<u>EXTRACT FROM THE RESEARCH:</u> *BOOSTING GROWTH IN JAPAN AND LATVIA: THE ROLE OF PUBLIC-PRIVATE FINANCIAL ENGINEERING*[1]

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The following extract addresses the fiscal measures for public-private financial engineering instruments (PP FEIs) in **Latvia**, providing detailed information on the entrepreneurial assistance programmes, and following with the section discussing future challenges.

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I. FISCAL MEASURES IN LATVIA

Financial means of the fiscal policy are widely used not only in Japan, but also in Europe, including Latvia, yet implementation mechanisms differ between countries. Japan is accumulating funds primary through market-raised FILP bonds (close to government bonds), while for example, United Kingdom raises funds through a combination of tax revenues and issuance of government bonds. The major sector eligible for financing in Japan is the private sector, while for UK these would be local governments with social infrastructure projects, but in Germany most contributions would go to the housing sector. Public intervention in Latvia's equity market is organised strongly through the revolving assistance provided by the European Union (EU) Structural funds, with a small additional programme established under the Swiss-Latvian program directed to the new EU countries and special government programmes. The sector eligible for PP FEIs financing in Latvia is mostly entrepreneurship, but there are also smaller programmes for the agriculture support, however excluded from the further research.

1.1. Background of Europe assistance

Since the Rome Treaty of 1957[2] one of the main tasks for the European Community has been to promote a "development of economic activities" referring to the development of the European Union. It took 40 years to establish financial instruments for this goal. Current system for Structural funds was created in 1986 through legal foundations introduced for the Cohesion policy by the Single European Act[3]. Since the Lisbon[4] and Gothenburg[5] agendas, the European Union aims for "the world's most competitive economy", remaining on the same track with the recently adapted EU 2020 Growth Strategy[6]. The legal frame of the PP FEI documents for the current programming period[7] is defined by the General Regulation (EC) 1083/2006, referring to different Community Strategic Guidelines, including the EU Guidance Note on Financial Engineering Instruments[8] (Guidance Note). The Guidance Note sets the frame of the financial engineering beneficiaries, including enterprises, public-private

[2] The Treaty of Rome, establishing the European Economic Community (EEC), (25 March 1957)

[3] Single European Act, (Luxembourg, 17 February 1986), European Union Official Journal - OJ L 169 of 29.06.1987.

[4] Lisbon agenda, also known as Lisbon Growth and Jobs Strategy, Lisbon Strategy or Lisbon Process, is an action and development plan for the European Union until 2010, European Council, Lisbon, March 2000, simplified and re-launched in 2005.

[5] In June 2001, the European Council at Göteborg discussed proposed by the European Commission. After a consultation paper in March 2001, the Strategy proposed measures to deal with threats to our quality of life - focusing on issues such as climate change, poverty and emerging health threats. More information: http://ec.europa.eu/sustainable/sds2001/index_en.htm , last viewed 15.10.2013.

[6] Europe 2020, European Commission, http://ec.europa.eu/europe2020/index_en.htm

[7] Cohesion policy delivery mechanisms have changed between different programming periods, starting 1988-1993, followed with 1994-1999 and 2000-2006, while currently implementing 2007-2013 (project implemented by mid 2015) and getting prepared for the next 2014-2020.

[8] Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006, European Commission, available on http://ec.europa.eu/regional_policy/archive/funds/2007/jjj/doc/pdf/cocof_guidance_note3_en.pdf, last viewed 29.10.2013.

partnerships, urban development projects, legal entities or natural persons carrying out specific investment activities in energy efficiency and use of renewable energy in buildings[9]. Revolving assistance of the EU, in addition to the more traditional grant assistance, has been available under the European Union Cohesion policy since before the 2000-2006 programming period, while in 2007-2013 different models of financial instruments become widespread, expecting wider application in the period 2014-2020. According to the Guidance Note, PP FEIs is regarded as vehicles for delivery of repayable investments which contribute to the achievement of the EU Cohesion policy goals[10]. Resources provided for the FEI are from the European budget Cohesion policy instrument - the Structural funds. Most facilities are financed by the European Regional Development Fund (ERDF), while the European Social Fund (ESF) providing minor support schemes, mostly to micro start-ups. Budget flow of PP FEIs is regulated by the Financial Regulation[11] referring to the general budget of the European Community and setting the rules for calling on, budgeting and using Structural funds. Therefore funding provided for PP FEIs comes from the EU budget, however constituted of revenues received earlier from Member States. Payments to the EU budget are applied at a uniform percentage rate (with exempts), but committed appropriations to the Member state depend on the GNI per capita, having highest support for lowest rates, meaning - richer subsidising the poorer areas for the common growth of the European economy. Latvia has been one of the leading consumers of the Cohesion instruments since entering the European Union in May 1, 2004.

