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FINANCIAL INSTRUMENTS – A WAY TO SUPPORT SUSTAINABLE DEVELOPMENT OF THE EU RURAL AREAS? CASE OF POLAND

Summary: Financial instruments (FIs) have been one of the EU rural development policy measures since 2000. Yet, they have not gained much popularity so far. There is a number of barriers for their wider implementation in rural development policy. The paper is based on literature review of the functioning of the FIs in the EU development policies. Its aim is to assess the potential of the FIs in supporting sustainable development of rural areas. The results show that there is not much demand for FIs in Poland. Yet, their attractiveness and effectiveness can be improved.

Keywords: financial instruments, rural areas, EU, Poland, sustainable development.

JEL Classification: Q18.

Introduction

The idea of introducing financial instruments (FIs) was put into practice in the EU cohesion policy already in the programming period 1994-1999. Initially they were known as financial engineering instruments and they have been applied in the European Regional Development Fund, European Social Fund and Cohesion Fund since the programming period 1994-1999, while in the case of European Agricultural Fund for Rural Development (EAFRD), which ithe second pillar of the CAP since the programming period 2000-2006. Yet, the financial crises which started in 2007, significantly limited investement in the EU and access to the capital, so the EC established special inititives to promote investement (the so-called Juncker Plan), which was followed by promoting FIs within the already established EU funds.

As stated by Kulawik, Wieliczko and Soliwoda [2018, p. 35], there is no universally accepted definition of FIs. In the case of the EU funds following instruments are considered as FIs: loans, microcredits, guarantees and equity. Most often implemented are loans and guarantees.

Polish agriculture and rural areas received a significant boost in their development with the Polish accession into the EU. The CAP fund play a vital role in the development of rural areas in Poland. Yet, with the planned significant drop in the allocation for the second pillar of the CAP, also known as rural development policy, in the programming period 2021-2027 a new ways of supporting rural areas are needed.

The paper is based on literature review. Its aim is to assess the rationale and the need for introducing financial instruments in rural development programme in Poland as a tool for supporting sustainable development of the Polish rural areas. The paper is based on review of literature concerning the functioning of FIs in the EU rural development policy and the popularity of external funding as a source of capital for launching economic activity or investment amoung farmers and rural entrepreneurs in Poland.

The paper is divided into four chapters. The first of them is devoted to the presentation of financial instruments in the EU policies, focusing on the rationale of their introduction into these policies. The second chapter presents application of the FIs in the CAP. The third chapter is concentrated on the experiences with the use of FIs in the CAP, while the fourth demonstrates results of the analysis of the need for implementing FIs in Poland as part of the rural development programme 2021-2027.

1. Financial instruments in the EU policies

The idea of increasing the availability of public funds to potential beneficiaries by using refundable support is not the objective of FIs application in itself. The key concept is to eliminate the problem supposed to be a developmental barrier for the EU and especially for its SMEs sector. It is limited access to capital. This is related to following issues:

- insufficient supply of adequate financial products;
- asymmetric information including principal/agent problems;
- high transaction costs;
- insufficient capacity to provide collateral to SMEs;

- insufficient or unpredictable cash flow [European Investment Bank, 2014, Table 1].

By offering public support in the access to capital public policies seek to overcome the problem of so-called valleys of deaths. These are the fundamental development phases in the growth of enterprises. It has been establish that numerous companies seize to exist at an initial stage of their development and later when they need capital boost to enter post-initial growth phase.

The key part of ex-ante analysis that must be conducted before implementing FIs is the assessment of the unsatisfied credit demand. The general approach relies of calculating financial gap which is built of cases in which a market failure can be observed (Fig. 1). These cases relate to such instances as lack of credit history or lack of collateral. The process of assessing the scale of financial gap is complex and time consuming. It includes both literature and data analysis as well as interviews with financial institution representatives and potential beneficiaries of FIs.

