:

(a) a focus on key investment priorities, where the EU is best placed to provide: innovation, support to small businesses, digital technologies and industrial modernisation, shift towards a low-carbon, circular economy and the fight against climate change;

(b) a Cohesion policy for all regions and a more tailored approach to regional development: Retaining the existing regional eligibility categories - lessdeveloped, transition and more developed regions – with GDP per capita remaining as the main allocation criterion, introduction of new criteria for climate change and immigration; proposal for further involvement of local, urban and territorial authorities and increase of co-financing rates to increase ownership of EU-funded projects;

(c) fewer, clearer, shorter rules and a more flexible framework: Simplifying access to funds through fewer rules and lighter control procedures for beneficiaries; a single rulebook to cover seven EU funds, flexibility in order to cope with unexpected events through a mid-term review; and

(d) a strengthened link with the European Semester to improve the investment environment in Europe: stronger Cohesion Policy support to structural reforms ensuring full complementarity and coordination with the new enhanced Reform Support Programme.

Although a Cohesion Policy modernisation is attempted through the suggested legislative changes in order to accelerate economic and social convergence for 2021-2027 period, support of Cohesion Policy through the EU budget is actually limited, a fact that is attributed not only to the consequences of the crisis and the inherent problems of the EU but to BREXIT as well and it amplifies the challenges it has to face in the post-2020 period to meet its objectives. The new changes expected to affect Cohesion Policy are:

I) Reduction in its available budget, which is the main consequence of the UK's forthcoming departure. Despite the fact that expenditure on cohesion policy for the 2021-2027 period appears increased over the 2014-2021 MFF (34.5% against 34.2%), changes in the composition of headings are significant because they conceal shifts in expenditure. Especially, cohesion policy budget seems to be limited at 29.1% as the new Cohesion and Values heading includes Erasmus+ (€26,368 million), the new EMU reform support tool (€22,282 million), and a number of smaller headings about Security and Citizenship. Taking into account only the ERDF, the Cohesion Fund and the ESF+, the proposed Cohesion Policy budget is around €331 billion for 2021-27 compared with €374 billion for 2014-20 confirming the reduction of expenditure that are exclusively attributed for the support of Cohesion Policy of the 2021 – 2017 period at 9% (Haas et al, 2018).

II) Change in co-financing rates. In particular, the EU reduces its participation through the new co-financing rates in order Member States to increase their own participation and ownership of EU-funded projects (Table 1).

**Table 1: EU co-financing rate proposals**

| MFF | Less Developed Regions | Transition Regions | More Developed Regions |
|---|---|---|---|
| 2014-20 | 80-85% | 60% | 50% |
| 2021-27 proposals | 70% | 55% | 40% |

**Source: own elaboration**

However, a significantly lower share of EU resources coupled with a higher co-financing rate would overstretch the national budget, having great impact on major development programmes and projects.

III) The transition from the n + 3 rule to the n + 2 rule. The slow-paced launch of the programmes in 2014-20 period was a challenge with negative policy implications regarding the performance of the EU Cohesion Policy in the context of the revision of its expenditure. To speed up the absorption, the Commission has proposed to get back to the n+2 rule according to which loss of bound programme funding might occur if not spent within two years as opposed to the three-year rule used in 2014-2020 period. Regarding the previous amendment, some Member States are critical of n+2 and argue that it will lead to a recurrence of problems during the preparation and management of large high-valued projects, will encourage a less strategic approach to project selection and may not even improve budget discipline, finally

IV) Reduction of pre-financing levels which will now correspond to 0.5% of programme resources to be paid each year except for 2027, the final year of the new funding period. Reduction of pre–financing rate aims at acceleration of absorption, but there is the risk that lower pre-financing will lead to liquidity challenges in less developed countries facing fiscal constraints.

In this context, the EU Cohesion Policy budget is required to respond to the conditions formed for the 2021-2027 period and to serve its objectives in a more intelligent, flexible and cost-effective manner, by utilising effectively traditional grants with financial instruments which have multiple effects and are closer to the market, since their exploitation concentrates all the desirable features in order, firstly to increase the absorption speed of resources and secondly to offset the limited availability of Cohesion Policy resources by leveraging and mobilising additional public or private sponsorships.

## Financial Engineering Instruments (FEIs)

The leading idea behind the use of FEIs for the implementation of public activities is the more effective use of public resources, the improvement of the commercial quality of investments by involving private actors and the liberation of new sources of finance. Consequently, FEIs are vehicles for:

- Providing new revolving forms of sustainable finance for long-term investments

- Opening new markets in different forms of public-private partnership, bringing in the expertise of international financial institutions;
- Promoting Structural Funds' resource sustainability
- Allocating experience and expertise amongst national and regional authorities, financial intermediaries and final beneficiaries;
- Building institutional capacity through partnerships between the public and private sector with the broader involvement of financial institutions/intermediaries in the context of the EU regional policy implementation.

The format of the FEIs comprises loans, guarantees and equity financing or quasi-equity financing. Nonetheless, their main categories are indicative and not restrictive, since the financial instruments can be of different forms and used combined with each other expanding the range of their use.

Although the use of financial instruments during 1994-1999 and 2000-2006 remained limited, as at a European level only € 1.3 billion allocated over the 2000-2006 period, the use of FEIs increased significantly over the 2007-2013 period when the overall funding reached € 11.6 billion EUR, accounting for around 5% of total European Regional Development Fund (ERDF) resources whereas financial instruments currently play an even stronger role since they account for more than 10% of total European Regional Development Fund (ERDF) resources.