The ultimate responsibility for implementation of revenues and expenditures of the EU budget lies with the EC[12]. However in practice, the lion's share of EU funds (76 percent)[13] is spent by the "shared management"[14]. Under these arrangements, it is the authorities in Member States, rather than the Commission, that develop national planning documents and set criteria and priorities for funds. However EU policy guidelines should be always observed.

According to the European Commission Staff working document[15], the ERDF support for PP FEIs in the current budget period 2007-2013 amounts to just over EUR 11.6 billion or 4.4 percent of total ERDF resources or 0.01 percent of the forecasted EU GDP per period[16]. The significance of the financial engineering instruments in EU as compared to the size of the

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[9] Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006, European Commission, available on http://ec.europa.eu/regional_policy/archive/funds/2007/jjj/doc/pdf/cocof_guidance_note3_en.pdf, last viewed 29.10.2013.

[10] Guidance Note on Financial Engineering Instruments under Article 44 of Council Regulation (EC) No 1083/2006, Article 2.1.1., European Commission, COCOF_10-0014-04-NE, available on http://ec.europa.eu/regional_policy/archive/funds/2007/jjj/doc/pdf/cocof_guidance_note3_en.pdf

[11] Council Regulation (EC, Euratom) No 1605/2002 (25 June 2002)

[12] Council Regulation (EC, Euratom) No 1605/2002 (25 June 2002), Article 48 (1)

[13] European Commission, Financial Programming and Budget, EU Budget at a glance, How is the money spent and controlled? Available on http://ec.europa.eu/budget/budget_glance/how_managed_en.htm, last viewed 12.11.2013.

[14] Regulation (EC, Euratom) No 1605/2002, (25 June 2002), Article 53

[15] Expert evaluation network 2012. The use of the ERDF to Support Financial Engineering Instruments. A report to the European Commission Directorate-General for Regional Policy, July 2012. Available also at http://ec.europa.eu/regional_policy/sources/docgener/evaluation/pdf/eval2007/expert_innovation/2012_evalnet_fei_synthesis_final.pdf , last viewed on 1.10.2013.

[16] World Economic Outlook Database, October 2013, International Monetary, available at http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/weorept.aspx?sy=2007&ey=2013&scsm=1&ssd=1&sort=country&ds=.&br=1&c=998&s=NGDPD&grp=1&a=1&pr.x=30&pr.y=7 , last viewed on 9.12.2013.

economy is much smaller than in Japan; however the share of ERDF going to PP FEIs has increased slightly over the current period and expected to increase in the future. Overall two-thirds were given to loans and guarantees, and one third to venture capital (VC) funds. The VC share, along with the PP FEIs total, has been larger in more developed parts of the EU, however fully complying with the situation in Latvia, also favouring risk capital. Meanwhile European Union is preparing for the next programming period from 2014 till 2020, projects implemented by 2022. By September 2013 all framework documents had been approved by the European Commission and the European Parliament, entering negotiation phase with the national governments, setting objectives and measures for the funding made available for the Member state. As on December 2013 Latvia is in the phase of unofficial consultations and measures are still negotiated, however first indications are clearly observable.

Swiss - Latvian cooperation programme FEIs are also implemented in Latvia. Under the Memorandum of Understanding between Swiss Federal Council and European Community about Swiss financial contribution diverted to the new European Union countries, still including Latvia, programmes aim to reduce economic and social disparities. The memorandum was signed on February 27, 2006 by funding set available till 2015. Swiss - Latvian cooperation programme is a financial assistance mechanism used in addition to financial assistance of European Union Structural funds and Cohesion[17]. Implementation of the Swiss assisted PP FEIS falls within the management system of the EU funds.

1.2. Latvia in the programming period 2007-2013

The European Union financial framework for Structural funds of the Cohesion policy is set by the EU multi-annual spending plan, currently for 2007-2013, coming 2014-2020. Programming documents set limits for committed appropriations towards each Member State for a time period of seven years.

The PP FEIs funding plan is developed, setting also priorities and eligible areas, with reference to the EU objectives and on the basis of priorities and objectives stated in the National Development Plan. Taking into account the significant importance of SMEs to the domestic economy, PP FEIs focuses strongly on the support to the entrepreneurial activities.

SMEs in Latvia are accounting for 99.8 percent of all companies, 77.4 percent of all employees (significantly higher share to the overall employment when compared to EU average), and 65.8 percent of total added value. That is despite the fact that the number of SMEs relative to Latvia’s population is lower than in other EU countries (27 SMEs per 1000 inhabitant vis-à-vis 40 for the EU-average[18]). On the positive side there is a high share of ERDF funding targeting business support, close to the EU average. As for the downside, the share of lost payments appears to be more noticeable than the EU average (3.8 percent of total as opposed to 2.9 percent on the EU). Besides a significant share of entrepreneurs in Latvia have chosen the entrepreneurial path out of a lack of alternatives and it is only 41 percent of entrepreneurs who went into business because they saw an opportunity[19], for others it was a need to maintain income. With this background it is even more important to provide

[17]Swiss-Latvia Cooperation programme, available on http://www.swiss-contribution.lv/page/10, last viewed 12.11.2013.