Yet, it must be borne in mind that the estimated figures are not the actual demand for credits. This is due to the actual conditions of credits that could be offered to the potential beneficiaries. Moreover, there is always a certain group of managers are reluctant to taking out credits due to their risk aversion.

The FIs, as opposed to grant support require a more complex implementation system. The whole concept of FIs is based on the cooperation of public administration bodies with financial institutions. These financial institutions act as intermediaries. They also offer the verification of applications. Given their experience and expertise in the field of evaluating business plans, it is expected that this will be done much better than in the case of public institutions.

The use of FIs offers certain benefits to all the involved parties. It is expected that FIs bring significant increase in the scale of investment. The multiplier effects are to be triggered by the FIs and contribute to greater capital availability not only thanks to the revolving nature of FIs but also due to involvement of private funds (Table 1). Also financial beneficiaries gain from participating in the system of FIs. Not only do they gain new clients, but also benefit from a capital relief as the offered credits and guarantees are funded from the public funds. Final beneficiaries not only gain access to capital they need, but they get it at interest rates lower than the market ones and with other terms and conditions preferential in comparison with the offers available on the market.

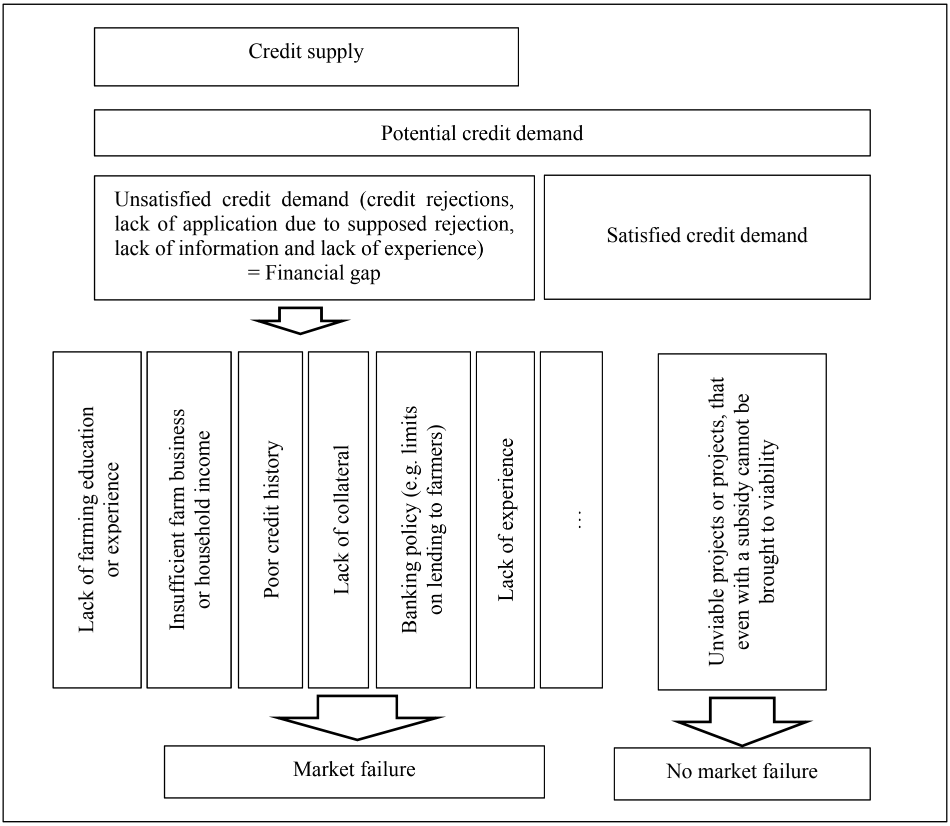

Fig. 1. General approach to identifying market failure in agricultural finance

Source: European Investment Bank [2014, Fig. 5].

