Micro and Small Businesses Access to Finance and Financial Literacy of their Owners: Evidence from Latvia, Estonia and Georgia

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Abstract. Lack of financial literacy of micro, small and medium-sized enterprises (MSMEs) owners/managers is often mentioned among the reasons of their financial exclusion. The main objective of the article is to verify whether the targeted group - MSMEs - access to finance and financial literacy of their owners/managers are closely linked in observed countries – Latvia, Estonia and Georgia. As a supportive objective, analysis of the relationship between financial literacy of MSMEs owners, adult literacy and the level of general education in a country is also analyzed. The research is exploratory in its nature, based on intensive literature review, analysis of the countries’ statistics and the case study. The main findings are as follows:

• Analysis of financial literacy scores and financial inclusion in Latvia and Estonia evidences a constantly positive association between these two indicators.
• Positive cause-effect relationships are observed between the level of general education of the population, personal literacy, financial literacy of MSMEs owners/managers and MSMEs access to finance.
• In the observed countries, the level of general education of the population is quite high, but the owners of micro and small businesses do not have sufficient specialized business education, skills and competences.
• Due to high general level of education, Georgia has a good chance to improve financial literacy of MSMEs owners in a short time.

The paper has the potential to impact policy decision-makers to consider the recommendations made.

Keywords: Access to finance · Financial literacy · Georgia · Latvia · Estonia
1 Introduction

Although there is a high degree of uncertainty about the post pandemic period, it is obvious that all companies will be negatively affected but small business will suffer the most. In order to support SMEs and to maximize their significant contribution to national economies, ‘it is important to identify their specific needs, take note of gaps and seek ways to address them’ [1]. As the literature evidences, financial exclusion remains one of the most pressing issue for SMEs in most countries [2–5]. According to IMF [6] total financing or credit gap is about two trillion USD. From the perspective of this article, it is important to separate micro and small businesses in a special sub-group within SMEs [7]. In fact, such separation has been used in international studies, e.g. ‘smaller-scale SMEs’ [8] and ‘micro and small and medium-sized enterprises - MSME’ [9] terms are in used.

Limitation of Research: The scope of this study is limited by the number of countries observed. In addition, the lack of regular statistics on SMEs and especially MSMEs limits the use of statistical methods of analysis.

2 Literature Review

Financial exclusion of SMEs is related to many reasons that might be classified as supply- and demand-side issues [10]. Whether most issues have an objective justification, a subjective component also exists. Financial literacy (FL) of SME managers, who are - in the most cases - the owners of micro and small enterprises (MSMEs), is also among the serious reasons of their financial exclusion [1].

FL of SME owners has been recognized as a vital precondition of small business performance in terms of raising profitability, competitiveness, and growth. Studies conducted in different countries evidence that lack of FL has caused limited accesses and the number of available sources of external financing [1, 11, 12], business failures [13] and also it negatively affected potential entrepreneurs [14].

Wide range of literature examines different aspects of financial literacy of SMEs owners. Some researchers identify FL as the combination of knowledge of financial subjects and skills that are essential for efficient management [15–17]. Broader interpretation includes psychology aspect that is the experience of sensation of financial freedom or financial well-being. These feelings help a manager to attain confidence, productivity and success [18]. OECD defines FL of owners and managers of MSMEs as ‘the combination of awareness, knowledge, skills, attitudes and behavior that a potential entrepreneur or an owner or manager of a micro, small or medium sized enterprise should have in order to make effective financial decisions to start a business, run a business, and ultimately ensure its sustainability and growth’ [19]. Narrower approach focuses on three pillars: financial knowledge, financial skills, and financial attitudes and behavior [20].

Of all the different types of external financial recourses available to SMEs, commercial banks and microfinance organizations have traditionally provided the bulk of credit [21–23]. Every stage of SMEs lending cycle is challenging [24]. Specifically, asymmetric information and moral hazard problem complicate the situation [25].
Insufficient collateral that is often a result of poor financial record keeping and is also the serious barrier to external financing [26, 27]. The use of Financial technology or ‘FinTech’ platform that opens access to new financial services and products, is limited for SMEs due to low FL of the owners/managers [1].

Thus, to raise financing MSMEs owners must have sufficient financial literacy skills to assess sources of financing options available, to understand the risks involved, to assess the appropriateness and suitability of equity vs. debt finance [28].

3 SMEs Financial Inclusion: Countries’ Comparison

In EU countries access to external financing for SMEs has been significantly improved since 2008, when ‘The Small Business Act for Europe’ was adopted. In the last, 2019 survey conducted by the European Commission and the European Central Bank (ECB), on the question, what is the most important limiting factor to get the financing, 45% of EU SMEs respondents reply ‘there are no obstacles’, in Latvia and Estonia these figures were even higher – 48% and 50%, respectively [29]. Latvia and Estonia are also in the group of countries, which results in availability of different financing sources and other relevant conditions, are above the EU average [30].