[18] SBA Fact Sheet 2012 LATVIA, European Commission, available on http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2012/latvia_en.pdf, last viewed 8.11.2013.

[19] Ibid

incentives for the business growth, to show the opportunity rather struggle and necessity in performing a business activity.

In the current programming period (2007-2013) most revolving assistance programmes in Latvia are addressed in the planning document „Entrepreneurship and Innovations" (others are for human capital and infrastructure). The second priority there on "Access to Finances" aims to promote availability of revolving funds important for business development. Management of PP FEIs in Latvia falls under the general scheme of EU fund management. Article 11 of the General regulation of Structural funds allows for each Member State to designate the most representative systems for delivery mechanisms of the Cohesion policy. For the planning period 2007-2013, Latvia has established a rather complex managing system for EU funds compared for the annual spending rates, involving the Ministry of Finances as the Managing authority, following with 11 first level intermediate bodies and 9 second level intermediate bodies. PP FEIs programs are implemented by second level institutions, equivalent to Japan FILP Financial agencies, and supervised by the upper level authorities, including Monitoring Committee, currently consisting of 23 members from public and non-governmental association sector representatives.

The types of PP FEI programmes are rather similar to those implemented in Japan – loans, investments and guaranties, however terms and conditions differ:

1. Loan programme:
    - Support in the access to financial resources to entrepreneurs for business development by providing loans in situations when SME's own collateral is insufficient to attract the necessary amount of credit resources or business is considered too risky to receive funding from banks;
    - Program consists of the following sub-measures:
        i. SMEs loan supporting entrepreneurial competitiveness.
            - general type loans for working and investment capital;
        ii. Mezzanine loan programme
            - provides long-term junior (with the highest credit risk) financing, subordinated in relation to the loan issued by the bank, and is enhanced with a lower level of security than a bank loan;
            - the aim is to cover all long-term costs related to investment projects in material and non-material assets, establishment of a new enterprise, expansion of existing businesses, diversification of production, development of new products and reorganisation of the overall production process;
        iii. Micro loan programme
            - activity provides access to financial resources to self-employees and business start-ups;

2. Risk / Venture capital
    - Provides access to financial resources to SMEs for starting up and developing business, by taking loan or receiving venture capital injection, in situations when their own collateral is insufficient to attract the necessary amount of credit resources.
    - According to a survey carried out by the Latvian Venture Capital Association in 2004, the main problems of the venture capital market in Latvia and even the Baltic States were found to be the small size (high costs per transaction), lack of information on

market risks (small number of transactions in the market) and limited exit possibilities[20];

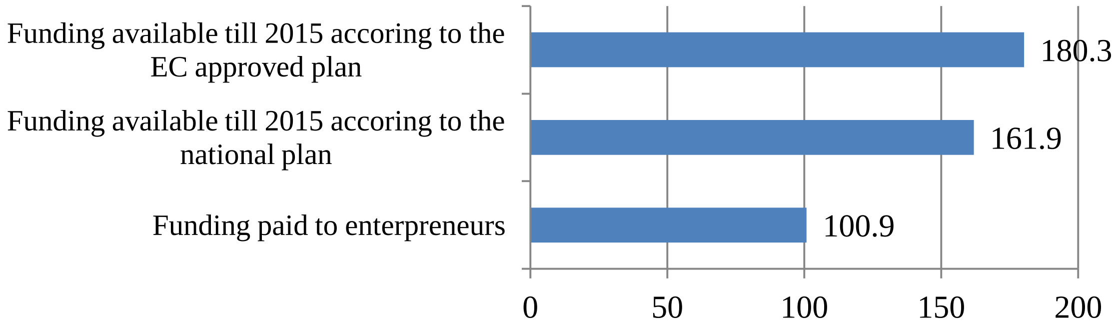
- Assisted risk capital takes the form of a long-term investment into an enterprise's unlisted equity or provision of equity related loan, with the purpose of supporting its rapid growth and development.