Table 1. Key benefits of implementing FIs

Managing authorities	Financial intermediaries	Final beneficiaries
High leverage	Capital relief	Reduced interest rates
Revolving nature	Risk protection on a loan by loan basis	Reduced collateral
Higher EAFRD contribution	Coverage of losses	Enhanced access to finance for riskier projects
Improved quality of the investments	Quick payment in case of default	Opportunity for new businesses (young farmers) with no credit history
Quick and easy disbursement	Increase in number of new clients	Preserved ownership of business
Demand-driven	Strengthened position in the market	Quick access to finance
Significant visibility	Quickly deployable products	Less paperwork
Efficient integration of grants and other types of support		Reduced external audits

Source: Cottogni [2017, p. 3].

2. Financial instruments in the CAP

The application of FIs in the EU rural development policy is supposed to support The EAFRD objectives, which include:

- fostering knowledge transfer and innovation in agriculture, forestry and rural areas;
- enhancing competitiveness of all types of agriculture and enhancing farm viability;
- promoting food chain organization;
- promoting resource efficiency and supporting the shift towards a low-carbon and climate-resilient economy in the agriculture, food and forestry sectors;
- promoting social inclusion, poverty reduction and economic development in rural areas, in particular with regards creation and development of small enterprises, as well as jobs creation [Fi-compass, 2015a, p. 4].

In the programming period 2014-2020 the emphasis on the implementation of FIs within the member state rural development programmes (RDPs) increased. Most of the member states (MSs) has already conducted ex-ante analysis of the necessity and applicability of FIs in their RDPs.

There is a number of examples of using FIs within rural development programmes (RDPs) in different MSs. Yet, they are limited to two types of FIs – loans and guarantees, that is the simplest for final beneficiaries to comprehend and for financial intermediaries to offer. There are several RDP measures for implementation of which FIs have been used so far. In the programming period 2014-2020 these include:

- investments in physical assets;
- farm & business development;
- basic services & village renewal;
- investments in forest areas;
- cooperation;
- LEADER/CLLD.

These are only six of the twenty measures envisaged in the regulation 1305/2013. Yet, not all of the measures can be implemented with the use of FIs as they are payments for specific activities undertaken by farmers such as agri-environmental practices or for operating is specific conditions such as areas with natural constraints.

In other than EAFRD (Fig. 2) a spectacular increase in the amount of support channeled through FIs was observed in the programming period 2007-2013 (Fig. 2). In the case of EAFRD the increase was from the zero base, yet still FIs accounted only for 1.3% of the EAFRD at that period [Kulawik, Wieliczko, Soliwoda, 2018, p. 37].

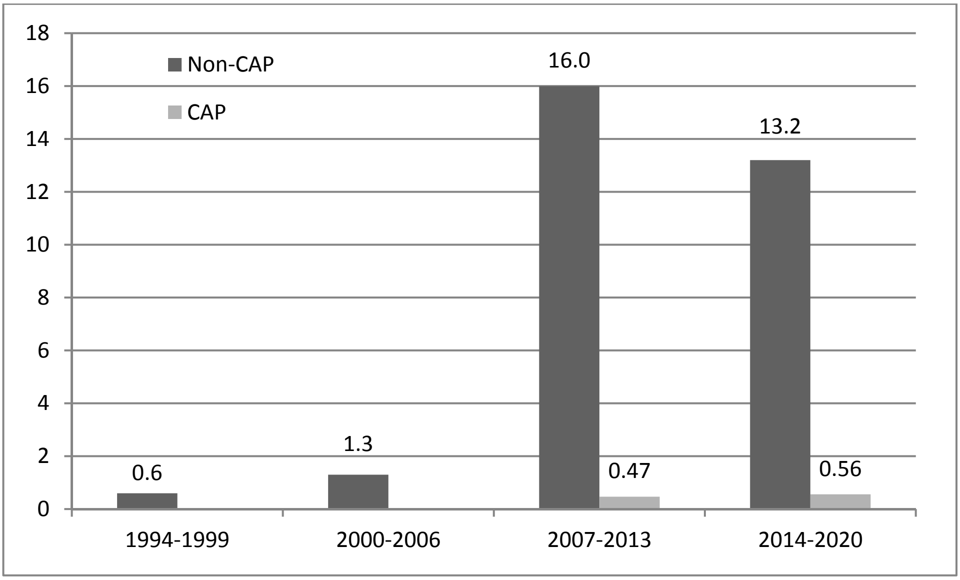

Fig. 2. Funds allocated for the implementation of FI in the EU (EUR billion)

Source: Kulawik, Wieliczko, Soliwoda [2018, Fig.1].