The use of FEIs during 2021-2027 is expected to be expanded as in the context of suggestions for the next MFF and of the 80 measures for simplification of Cohesion Policy, there are remarkable improvements regarding: i) the flexibility option for the bodies providing financial instruments and ii) the ability to provide either investment grants or grants for supporting the establishment of investments. At the same time, administrative authorities may decide at Partnership Agreement (PA) stage to contribute to InvestEU and implement their FIs through the four policy windows exploiting the EU-level budgetary guarantee mechanism: increased leverage, better complementarity, increased coverage of risks, higher economies of scale, lower administrative burden, simplified accountability framework. Applicable rules are those of InvestEU and hence, complexity derived from multiple rulebooks does not exist.

The aforementioned acts contained in the suggestion for a regulation on common provisions for providing a common set of basic rules for the seven funds can contribute significantly to the more efficient and accelerated absorption of public resources and their leverage by the involvement of private bodies at the disposal of those resources.

The experience from using FEIs in the exploitation of public resources has been evaluated positively because has resulted significant public and private investment mobility has been noticed within the EU through InvestEU Fund. The emergence and enrichment of FEIs by using agile and business-friendly tools and procedures are required in order Cohesion Policy to benefit from the accelerating resource absorption through the utilisation of FEIs. Taking into consideration that the forms of FEI being dominant in the

Cohesion Policy resource allocation so far are those of funding or co-financing, guarantees and equity financing, it is suggested that their enrichment will include more flexible forms of funding, equally compatible with the framework of Rules regarding FEIs, such as factoring and focused at smaller scale investment needs such as leasing.

## Leasing and Factoring

These particular instruments are types of asset-based financing, a form of financing in which the company assets are a prime determinant in obtaining finance. Briefly:

Leasing is a mid-/long-term type of financing and denotes the transfer of the right of using a fixed asset from the lessor to another lessee for a specific fee for a specific period of time in the form of the lease.

Factoring is a short-term type of financing, a package of financial services that meet the business requirements which sell products or provide customers having repetitive purchasing behaviour with short-term credit services. It is a contract between the factor (factoring house or the factoring division of a bank) and the seller, whereby the seller assigns to the factor his claims from his customers (debtors).

As it is suggested in OECD's report where these two funding instruments have been classified as low-risk financing means - due to being asset-backed types of financing - it is necessary to enlarge the range of financial means being available to SMEs and entrepreneurs in order to be allowed to continue playing their role in investments, development, innovation and employment.

However, what could be the advantages of the exploitation of these instruments for enterprises and how could they enhance the absorption of Cohesion Policy resources?

A major problem for small- and medium-sized enterprises is the lack of access to financing especially enterprises based in southern countries. This is a crucial factor for utilising Cohesion Policy resources, because without the use of bank financing, investment and/or enterprise planning - a vital process for their growth due to the weakness of raising funds - becomes more harsh. The access of firms to the FEIs has contributed to reducing the financial costs of interest rates, mainly through co-financing instruments. On the other hand, enterprises lacking of creditworthiness the economic recession have not sufficiently facilitated to access financing, as in the case of Greece (SBA, 2017). The comparative advantage of financing through factoring and leasing is the fact that financing is based on the assets being funded, which enhances business access to financing to a great extent since no further guarantees are required for their funding.

Taking into account the size of businesses in the EU-28 Member States, it is found that the vast majority of -the non-financial sector- enterprises, ie 93.1% or 23 million enterprises, are very small[4] (employing less than 10 employees and having a turnover and assets less than € 2 million). Business development needs are usually limited to their need for micro-financing as their investment plans are of a smaller scale and they may concern, for

[4] European Union (2018), "Annual Report on European SMEs 2017/2018 - The 10th Anniversary of the Small Business Act".

example, purchase of one and only machine or the assignment of a single claim in order to obtain the necessary liquidity for their operation. In that case, instruments such as leasing and factoring can respond in a flexible and immediate way to the need of the enterprise and through their services to avoid long procedures, such as those required to receive a grant, which discourage the firms.

Moreover, the benefits from the aforementioned instruments can facilitate the access of firms to funding, if combined with Cohesion Policy resources through either funding or guarantee supply or a combination of several forms of grants, for instance, amongst many other ways. As a result, those services will be more conducive for them. Ultimately, there is also the possibility for the bodies of providing grants (investment grants and grants for supporting the investment establishment) in the context of simplification measures being available from Regulatory framework. This is a worth considering component for speeding up key services as on enterprises' side as Cohesion Policy resource absorption's side.

**Conclusions**

Funding forms such as Leasing and Factoring compose those desirable features that can significantly address business needs while serving the objectives of Cohesion Policy.

The faster upcycle of these resources and their leverage from private resources can further enhance their multiplier effect, especially in the post-2020 period, where Cohesion Policy resources are limited and the regulatory arrangements do not seem to favour the implementation of strategies and large investments.

Furthermore, the possibility of providing "single-stop" services, not only does it provide promptness particularly in the case of a very small enterprise regarding its access to financing, but ensures its access to Cohesion Policy resources as well. Thus, the possibility of micro-absorption from a huge pool of very small enterprises not having have sufficient access to financial services is enhanced and so are their prospects of growth; a fact that is essentially one goal of the Cohesion Policy. That happens given that the support of small and medium-sized firms is the cornerstone of the economic and social cohesion, because they promote social stability, ensure high rates of sustainable development, act as training areas and create more and of higher quality job vacancies while they simultaneously contribute to the maintenance of the vital link between productive reality and its territorial dimension, which is also the most effective way of fighting unemployment and all the issues caused.

The determination of the type of contribution of both Cohesion Policy and InvestEU resources among funding, guarantees or grants can be done through preliminary research at a Member-State level in order to identify the needs of the stakeholders bearing in mind that - specific instruments have low levels of penetration in the enterprise environment so that the upcoming FEIs will be equally desirable both by firms and the financial institutions that will be invited from the EU Member-States to provide them.

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