3. Guarantees
    - Credit guarantees are provided for SMEs to ensure company's planned credit to perform commercial activities in situations, when the SME does not have in its possession security for obtaining sufficient credit in the required amount[21]. In case of insolvency, the guarantor (state agency) repays the primary loan to the financial institution;
    - Export guarantees are committed in a situation where, if a foreign buyer does not make a deferred payment regarding delivered goods or services within the specified time period. In such a case the guarantee agrees to compensate the exporter (or the bank or factoring company which financed the exporter)[22];

SMEs in Latvia are eligible to receive both types of EU assistance - non-repayable grants and repayable loans, equity etc. However accounting should be kept really distinguishable. In line with the State aid guidelines[23], the cumulation of different measures of assistance is possible, as long as they concern different, identifiable and eligible assets.
The performance of FEIs in Latvia is measured in accordance to EU guidelines, and not expected to be solely motivated by the financial returns[24]. However from the perspective of investment recycling by re-investing in the next company, ability to generate the income by the loan receiver (quantitative criteria) is expected to be crucial.

Total EU fund budget reserved for the PP FEIs is 180.3 million EUR of 4.0 percent of the total budget for the period 2007-2013 (projects implemented till 2015). However national plans are modified by decreasing the expected allocations due to observed slowness and projected inability to reach the target of assisted SME. By the end of October 2013 the general progress of accumulated funding of PP FEIs was 56 percent[25] of the available budget.

[20] Operational Programme „Entrepreneurship and Innovations", available on http://www.esfondi.lv/upload/04-kohezijas_politikas_nakotne/op/2_dp_2009-07-28_ENG.pdf , last viewed 6.11.2013.
[21] Latvia Guarantee Agency, http://www.lga.lv/index.php?id=1&L=1
[22] Latvia Guarantee Agency, http://www.lga.lv/index.php?id=1&L=1
[23] EU rules applicable to state aid, available at http://europa.eu/legislation_summaries/competition/state_aid/, last viewed on 22.10.2013.
[24] Commission staff working document on Financial Instruments in Cohesion policy, European Commission, Brussels, 27.02.2012., Page 2
[25] EU Structural fund Monitoring committee materials, available at http://komitejas.esfondi.lv/Pazinojumi/DispForm.aspx?ID=224, last viewed on 10.12.2013.



Graph 6. Progress of the PP FEIS by 31.10.2013.; million EUR.
Source: EU Structural fund Monitoring committee materials

Having only 16 month left till the finale payment date, but bearing still a half of the disbursable funding, the risk of not accumulating all funding available is increasing. It is a loss of funding reserved from the EU budget to Latvia with no option to carry it forward for the next programming period. The Latvia Ministry of Finance has recently suggested reducing funding for programs aiming to support entrepreneurs with venture capital investments, and transferring it to new risk capital programmes, addressing pre-start-up stage[26]. Since PP FEI funding is provided mostly through EU revolving assistance, followed by strict national regulations, all programmes have limitations, both in terms of participants and supported lines of business, while agriculture, fisheries etc. are strongly separated from the business support programmes. In addition, entrepreneurs and international experts[27] are referring to the lack of seed-capital as the biggest obstacle for the business start in Latvia. Thus it was clear that under the current terms and conditions there is a lack of appropriate and eligible projects to be supported, and it is expected that new PP FEI programme will serve start-up needs. By end of October the venture capital programmes had allocated only 40 percents of the annual available funding and 26 percent of total available funding. New programmes are expected to stimulate the progress; however the stumbling block could still be a strict focus on innovative businesses.

In overall there are several PP FEIs scheme to support business creation and expansion in Latvia. The biggest share has been reserved for venture capital projects (43 percent), following SME loan programme (30 percent). Acknowledging that commercial entities go through five main stages of the business life-cycle - development, start-up, early-growth, rapid-growth, and exit -, the first problem at hand is a prominent capital gap between the needs of early-stage ventures and the suppliers of early-stage capital[28]. Apart from internal funding options - self-funding, bootstrapping, friends and family – the external funding from investors is usually needed. However the small market of Latvia is of rather limited interest for the big foreign venture capitalists, therefore public funding tends to cover this market gap on the first hand and assistance for the venture capital has the highest share among the State aid programmes in Latvia. For all that, most important programmes for SME are Risk capital, Mezzanine loans, and Guarantees. In Latvia they all are administered by the Latvian

[26] EU Structural fund Monitoring committee materials, available at http://komitejas.esfondi.lv/Pazinojumi/DispForm.aspx?ID=224, last viewed on 03.10.2013.
[27] Materials of the Forum on Development http://latvijasattistibai.lv/attistibasforums/#/video, and Karina Sotnik of the University of Pennsylvania in the expert meeting on promoting of the innovative businesses in Latvia http://www.latvijasattistibai.lv/full.php?article=start_up_vide_latv_jamaz
[28] Schweser K, CFA Level 1 Book 5: Fixed income, derivative, and alternative investments, Page 251

Guarantee Agency (LGA). Rural Support Fund also issues guarantees, which are particularly aimed at supporting Latvia’s agriculture, however not addressed for further research.
Small and micro loan programmes are delivered by the Mortgage and Land Bank of Latvia, currently being reorganized to a development-type bank. Even if the share of these programmes is rather minor, micro programs address the most vulnerable part of society – individuals, especially in rural regions, willing to establish small, family businesses.