3. FIs in sustainable development of the rural areas in the EU

In 2015 the European Court of Auditors stated that “financial instruments had been unsuccessful in the field of rural development and although the 2014–20 period is potentially promising, it will be a considerable challenge to achieve the desired impact” [European Court Auditors, 2015, p. 7]. The problems emphasized by the ECA included, i.e. delays in implementation and lack of justification for the scale of funds allocated to FIs. The regulations and practices related to FIs are constantly being upgraded to improve the ease of their implementation and thus increase their attractiveness. It is done even during a programming period. An example of this is the recent Omnibus regulation [www 1]. However, a full realization of all the benefits that FIs are supposed to offer, mentioned in Table 1, has not been achieved, yet.

Fi-compass, the EU public institution established to promote FIs and support member states in their implementation, assessed the scale of financial gap in the EU agriculture. It amounts to approx. EUR 18.6 billion (Table 2), while the CAP annual budget reaches approx. EUR 30 billion.

Table 2. Estimated financial gap in the EU agriculture (in EUR)

Specification	Lower boundary	Upper boundary
Short-term loans	1 565 006 622	4 120 785 592
Medium and long-term loans	5 498 698 235	14 478 505 168
Total	7 063 704 857	18 599 290 760

Source: FI-compass [2018b, Table 2.2].

This figure cannot be treated as a total demand for FIs in the EU farming sector. This can be seen only as a financial gap in the sector, but the actual demand is much lower. There are numerous reasons for this. Most important is lack of financial knowledge still present among farmers and their risk aversion. Moreover, it must be borne in mind that the investment behavior of farmers is influenced by many factors, such as "household structure, attitudes and evolution, long-term expectations, perceived opportunities and costs of resources, which focus attention on the wider socio-economic context" [Gallerani et al., 2008, p. 85].

Another explanation for low uptake of FIs in RDPs is the general approach of EU farmers to capital sources for their investment. A study conducted by Lefebvre et al. [2014] showed that minority of farmers (only 30%) intends to finance their planned investment with bank loans (Fig. 3), while a tiny share mentioned public support as source of investment funding (4%). Most common among the surveyed farmers was using own resources to undertake an investment. The shares varied depending on the type of investment. Farmers most often planned to use bank loans when investing in land as well as machines and equipment. In addition, the research showed that only 26% of the survey participants named lack of financial resources as a reason for the lack of investment plans. However, there were significant differences among MSs.