Although access to external financing is still mentioned among the first three-four obstacles, the clear positive trend might be observed in evolution of EU SMEs access to finance [27, 30–32].

As Table 1 shows, debt financing is preferred over equity financing by SMEs at EU level (82%), whereas in Latvia and Estonia debt financing was lower, 75% and 82%, respectively. These proportions have been rather stable since 2015, although the relevance of bank loans as a source of external financing has been consistently decreasing [23, 29].

| Sources of financing | EU | Estonia | Latvia |
|----------------------|----|---------|--------|
| Credit lines         | 34 | 18      | 21     |
| Leasing              | 24 | 36      | 31     |
| Bank loans           | 15 | 13      | 13     |
| Trade credit         | 17 | 19      | 8      |
| Grants               | 8  | 4       | 3      |
| Internal funds       | 14 | 13      | 11     |
| Other loans          | 7  | 15      | 14     |
| Equity capital       | 1  | 0       | 9      |

Table 1. Sources of financing recently used by SMEs (%), 2019.

One can see that in observed countries leasing, trade credit and credit lines are the most recently used sources of financing. Small variety between the countries reflects the difference in development of financial institutions such as banks, investment funds,
insurance and pension funds etc. as well as the development of financial markets segments such as the stock exchange and bond market.

In Georgia limited access to finance is still a serious obstacle to SMEs growth. According to the IMF, SME Financial Inclusion Index in Georgia is only 0.5 out of 1.0. In this index, Georgian is ranked the 7th place among 9 efficiency-driven European economies [33].

The main source of external financing for many Georgian SMEs is traditional bank lending. As Table 2 shows, in Georgia the largest part of loans (95.5%) requires collateral, and the value of collateral is very high (223.3% of the loan amount). Besides, although average interest rate for SMEs loan has trended down (15% in 2011), it is still high (around 9% in 2019) [35]. Falling interest rates have a positive effect on expansion of SME loans in the portfolios of banks. Remarkably, the spread of interest rates on SME loans is narrowing vs. large firms’ loans reflecting improvement in SME credit conditions [36].

Table 2. Bank loans conditions, 2017.

| Country | Value of collateral needed for a loan (% of the loan amount) | Proportion of loans requiring collateral (%) | % of firms with a bank loan/line of credit | % of firms using banks to finance investment |
|---------|-------------------------------------------------------------|------------------------------------------|-----------------------------------------|------------------------------------------|
| Georgia | 223.3                                                       | 95.5                                     | 35.8                                    | 22                                       |
| Latvia  | 229                                                        | 60.6                                     | 20.1                                    | 7.9                                      |
| Estonia | 151.6                                                       | 75                                       | 40.2                                    | 32.7                                     |

*Source: Compiled by the authors based on data of [34].*

Falling interest rates have a positive effect on expansion of SME loans in the portfolios of banks. Remarkably, the spread of interest rates on SME loans is narrowing vs. large firms loans reflecting improvement in SME credit conditions [36]. Additionally, since in Georgia banking sector is highly concentrated [34, 35] and out of 15 operating banks, 14 are foreign controlled [37], asymmetric information causes personalization of lending relationships and discourages SMEs loans. As a result, Georgian SME sector is low lending (Table 3).

Table 3. Composition of the bank loan portfolio by segment in Georgia.

|          | December 2015 (%) | December 2016 (%) | December 2017 (%) | December 2018 (%) |
|----------|-------------------|-------------------|-------------------|-------------------|
| Corporate| 37                | 34                | 31                | 30                |
| SME      | 23                | 21                | 23                | 25                |
| Retail   | 40                | 45                | 46                | 45                |

*Source: Compiled by the authors, source of data [38, 39]*

One can see that the composition of the loan portfolio by segment slightly changed from year to year. Small increase a portion of SME segment can be attributed to the
technical reclassification of the SME rather than real changes. It should be noted that so-called ‘technical reclassification’ was done by National Bank of Georgia (NBG) in 2016, based on the EU standards. But as the practice evidences, classification of enterprise is still a matter of a great deal rather than ‘technical’, when the firm applying for a loan [40]. The Georgian banks still use their own classification criteria, and consider many borrowers as corporate clients rather than SME [19]. As for alternative sources of SMEs financing, for instance, micro-finance institutions, it is easier in terms of procedure but more expensive (larger collateral and higher interest rate). Leasing operations, factoring services, venture capital activity etc. remain underdeveloped and lack diversified in the country [41]. Therefore, whereas some SMEs exclude themselves, because they lack profitable investment projects or enough collateral, others cannot provide all the required information due to the lack of expertise needed to produce sophisticated financial statements, including financial reporting in accordance with International Financial Reporting Standards for SMEs (IFRS for SMEs). Low quality of financial reporting is a very painful challenge of Georgian SMEs [41].