The following section addresses programmes for SME and Micro support, operated under the Latvian Guarantee Agency and the Mortgage and Land Bank of Latvia.

1.2.1. Latvian Guarantee Agency

The Latvian Guarantee Agency (LGA) is a state limited liability company, which provides support to Latvian businesses. Apart from acting as a "fund of funds" within the venture capital aid scheme, LGA also provides credit guarantees for SMEs and Mezzanine loans. Obligations made by the LGA are ensured by the fixed capital of EUR 112 million, with 75 percent originated from the EU Structural Funds and 25 percent from the Latvian government. Each fund in which the LGA invests is monitored by an investment committee with both public and private sector representatives.

Venture capital funds are rather new in Latvia. They have been created only 20 years ago, which is about a life cycle of a venture investment[29]. Latvia has allocated one of the highest shares from EU funded PP FEIs to the risk capital if compared to other EU countries. However performance has been rather weak. Measurement has also been rather difficult, due to usual problems in estimation of expected payoff at exit, timing of exit (4-6 years, or more, less) and probability of failure[30].
Recently, the Managing Authority of EU funds has suggested decreasing the total funding for Risk capital programmes, foreseeing its limited accumulation. In some cases heavy progress grounds in the very strict requirement for venture investments. For example: *focus on high-technology entrepreneur at an early stage in its commercial development; investments in start-up technology businesses which are based on innovative intellectual property, and led by strong teams and have high international growth potential*[31]. Finding potential business "Cows" or "Stars" has always been a challenge for venture capitalists, however observing the experience of Japan, more traditional business and micro business can also originate features of the future.
Following requests from the private sector, LGA has recently introduced new risk capital programmes, specifically addressing seed money. With the new risk capital funds agreements signed in August 2013, LGA expects to promote assistance to the following:

- start-up companies with developed business model (FlyCap)
- commercial production beginners (Expansion capital)
- seed and start-up capital investments (ZGI capital)

[29] Венчурные фонды: риск – благородное дело. Telegraf.lv, 11.07.2013, available on http://www.telegraf.lv/news/venchurnye-fondy-risk-blagorodnoe-delo, last viewed on 01.10.2013.
[30] Schweser K., CFA Level 1 Book 5: Fixed income, derivative, and alternative investments, Page 251
[31] Imprimature, http://www.icfm.lv/en/home

It is expected that newly announced programmes will facilitate accumulation of the rest of the funding available, which would otherwise be lost for the Member State if not invested in business at least once before 2015. Additional programme is being planned for the micro loans, however still in development. There is no deadline for re-investments to be made after the first instalment; therefore first investments play a vital role for future funding base.

Table 4: Risk capital programmes managed by the Latvian Guarantee Agency, fund absorption rates

	Public funding, MEUR	**Acquisition by August 30, 2013**	
		MEUR	**Percent**
Holding fund for investment in guarantee, high-risk loans, and venture capital fund	**73**	**21**	**28**
BALTCAP risk capital	20	10	49
IMPRIMATUR seed and start-up capital	11	3	31
Funded risk sharing	8	8	96
FLYCAP, EXPANSION capital, ZGI capital*	30	0	0
New microloan fund	5	0	0

* Contracts signed on August 6, 2013

In following, the mezzanine loan programme was launched in 2012 after observing a slow progress in other existing programmes. The minimum amount of a Mezzanine loan is EUR 143 thousand and the maximum EUR 996 thousand, and loans may not exceed 40% of the total investment project cost, nor may they run for more than ten years. Lately, after noticing a widespread slowdown within the Mezzanine requests (only 10 percents of progress), LGA has suggested to introduce changes to the programme, by excluding the restricted industries/activities list, and making mezzanine loans subordinated in relation to a long-term loans granted by a credit institution or by a private investor.

Meanwhile the LGA guarantees are issued since 2008 to promote, either, competitiveness of entrepreneurs by securing their credits, or exports by securing their exported goods or services. The export turnover covered by the export credit guarantees by August 2013 exceeds EUR 70 million, while the defaulted guarantees are 1.2 percent of total issued guarantees[32].
Guarantees assessment is free of charge. However guarantee premium rates are determined, by assessing finances and security provided by the client. The limits thereof are from 0.2 percent up to 2 percent.

Table 5: Business assistance programmes provided by Latvian Guarantee Agency, fund absorption rates

	Public funding, MEUR	**Acquisition by August 30, 2013**	
		MEUR	**Percents**
Mezzanine investment loans	18.7	1.8	10
Guarantee for development of enterprise competitiveness	15.9*	15.9	100

* Multiplier of 4 is expected to be achieved

[32] LGA Progress presentation, available in the EU funds Monitoring Committee e-meeting materials http://komitejas.esfondi.lv, last viewed on 31.10.2013.