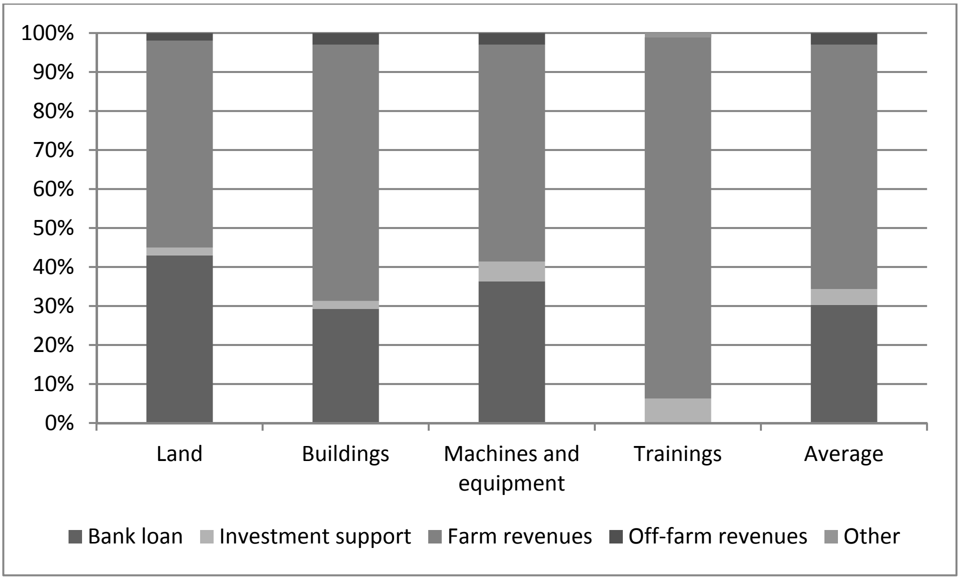

Fig. 3. Percentage of planned investment financed mainly with a particular source of financing

Source: Own elaboration based on: Lefebvre et al. [2014, Fig. 15].

The above mentioned study findings clearly show that the interest in FIs is limited as farmers prefer saving for their investment. Also the experiences of the countries that have already implemented FIs within their RDPs show that the uptake is not as high as the financial gap assessment would suggest. An interesting example is the case of FI implementation in the Mecklenburg-West Pomerania (Germany) in the current programming period. This case also shows other limitations of FIs. FI is used in region's RDP as a loan fund for the market launch of innovative products in the food and agriculture sector. The food sector was chosen for two reasons. First, it is seen in the region's development strategy as a future sector. Second, in the previous programming period an attempt of implementing FI for farmers was unsuccessful due to the fact that the banks themselves offer loans to farmers. The analysis of the agri-sector's situation showed that there SMEs which develop marketable products (often with the support of ERDF), but lack financial capacity to launch them on market. A size of a single loan is EUR 80,000 – 1 million. The maturity of loans depends on their type. For working capital it is up to 8 years and for investment up to 20 years [Fi-compass, 2018c]. The process of implementing this FI started in March 2015 with a public procurement for ex-ante assessment. The application process for loans started in October 2016 and the first loans were granted in May 2017. Yet, until June 2018 only two loans were granted and less than 1/10 of the total project's budget absorbed [Wienkemeier, 2018].

The length of the launching process in the Mecklenburg-West Pomerania case is typical of FIs. Launching the EAFRD Credit Fund in Lombardy took over two years from completion of ex-ante assessment to selection of individual investment projects and then four months to signing first contracts [Fi-compass, 2018a, p. 7].

The Mecklenburg-West Pomerania and Lombardy cases, as all the other case of implementing FIs in RDPs, indicate the length of the process of launching such instruments. Moreover, each of the phases is fundamental for the success or failure of FI. Apart from assessing the demand, choosing financial intermediaries and shaping relations with them seem to be the key issues. Another important thing is taking into account the possibility of changes in the market situation. A good example is the case of the Latvian Credit Fund were the account allocated for loans was not fully absorbed due to the fact that commercial loans became more accessible (both in terms of price and availability [Fi-compass, 2015b, p. 8].

The financial sector seems to be more and more familiar with the needs and specificity of the agricultural enterprises. Yet, for the new farmers and entrepreneurs it is still difficult to receive external funding as they lack credit history and income, which are the key factors in granting a loan (Fig. 4).

