EVALUATION OF THE FUNDING SUPPORT MADE AVAILABLE TO THE PRIVATE SECTOR IN THE 2014-2020 PROGRAMMING PERIOD AND EX-ANTE ASSESSMENTS FOR THE SETTING UP OF FUNDING SUPPORT FOR THE PRIVATE SECTOR IN THE 2021-2027 PROGRAMMING PERIOD IN MALTA - LOT 2

Ex-ante assessment Report

State Aid Schemes

Executive summary

The present report is aimed at supporting the Managing Authority (MA) in preparing its investment strategy for the design and implementation of non-repayable schemes that will support SME competitiveness in Malta in the 2021-2027 Programming Period through the European Structural and Investment Funds (ESIF). Building on a market assessment and the lessons from the past programming period, this report outlines the need and structure of potential state aid schemes to help Maltese SMEs grow, survive, and expand.

This report should be read in conjunction with the thematic evaluation of State Aid schemes made available to the private sector in the 2014-2020 programming period under the Thematic Objective 3 - Enhancing the competitiveness of small and medium enterprises and the *ex-ante* assessment for a financial instrument on SME access to finance for the 2021-2027 Programming Period.

The report includes two logically interconnected blocks: i) the market assessment (including an analysis of the Maltese context and market failures, an analysis of the value added of grant schemes, and a discussion of the lessons learnt from the previous programming periods); and ii) the investment strategy including delivery and management of the instruments. Based on the analysis developed in the first block, the second block adopts a less analytical and more operational approach to identify the main characteristics of the proposed instrument(s) and ensure smooth implementation.

Market assessment

Analysis of Maltese context, market failures, and investment needs

The Maltese economic environment remained overall favourable after the recovery from the 2009 deep recession and until it entered the COVID-19 pandemic. Since 2013, Malta sustained several years of strong economic performance, with growing GDP per capita and investment and a positive balance of payments. Thanks to this strong performance, Malta has overall performed better than other euro-area Member States. **This notwithstanding, some structural features of the Maltese economy continued to pose challenges for sustained competitiveness and long-term growth prospects.**

In 2020, the COVID-19 caused a deep recession whose effects will last even if a rebound is expected by 2022. In 2020, because of the pandemic, Malta's economy contracted at a faster pace than the EU average, reflecting the high exposure to tourism and related services sector. Although Malta is expected to reach pre-pandemic levels of economic activity in 2022, the overall landscape remains fragile and extensively impacted by the COVID-19 pandemic. Persistent logistic and supply bottlenecks keep weighing on production, as do the elevated prices of energy, and the other uncertainties created by the unfolding conflict in Ukraine.

Malta shares some of the features typical of other insular economies. Its international competitiveness is constrained by the size of its internal market and restricted range of growth sources due to its economic specialisation and reliance on a few service activities. Indeed, Malta and Gozo have developed into modern service-based economies, where tourism plays a central role. As an open economy, international trade is not only an important contributor to economic performance but also to employment. Malta's ability to export goods and services, and its relative competitiveness, are critical to sustaining the labour market and the broader economy.

The business sector is overall dominated by SMEs (constituting 99.8% of registered enterprises) and micro-enterprises in particular, whose share of value-added and employment is significantly higher compared to other EU countries. The micro enterprises dominating the business sectors are generally family-owned (traditional) businesses, predominantly active in low-value-added services sectors such as wholesale and retail trade, transportation and storage, accommodation and food service activities, with limited resources and competencies. This limits their ability to assess their growth and competitive potential and embark on investment initiatives. While some higher-value-added services (most notably professional, scientific and technical activities and financial and insurance services) have shown a positive performance over the past years, their growth still needs to be stimulated to convert these industries in engines of economic growth and structural transformation.

COVID-19 has heavily impacted the performance of Maltese SMEs and SMEs' investment plans. The share of financially distressed companies, particularly micro firms, grew significantly compared to pre-COVID times. Similarly, the number of non-liquid and insolvent firms also increased, including firms that were solvent before the pandemic facing liquidity or insolvency problems after the pandemic.[1] This may result in greater financial constraints for the SME sector, notably smaller firms, in the form of reduced or more costly access to lending due to lower financial buffers.[2] According to the EIB Investment Survey 2021, Maltese firms are much more pessimistic than EU firms about the economic climate, the availability of internal finance, and business prospects in their sector. Moreover, according to the EIB Investment Survey 2021, the share of firms whose investment is expected to decrease remains slightly above the share of firms expecting to increase it, making Malta the only country in the EU with a negative investment outlook.