1.2.2. The Mortgage and Land Bank of Latvia

The state joint-stock company Mortgage and Land Bank of Latvia (MLBL) is managing six State aid loan programmes, including three for business support provided by the EU Structural fund - European Regional Development Fund (ERDF) with 62 million EUR - and the Swiss-Latvian cooperation programme. The financial assistance of the Swiss-Latvian Cooperation programme adds additional EUR 7.7 million for the PP FEIs in Latvia.

Since 2009 the MLBL is being reorganized to focus only on tasks of the development institution. The decision to sell the Mortgage Bank's commercial part was a continuation of the Cabinet of Ministers decision of 2009 to stop the Bank's commercial activities. Selection of buyers of the commercial part was completed in June 2012, ensuring further development of the commercial part in the private sector, and leaving MLBL focused only on economic development direction - financing of small and medium-size enterprises, promotion of new enterprises, development of infrastructure and other national development projects within the framework of government approved programmes.[33]

MLBL offers PP FEIs programmes for companies and individuals, financing business start-ups and new businesses. For experienced entrepreneurs it offers development funding. The Swiss-supported micro programme provides opportunity to apply for the grant after the first successful year of business, to partly cover the loan.

Table 6: Business loans provided by the Mortgage and Land Bank of Latvia

Type of loan	Public funding, MEUR	Specific note	Maximum amounts and lending period available
Micro lending programme (through the Swiss - Latvian cooperation programme)	7.7	Loans for self-employed persons, micro and small enterprises up to 10 employees with a maximum annual turnover of 2 million EUR, and for business start-ups. Assigned to be implemented till September 30, 2015.	Up to EUR 14 thousand for investments, and up to EUR 7 thousand for working capital; with a fixed annual rate of 5 percent to 8 percent or a floating interest rate of up to 3 percent plus 6 months RIGIBOR. Loans are issued up to 5 years term, covering up to 90 percent of project costs. For loans up to EUR 7 thousand no co-financing needed. After the first successful business year, it is possible to receive a grant partly paying off the loan.
START programme (ERDF	12.0	For Latvia residents aged 18 and over, including the unemployed who	Up to EUR 85 thousand with co-participation of at least 10 percent. Client participation is not

[33] Mortgage and Land Bank of Latvia http://www.hipo.lv/en/about_the_bank/jaunumi/20120622_hipoteku_bankas_komercdalas_cetram_paketem_atrasti_pirceji, last viewed on 12.11.2013.

assistance)		wish to start a business or self-employment, or new businesses (registered not earlier than 3 years before the support program). Also support available for existing entrepreneurs who want to start new activities, producing an entirely new product or service.	required if the loan is less than EUR 7 thousand. Interest rate could be subsides in up to 80 percents. Loan is issued up to period of 8 years.
Competitiveness Improvement Programme (ERDF assistance)	49.9	Funding for micro, small and medium-sized enterprises, having economically feasible business plans, but no credit funding available due to increased credit risks.	Working and Investment loans not exceeding EUR 2.1 million for one or inter-related companies.

Within the last three years MLBL have carried out several additional support programmes using European Social Fund funding, including hybrid program providing combined loans and grants for self-employed. However, programme was utilized at its full financial capacity and closed down due to no additional funding available. EU regulations rather limit the transfer of finances among PP FEIs, therefore there was no possibility to extend programme, using sources of European Regional Development Fund.

Since 2007 more than 78.9 percent of micro loans had been obtained outside Riga. The average size of loan has been 6.6 thousand EUR, mostly used for food and forestry product processing or wholesale and retail[34]. Japan has a similar regional orientation of the micro loans, mostly obtained for the wholesale and retail. However interesting is rather high share of the restaurant-related services and hotels in Japan, but having a minor share of these businesses supported in Latvia.

1.3. Latvia in the next programming period 2014-2020

On December 4, 2012 the European Commission (EC) has presented its' position on the preparation of the planning documents of EU funds for 2014–2020, starting an informal dialogue between the EC and Latvia. The total funding made available through Structural funds for Latvia was set in the amount of 4,430 billion EUR. It is slightly smaller than for the current programming period, but decrease was compensated with the increase in the agricultural funding.

[34]Mortgage and Land Bank of Latvia seconded web page http://www.atbalstaprogrammas.lv/mikrokrediti.html , last viewed on 8.11.2013.

The investment priorities of the European Union (EU) funds for 2014–2020 planning period were approved by Latvian government on January 29, 2013[35]. An indicative allotment of funding were made between the thematic goals on the basis of the priorities, course of action and tasks set in the National Development Plan (NDP) and their indicative amount of funding. For the next programming period the highest share was given to the public infrastructure, with this initiative not welcomed by the EC, however there is an increase of 6 percent funding for the Research and Development as compared with the current programming period.