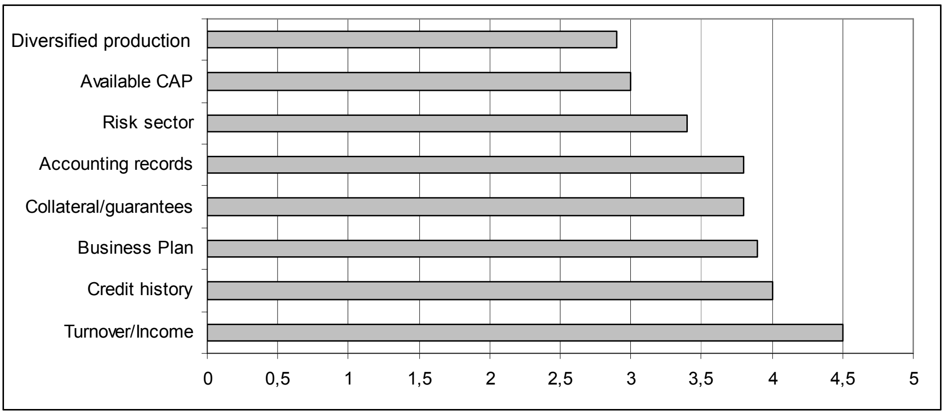

Fig. 4. Importance of factors when assessing agricultural enterprise applications for finance (1 = low, 5 = very high)

Source: Fi-compass [2019a, Fig. 4.1].

Summing up, it can be stated that the lessons learnt so far help improve the regulations and create good practices but when competing with grants the FIs have no chance of attracting large number of beneficiaries. Currently, they merely serve as pilot projects for introducing investment support only in the form of FIs which can be expected as the EU budget is limited and new challenges require funding. Yet, with the expected increase in the demand for finance [Fi-compass, 2019b, p. 17] in agriculture financial instruments can help meet this demand for funds enabling modernization of farms. Also non-rural entities will need external resources to modernize in line with the rapid changes in technology and consumer expectations.

4. Do we need FIs' help in sustainable development of the Polish rural areas?

The problem of the lack of access to external financing is one of the barriers to the development of economic activity, both among farmers and people opting for non-agricultural activities, but it is not a key factor. It should also be noted that the use of repayable funding is not a popular way of financing the establishment and development of businesses in Poland. As Kulczycki [2016, p. 69] shows, "the majority (about 60%) of micro-, small- and medium-sized enterprises do not use loans at all". Also among farmers, loans are not a popular source of financing. Farmers point mainly to the lack of demand for external financing as the reason for not applying for such financing (58% in the survey for the purposes of *Ocena ex ante*..., 2019, Fig. 10). The use of own resources came in the next place.

As research shows, for farms and agri-food processing enterprises the main obstacle to access to financing are high security requirements, and to a lesser extent − interest [*Ocena ex ante*..., 2019, p. 5]. Moreover, in many cases the barrier to obtaining financing is the lack of security resulting from the common practice of land lease (especially among small farms) and restrictions on the use of agricultural land as collateral [*Ocena ex ante*..., 2019, p. 67]. At the same time, small farms have the biggest problem with access to financing [*Ocena ex ante*..., 2019, p. 67]. Almost 22% of farmers and 49% of small rural entrepreneurs clash with the lack of access to credit or can get a loan, but on worse conditions compared to other groups of bank clients [Kata, Walenia, 2015, p. 9].

The research conducted by Lefebvre et al. [2014] showed that Polish farmers more seldom than in other EU member states studied name lack of financial resources as a reason for not investing (Fig. 5).