In observed Baltic states, Latvia and Estonia, access to financing is still a pressing issue for micro and small enterprises [42, 43], especially after implementation of Basel III Requirements [44]. MSMEs are less confident to talk with banks and potential investors about financing than are large enterprises. In Latvia only 38% of MSMEs have positive aspiration, while 28% answered negatively; in Estonia 41 and 29%, correspondingly, compare to 67 and 20% in EU (Table 4).

Table 4. Micro and small enterprises obstacles to financing, % in total.

|                         | EU | Latvia | Estonia |
|-------------------------|----|--------|---------|
| Insufficient collateral or guarantee | 12 | 20     | 20      |
| Interest rate too high | 12 | 16     | 16      |
| Too much paperwork involved | 8  | 12     | 1       |
| Positive/negative aspiration | 67/20 | 38/28 | 41/29   |

*Source: Compiled the authors based on data of [27]*

IFC applied new methodology to measure MSME financial gap, which is estimated as the difference between current supply and potential demand. This approach shows more realistic picture because it distinguishes between fully credit-constrained firms and partially credit-constrained firms [10]. According to this methodology, MSME financial gap in Georgia is still substantial – 18% to GDP (Fig. 1), which is less than in Estonia (23%), but higher than in Latvia (5%).

In observed countries many of MSMEs have a higher “potential” demand for financing, which is unacknowledged because the owner knows that is not likely to be met due to insufficiently projects, a poor repayment history, or any other reason.
4 Financial Literacy: Countries’ Comparison

These days, during the COVID-19 pandemic, the topic - financial literacy of MSME owners - becomes even more alarming and relevant because in many countries, governments introduced anti-crisis plans to support the businesses. The questions arise – Could micro and small businesses effectively use financial support provided by the Georgian government, commercial banks, international and local organizations? Is there a solid background for improving financial literacy of Georgian MSME owners in a short time?

In 2016 NBG declared the improvement of the level of financial literacy in the country as one of the priorities [38] and special financial education program was developed. According to NBG 2016 countrywide study on financial literacy and inclusion, ‘the overall financial literacy levels of the Georgian population can be assessed as intermediate, leaving vast room for improvement’, because only 54% can be considered reasonably knowledgeable [45]. Remarkably, according to Global Entrepreneurship Monitor survey, conducted about in the same period, only 1/3 of the Georgian population identified business opportunities and most of them (58%) believed that they did not have enough knowledge and skills to act entrepreneurially [46]. The most financially educated segment (11.7% of the total Georgian population) includes “business minded” people, who attained the highest financial literacy score – 65.6 (on a 100-point scale). They are young people (18–45 age group) and most of them got university education (Table 5). Also, those with university education, received higher financial literacy scores (62.0 out of 100) than those with complete secondary school (57.1) and technical/vocational education (57.8) [45].

As Fig. 2 evidences, in observed countries (Estonia, Latvia and Georgia) individual financial literacy is quite comparable with EU average level. Still, in Latvia and Estonia adults had high levels of basic financial knowledge but they did not have high overall levels of financial literacy on such a measure due to their low financial behavior scores [47]. Studying the two Baltic states’ practices, one can see that improvement in SMEs financial inclusion was correlated with a high level of general education as well as high level of FL, both individual and SMEs owners (Table 6). Estonia is a leader in financial literacy performance of the students at the national level among EU countries with
mean score above the EU average. Between 2012 and 2018, there was a significant increase in the proportion of students who scored at the highest level (Level 5) in financial literacy [48], the fact that evidences that education is matter.

5 Conclusion

The main findings of the research are as follows:

- The most vulnerable group of SMEs is micro and small businesses (MSMEs). Owners of such enterprises still mostly suffer from a lack of financial literacy and therefore mostly face limited access to external financing.
• Analysis of financial literacy scores and financial inclusion in two Baltic states, Latvia and Estonia, evidences a constantly positive association between these two indicators.
• Positive cause-effect relationships are observed between the level of general education of the population, personal literacy, financial literacy of MSMEs owners, and MSME access to finance.
• In the observed countries the level of general education of the population is quite high (see more [49]).
• Based on essential background in terms of high general level of education, Georgia has a good chance to improve financial literacy of MSMEs owners in a short time.

6 Recommendations

Despite the exploratory nature of the research, the paper has the potential to impact policy decision-makers to consider the recommendations made.

• It is time for the governments to focus on the subgroup of SMEs – micro and small businesses (MSMEs)
• MSMEs urgently need government-based system of training and educational centers.
• The system should provide special targeted support in terms of free of charge training programs, mentorship, consulting and advisory services, online courses, educational TV-programs, webpages etc.
• In addition to government agencies, commercial banks, financial industry associations, universities, other stakeholders should be involved in the system.

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