Table 7. Financial allocation by priorities

Funding priorities	Share of funding
1. Strengthening research, technological development and innovation	11%
2. Enhancing access to, and use and quality of, information and communication technologies;	4%
3. Enhancing the competitiveness of small and medium-sized enterprises	6%
4. Supporting the shift towards a low-carbon economy in all sectors	11%
5. Promoting climate change adaptation, risk prevention and management	14%
6. Promoting sustainable transport and removing bottlenecks in key network infrastructures;	27%
7. Promoting employment and supporting labour mobility	13%
8. Investing in education, skills and lifelong learning;	12%
9. Technical assistance for the management and implementation	2%

PP FEIs programmes are planned to be developed under the third thematic objective, by allocating 67 million EUR funding for financial instruments. Funding for the PP FEIs in the next programming period is indicated substantially smaller compared to 180 million EUR of the current period. Meanwhile funding of the current period implemented by the Latvian Guarantee Agency and the Mortgage and Land Bank of Latvia is also expected to remain in Latvia (if invested at least ones before 2015) and potentially re-invested into other new businesses. Even more, in April 2013, the government supported the creation of a single financial development institution on January 2014, combining "The Mortgage bank," Ltd "Latvian Guarantee Agency", and the "Rural Development Fund". That will establish a new holding company providing PP FEIs for entrepreneurial activities. At the beginning of next year the holding will change the name to the State joint stock company "Latvia Development financial institution Altum". This reform is similar to the establishment of the Japan Finance Corporation, Altum providing in the future similar services to micro, small and medium entrepreneurs, as well as to agricultural sector. As from the experience of JFC, programmes united under one management are expected to create a better framework for implementation and analyses.

[35] EU Structural fund Monitoring committee materials, available at http://komitejas.esfondi.lv/Dokumenti/Forms/AllItems.aspx?RootFolder=%2fDokumenti%2f2014%20%2d%202020%2f03%5fTematisk%c4%81s%20sarunas%20ar%20EK%2fTik%c5%a1an%c4%81s%20ar%20EK%20Brisel%c4%93%5f27032013&FolderCTID=&View=%7b891B9B05%2dE11F%2d48BB%2d8B73%2dBA7E31F29B09%7d , last viewed on 11.12.2013.

Meanwhile, during the informal negations with the EC, the biggest share of PP FEIS has been indicated for the Early Stage risk capital (40 million EUR), remaining with the smaller share to loans (including micro loans) and guaranties. The caution within the current proposal remains in serving needs of small, traditional, and regional entrepreneurs to-be that facilitate employment and generate income. Taking experience of Japan and the current programming period in Latvia, micro loans are of a special interest in regions, while more start-ups, especially innovative had been created in cities. In addition, there is still a space in Latvia for the social group PP FEIs (women, senior), as well as for urban regeneration umbrella projects (special assistance for entrepreneurs entering depressed areas of cities), second business chance programmes, or revitalisation assistance for entrepreneurs. These programmes are hardly expected to be introduced by commercial banks, while EU funds could be used to generate business knowledge and encourage becoming innovative.

II. CHALLENGES AND SUGGESTIONS

The strength of European Union, including Latvia, lies within seven years planning period providing sustainability of measures. According to the European Commission guidelines, financial instruments can be used in all policy areas where feasible as long as complementing the EU objectives. Latvia has chosen to establish PP FEIs for entrepreneurship promotion, providing grant programmes for energy and urban projects, in contrast to the neighbouring countries (Estonia, Lithuania). Meanwhile enterprises, especially small and medium often lament a lack of growth funding. Their ability to access the finances is crucial to fund the level of investments needed to maximise the growth potential, and through this stimulate the job creation and economy. The public-private business support programmes in Latvia also provide combining of grants and loans, especially interesting for the self-employed and start-ups in regions.

The following section discusses foreseen challenges (A) and provides suggestion (B) to improve the PP FEIs programme, their impact and usage in Latvia.

1) <u>Limited sources of revenues</u>
    a. Depending strongly on the EU funds with following conservative rules at EU and national level creates limits for the variety and areas of investments.
    b. It is advisable to diversify the revenues stimulating entrepreneurial activities, by this expanding the scope of eligible users or activities, for example supporting business revitalisation, loans or overseas businesses, second chance business etc. Potential sources identified are dividends of the state companies, matching the needs of industries (for example State power industry enterprise providing funding for the loans for energy efficiency). I addition, also PP FEIs agency bonds might be a considerable solution, performing ex-ante policy cost analyses. After entering the Monetary Union, the credit rating of Latvia is expected to increase, providing more favourable rates for the market-raised funding.