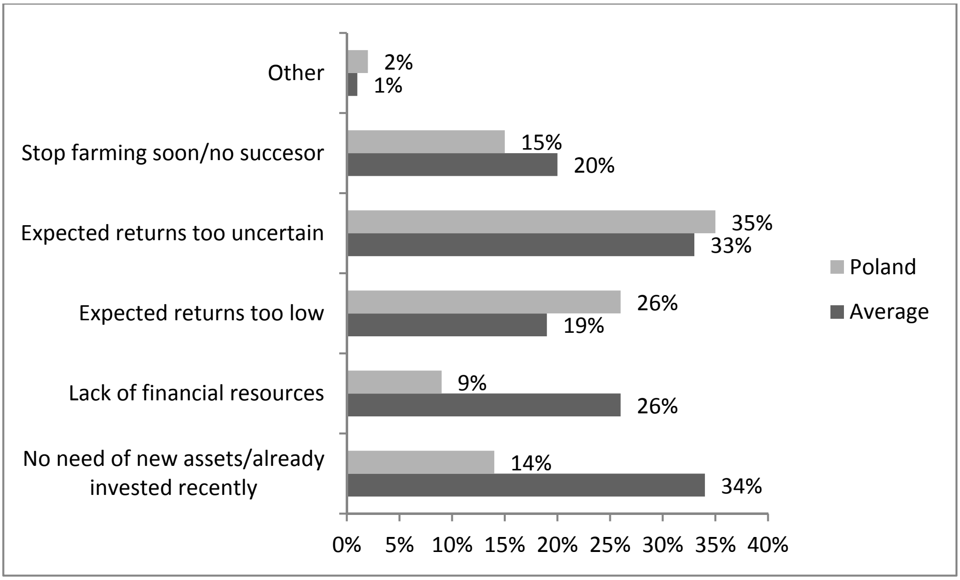

Fig. 5. Reasons for not investing (multiple responses allowed)

Source: Own elaboration based on: Lefebvre et al. [2014, Fig. 14].

In the case of starting economic activity in rural areas, the main source of its financing are own savings. The research conducted by Pomianek and Niewęgłowska [2017, Fig. 2] shows that over 80% of respondents use this source, and only 30% of respondents get a loan. Similar results are presented by Szepelska [2016, Fig. 1] in relation to women undertaking economic activity in rural areas in the Podlasie voivodeship. According to her research, only 25% of women reach for a loan, and own funds are the source of financing business activity in the case of as many as 86% of respondents. At the same time, the availability of loans is one of the barriers to the development of entrepreneurship in rural areas, but this is not a key problem in the opinion of the respondents (Fig. 6).

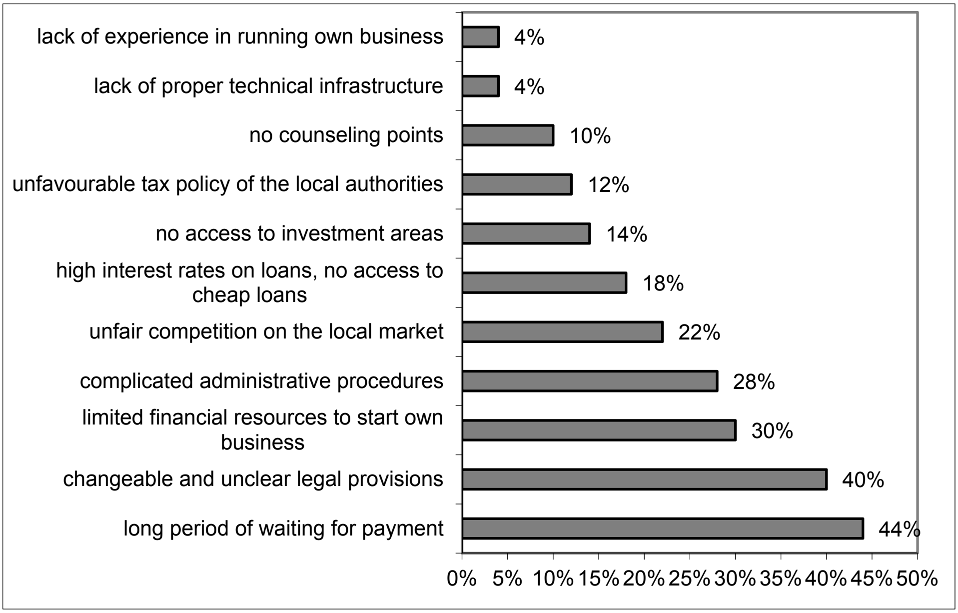

Fig. 6. Barriers to entrepreneurship development in rural areas in the opinion of business owners

Source: Pomianek, Niewęgłowska [2017, Fig. 3].