The labour market is tightening, resulting in labour shortages and a greater reliance on foreign workers. Beset by an increasingly ageing population, Malta relies heavily on foreign workers, including many high-skilled individuals, from within and outside the EU to fill labour shortages. Labour shortages worsened due to the pandemic. Another long-term issue of Maltese labour market is **skill mismatches and skill gaps**, particularly concerning ICT and digital technologies. In addition to the skills mismatch problem, there is the underlying factor of the low educational levels of the local Maltese workforce in certain sectors, which negatively impacts labour productivity. Interviews with business associations also point out that attracting and retaining foreign workers with ICT skills is also an issue, particularly in Gozo.

Productivity has significantly improved in the last years before COVID-19, but research and innovation still play a limited role in the economy, thus, hampering Maltese productivity growth. Maltese SMEs face barriers to innovation and diversification that originate from both traditional factors (financing difficulties, shortage of, and difficulties in, the recruitment of qualified, skilled staff, organisational barriers such as less experienced and limited internal know-how on how to manage innovation processes effectively and efficiently) and new emerging trends (lack of new markets, knowledge and technological transfer to enter those markets).[3]

Although few firms see themselves as financially constrained, and many choose to invest, the investment intensity is much lower than in the EU pointing to a mismatch between supply and demand for funding. From 2014 to 2020, SMEs' access to finance has registered a remarkable improvement, which in all probability is due to the government measures targeted at addressing the problem. The offer of public support measures (including financial instruments and grant schemes) available for firms in Malta has widened since 2014. In particular, the supply of guarantee products in Malta increased first with the establishment of the Malta Development Bank in 2017 and then in response to the COVID-19 crisis.

[1] IMF (2021b).
[2] *Ibid*.
[3] See among others, European Commission (2021) Study on the effectiveness of public innovation support for SMEs in Europe. Final report. Available here: https://op.europa.eu/en/publication-detail/-/publication/d031aa03-9295-11eb-b85c-01aa75ed71a1/language-en Last access on 11/06/2021

However, **several structural features of the banking and financial system make external financing problematic, especially for micro firms.** According to a study by the European Commission and the EIB (2019), in 2018, 7.6% of the viable Maltese SMEs faced difficulties in seeking debt finance. This share was higher than the EU average (4.25%) and the third-highest after Greece and Cyprus. Based on this data, the study includes Malta in the list of EU Member States experiencing particular difficulties in accessing debt financing.[4] Similarly, the 2020 EIF SME Finance Index indicates that Malta is the 8th least favourable Member State in terms of SME financing conditions.[5] A few structural factors hamper access to finance, especially for micro and small enterprises[6]. These are:

- **SMEs dependency on bank-financing**. Bank-related products such as overdrafts and credit lines and, to a lesser extent, bank loans remain to-date the most popular source of external financing in Malta. Market–based products and other sources of finance are still underdeveloped.[7] Business angels, venture capital funds, mezzanine finance, and other sources of finance are scarce in Malta.[8] The dependence on the banking sector is perceived as an issue of limited funding options and should be taken into account, even in the absence of financing gaps.
- Secondly, the **risk aversion of local banks** intensified in the years before the pandemic. Stricter restrictions (in the form of collateral and loan covenants) created additional barriers to access credit, especially to smaller firms or start-ups that do not possess a solid credit history or do not have collateral to provide.[9] The lack of adequate collateral currently is the major source of dissatisfaction of Maltese firms, even more so in 2021 than in 2020. This frustration is even higher for micro and small firms.[10] This situation creates a market failure as when it comes to traditional banking, firms are refused credit based on their **inability to provide collateral and lack of credit history** rather than their project or business plan.[11] Micro and small enterprises that are not asset-based and cannot provide collateral are consequently excluded from traditional banking finance. In turn this presents difficulties for smaller companies to grow and develop.
- Third, the **cost of financing** is the second most important source of dissatisfaction, and similar to the need to provide collateral, micro and small enterprises are the most affected. Indeed, interest rates in Malta tend to be high, further hampering access to credit.[12] The announced increase in ECB interest rates will lead to a rise in the banks' financing cost. The latter in turn will cause higher interest costs for borrowers. This coupled with a deterioration of the financial profile of SMEs is likely to limit their possibilities to invest, thereby hindering their chances of improving their competitiveness and innovation profile.