2) <u>Regional perspective in risks capital</u>
    a. It is widely accepted that innovations are the shortest way to economical growth; however capacity in the current Latvia to produce innovative products

or services is very limited, especially in rural regions. According to the National Statistical office in the last years disparity of GDP per capita in capital city Riga and regions and number of newly established entrepreneurships has increased. Commercial banks are tied with strong regulations and liquidity requirement, reflected in the high risks premium for loans, expected to be even higher in the future. Therefore less innovative, potential entrepreneurs in regions are discouraged or not eligible to borrow from financial institutions. In addition, limited knowledge of attracting the right financing to the business is still widely observed.

b. Taking into account the general perspective of the Structural funds – serving for the benefit of the pubic - revision of the public funded risk capital programmes would be advisable. Previous sessions showed that more star-ups are established in cities, then regions. Broadening eligible base for participants would open programmes for regional initiatives that also serve the employment needs and generate income. Programmes for the social group PP FEIs (women, senior), as well as for urban regeneration umbrella projects (special assistance for entrepreneurs entering depressed areas of cities), second business chance programmes, or revitalisation assistance for entrepreneurs would be also very welcomed in regions, as from the experience of the other EU policy programmes. EU funds could be used to generate business knowledge and encourage potentially innovative start-ups to be established also in regions.

3) <u>Lack of pro-active examination of programme failures</u>

a. The new EU budget period (2014-2020) is soon to be launched, meaning also new PP FEIs. Current period programmes have experienced many changes in terms and conditions, especially by coming closer to the end of the budget period. That indicates a lack of pro-active data analyses already at the early stage of programme launch, rather acting post factum.

b. On January 2014 the new holding company for PP FEIS will be launched as a result of merging three policy-based institutions. Having a common frame of implementation it is expected to improve tools for analyses. It would be advisable to examine the possibility to use Credit register data as an additional tool to analyse tendencies and failures of the businesses. The Credit register provides information on types and duration of credits obtained, as well as data of the bad loans, giving indicators to the programme developers. The Credit Register could also serve as a pro-active examination tool by comparing the situation in the SMEs industry and dominant size of borrowers or their sectors of activities. Addressing market failure would secure a better progress of the programmes.

4) <u>Many grants, too few loans</u>

a. Traditionally SMEs in Latvia are used to benefit from EU non-repayable assistance, i.e., grants and subsidies. During the crisis, that was in many cases the only money for development. However, the EC has announced that in the future an even wider application of PP FEIS is envisaged. Therefore the focus of SMEs assistance programmes should be shifted from non-repayable grants to repayable financial instruments.

b. Taking experience from Japan - if the project is able to generate sufficient income - the loan approached should be applied. However, bearing in mind the economic indicators of Latvia, loans could be offered at 0 or close to 0 percent interest rate. That would help to smoothen the change from grant dependency to more added value financing.

III. CONCLUDING REMARK

Chris Burry, CEO of US Market Access Centre, in his speech at the “International Conference on Start-ups and Innovation" (Riga, 1 October 2013) said: "In the Baltic countries (Latvia, Lithuania, Estonia) new entrepreneurs hold know-how on technical issues and have a good working culture, however they are restricted by low ambitions, low know-how on business models and limited access to the capital, that prevents the business growth"[36]. This research has clearly showed that a network of PP FEIs exists in both countries; however, in some programmes the capital provided by government exceeds the market demand or ability to accumulate. Nevertheless, the governments of both Japan and Latvia are expected to continue addressing the challenge of creating an environment where companies are willing and able to invest. Proven by the case of Sweden, the return of public investments in innovative businesses has been very high: 2.2 SEK or 120 percent profit[37].

Latvia's GDP growth rate, according to the latest projections as of October 2013, has been improved to 4.1 percent. However it is too early to analyse contribution of the PP FEIs to the economic growth, since several programmes are still on the low track of usage, while new measures are to be introduced shortly. The general challenge in Latvia remains the conservative regulation in the funding side, limiting the expenditure varieties. Public intervention in the equity market is mostly performed using EU funds, whose following national regulations set a rather narrow frame of eligible areas and conditions. In the next period programmes more regional and social oriented programmes would be advisable, where EU funds are used to create a sustainable knowledge and practical business skills. That would facilitate creation of the critical mass of entrepreneurs encouraged to expand, become more innovative or develop innovative spin-offs. By obtaining other types of funding (for example, agency bonds of the newly established state holding company), Latvia could also add opportunities for PP FEIs investment.

[36] IT investors: Jaunuzņēmējiem spārnus apgriež nepietiekams finansējums, available at http://nozare.lv/business/top/DDBCA4C6-0BFB-4FC7-B002-2B826A1168CF/, last viewed on 2.10.2013.
[37] Magnus Lundin, CEO of Association of Swedish Incubators and Science Parks, in the conference "Crossing Borders to Boost Start-ups and Innovation", October 1st 2013, Riga