The Maltese economy is striving to boost the growth of higher-value-added sectors (especially services) and strengthen its business sector. This process requires concrete

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[4] European Commission and EIB (2019).
[5] Kraemer-Eis et al. (2021).
[6] Indeed, according to the survey conducted under this assignment, the importance assigned to barriers, including access to finance, depends on the size of the SMEs. While micro and small enterprises have always suffered from the issue of high interest rates, the latter was perceived as a minor barrier for medium enterprises and became a problem only since 2020, when the COVID-19 pandemic broke out. The burden or effort to obtain finance, the difficulties related to file the application process and the insufficient amount of collateral were and still will be major problems especially for micro and small enterprises, while only a small percentage of medium enterprises reported these issues.
[7] Central Bank of Malta (2020).
[8] Central Bank of Malta (2015).
[9] Central Bank of Malta (2015) and IMF (2021b).
[10] While this evidence comes from the EIB Investment Survey, this finding was corroborated by interviews.
[11] Central Bank of Malta (2015).
[12] Central Bank of Malta (2015).

efforts to support SMEs to invest, grow, and become more innovative, while fixing traditional market failures that affect the Maltese banking sector. Pursuing these objectives is essential to create new long-term sources of economic growth, job creation, innovation, and competitiveness.

Analysis of the value-added of the non-repayable grant schemes

Non-repayable grants are well-suited to finance projects that are unlikely to generate short-term revenues or where there is a need for an 'incentive effect' to persuade firms to undertake initiatives/investments that they would not do otherwise. Conversely, financial instruments are viable where the purpose to which they are put has the potential to generate revenue or savings which can be used to repay the original outlay – for example, successful commercialisation of an innovation or cost savings from energy efficiency investments. Nonetheless, the advantages and disadvantages of grants are product and policy specific.

The combination of grants and financial instruments appears particularly useful when the degree of bankability of the targeted project is low. The combination of grants and financial instruments could serve well the policy objectives of fostering SMEs' competitiveness and promoting innovation and sustainability. An important change brought about by the 2021-2027 Common Provision regulation (CPR) is the enlargement of possible options to combine financial instruments and grants in one operation.

In combining grants and other forms of public intervention, it is important to avoid crowding out investments. Avoiding cannibalisation and minimising misalignments of incentives are essential to preventing conflicting elements or overlaps with other forms of public interventions. Hence the offer of EU-backed grants cannot be seen in isolation from other forms of support, both nationally and EU funded.

Lessons learnt

The thematic evaluation put forward two sets of recommendations: i) general, where they refer to more high-level aspects; ii) specific, where they concern procedural / administrative aspects of the various schemes.

- Given the small size and limited diversification of the Maltese economy, the strategy to provide generic instruments covering the different lifecycle stages of firms, regardless of the sector, and with differentiated conditions depending on company/investment size proved effective to achieve a good uptake of schemes and should be kept. Generic instruments remain especially relevant in the aftermath of a crisis as they play an anticyclical role.
- While traditional sectors such as tourism remain vital to the economy, the recent COVID-19 pandemic has highlighted the increased importance of diversifying the economy further. Also, in the light of European industrial policy, supporting the twin green and digital transitions is key to remaining competitive and building a lasting growth for the Maltese economy. Therefore, more funds should be allocated to schemes that support diversification and innovative investments, as well as consultancy services for modernisation and organisation/process re-engineering.
- The presence of an online platform that can be accessed by beneficiaries for uploading in a unique repository all documents related to the application and reimbursement phase as well as by all the authorities involved in the monitoring and auditing of the schemes proved effective in the context of the BEGS. Therefore, such a centralised information system used for the BEGS, possibly enhanced to further improve procedural efficiency, should be extended to all State Aid schemes.

- Continuing investing in communication campaigns and further involve business associations in the promotion activities. Moreover, since some firms expressed concern about the fragmentation of the information (e.g., different websites) on the different funding possibilities available in the country, the creation of a unique online platform including all funding possibilities available in the country, either funded by EU funds or national funds could be considered.
- Adapting and/or re-designing the SME internationalisation scheme, to avoid overlaps with nationally funded schemes.
- Consider widening the scope of services covered by the Consultancy Services scheme to include advisory services to prepare applications for investment support schemes among others.
- SMEs' initial financial strength and capacity to access credit are necessary prerequisites for engaging in an investment, for which EU funds act as a catalyser and accelerator rather than the main causal trigger. Therefore, the synergy between different streams of assistance, such as financial instruments and grant schemes, should be improved to ease access to EU-funds, especially for micro-enterprises and start-ups, which generally have limited financial resources and more difficulties in accessing credit.
- The introduction of Simplified Cost Options (SCOs) under the SME Consultancy and the IIS ensured a simplification in the documentation to be provided and reduced the checks performed by the Intermediate Body at the reimbursement stage, thus increasing the overall efficiency of the reimbursement phase for both the MA and beneficiary SMEs. Therefore, the adoption of SCOs should be applied to all State Aid schemes, where possible, at the very least in the case of projects with small budgets so as to adhere to the principle of mandatory use of SCOs for small operations outlined in Article 53(2) of Regulation (EU) 2021/1060.

Proposed investment strategy

With a view of maintaining a certain continuity with the previous programming period in order to benefit from the lessons learned and viewpoints expressed by all sides (SMEs, MA, and implementing bodies), the proposed investment strategy revolves around the following points:

- As far as the **budget** of grant schemes is concerned, the funding available in the programming period 2014-2020 targeting SMEs competitiveness should at least be maintained, in view of the estimated proportion of SMEs likely to continue to experience access to financing problems and the potential scale of the debt and equity gap post-2021.
- In terms of the **processes for the selection of beneficiaries**, two features of the 2014-2020 schemes could be maintained. First, adopting an open rolling call system proved successful in the last programming period. Efficiency was even higher when cut-off dates were more frequent (i.e., bi-monthly instead of monthly cut-off dates). Second, the thematic evaluation suggests that the wide eligibility criteria of the 2014-2020 period should be maintained.
- **Some novelties in the application procedures** could facilitate access to the smallest SMEs. Two changes are being considered in this respect:
    - The thematic evaluation positively assessed the training sessions and seminars (on public procurement, combatting fraud in EU funding, management verifications, visual identity requirements, and changes) available to MA staff, project beneficiaries, and stakeholders. While not exclusively dedicated to the BEGS, they facilitated the implementation of these schemes by disseminating good practices. Building on the experience of other countries, the possibility of organising training sessions on successful application writing could be considered.

- Alternatively, it might be considered to expand the scope of the SME Consultancy scheme to embed advisory activity to access the investment schemes. These might be particularly important for start-ups and family business firms to assess more complex schemes tied to growth, competitiveness, and job creation, including productive investments.

- Concerning **payments**, Simplified Cost Options (SCOs) were already introduced under the IIS scheme (since the beginning), in the second call of the SME Consultancy Services grant scheme, and in small projects under the SME Diversification and Innovation grant scheme (since November 2021). The change from payments based on costs actually incurred and paid to SCOs, simplified and shortened the reimbursement phase. Building on this finding, the adoption of SCOs could be envisaged under all State Aid schemes at least for projects with small budgets.

- Set up of a **unique online platform** to disseminate information on all funding possibilities available in the country (funded by EU funds or national funds).

- **Potentially set up of a database or sharepoint common to all authorities** involved in the implementation and monitoring of State Aid schemes. Such an IT tool would allow beneficiaries to upload all the related documentation from application till the certification stage in a unique platform.

- **In terms of schemes, the investment strategy can be summarised as follows:**
  - The "Investing in Skills" scheme shall be maintained, and only a few (minor) modifications are proposed.
  - The "SME Consultancy Services" and the "Start-up Investment" schemes shall be maintained but modified in various components. The former could be modified in the scope by expanding it to embed advisory activity. The latter could be modified by extending it to unlisted small enterprises for investments up to the permitted amounts under GBER part-financing eligible expenditure up to 50% for projects in Malta and 60% for projects in Malta, as well as extending the eligibility criteria for companies who have been registered up to 5 years (previously was up to 3). For eligible undertakings that are not subject to registration the 5 years eligibility period may be considered to start from the moment when the enterprise either starts its economic activity or is liable to tax for its economic activity. Moreover, the criterion for a start-up being autonomous should be removed.
  - The "SME Growth" and the "SME Diversification and Innovation" grant schemes shall be maintained but merged as a concept to form again two or more separate schemes differentiated by the size of investment. Further to discussions and feedback gathered from the Maltese authorities, the proposed new schemes should support new investments (including those for diversification and innovation) by those companies who are not termed as a start-up. The new schemes will now differentiate by size of project which in turn affects the regime which is applied - General Block Exemption Regulation for large projects over EUR 200,000 or *De Minimis* for small projects up to EUR 200,000.
  - The "SME Internationalisation" scheme can be. redesigned to support enterprises beyond participation in fairs and the associated marketing costs but also to cover transitional costs such as product customisations for specific markets. Internationalisation efforts by applicants under the other investment schemes can also be rewarded in the scoring.

The **synergies with financial instruments** (FIs) could be strengthened by considering the introduction of a bridging loan facility to fund the early phases of the investment cycle. As EU financial support in the case of **non-repayable grants** is normally delivered only after the eligible expenditure is invoiced and verified, the thematic evaluation has indicated that the availability and cost of private loans to SMEs is perceived as a significant constraint on their ability to engage in investment at the desired time and intensity. In view of this, it would be useful to have a financial mechanism – possibly a FI – enabling companies to finance on better terms the first phase of the investment cycle of the project. However, should a financial instrument be considered in this regard, note should be taken of the requirements emanating from the new CPR, notably Article 58(7) which is meant to ensure no element of double funding between the different funding instruments.