At the same time the financial gap in the Polish agriculture is estimated to be significant (Table 3). However, unwillingness of farmers to reach for credits results in much lower actual unrealized demand for loans. Also preferential credits already applied in Poland as part of the national agricultural policy are losing their popularity. Therefore, it has been proposed that within the Polish RDP 2014-2020 guarantees should be introduced [*Ocena ex ante*…, 2019].

Table 3. Estimated financial gap in the Polish agriculture (in EUR)

Specification	Lower boundary	Upper boundary
Short-term loans	187 587 219	411 804 167
Medium and long-term loans	601 810 861	1 321 135 956
Total	789 398 080	1 732 940 123

Source: FI-compass [2018b, Table 2.1].

As the studies often point out [i.e. Kata, Walenia, 2015], farmers require a more flexible approach from banks as the specificity of their activity is related to cyclicality, price volatility and other unexpected changes in market conditions. Therefore, farmers are in need in flexible financial instruments. Introduction of guarantees should give farmers more options for financing their investment and current activity. Yet, it should be also considered whether such an instrument should also be available to new rural entrepreneurs. With the lowering of the budget for the EU rural policy, financial instruments can become the only instruments that can support development of rural businesses.

Conclusions

Sustainable development of rural areas in Poland and in other EU members states requires funds for investment in new jobs and technologies enabling balancing the economic, social and environmental needs of rural areas and their inhabitants. Due to budgetary limitations the EU tries to make use of financial instruments as a way to support more beneficiaries using the same amount of funds.

Using FIs in rural development policy has a number of advantages. Yet, their application is not an easy process for all the stakeholders involved. Moreover, which can currently be considered the biggest challenge for their wider application, it is costly and time consuming to establish an institutional system required to the FIs implementation.

The experience gained so far shows, that the interest in making use of FIs as sources of investment capital, especially among farmers, is much lower than expected. It is related to risk aversion of farmers, who are not willing to take out credits if it is not absolutely necessary. Even the preferential terms of repayment are not a sufficient lure for them. Moreover, the market situation can change rapidly so in order to make the FIs more attractive to farmers clearly stipulated rule on such things as grace period in the case of drought or other natural events that lead to a decrease in production and incomes should be presented together with the offer.

In Poland, both farmers and rural entrepreneurs seldom apply for bank loans. This seems to be more related to risk aversion and limited knowledge of the offer of financial companies than with the lack of supply of different financial products. Yet, for growth of rural SMEs and farms external capital is needed. Application of public funds into FIs offering more flexible conditions for rural entities can support the development process as a wider availability of guarantees.

Currently, the most promising seems to be the combination of grants and FIs as this can be the way to familiarize the final beneficiaries not only with the way FIs work but also to get them accustomed to FIs within the EU support measures. The EC sees also new uses of FIs in rural development policy. In its proposal concerning the CAP 2021-2027 it stated that FIs can be applied also to tackle the increasing problem of generational renewal in the EU agriculture by helping young farmers and new entrants in getting access to financing. Moreover, it proposed wider use of a combination of grants and FIs to make the scale of offered support higher as well as to benefit from the advantages of these two forms of offering aid.

The FIs have the potential to support sustainable rural development in Poland and other EU member states by boosting access to funds. Yet, they cannot fully replace grants as a form of the EU rural development policy, because the need to repay the support received, even under more preferential terms than the market ones, is a significant barrier for the smallest and thus the weakest entities, especially in the remote regions struggling with depopulation and outflow of economic activity.

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INSTRUMENTY FINANSOWE − DROGA DO POPRAWY ZRÓWNOWAŻONEGO ROZWOJU OBSZARÓW WIEJSKICH UE? PRZYPADEK POLSKI

Streszczenie: Instrumenty finansowe są jednym z instrumentów polityki rozwoju obszarów wiejskich UE od 2000 r. Dotychczas nie zyskały one jednak dużej popularności. Istnieje również wiele barier w kwestii ich szerszego wdrażania w polityce rozwoju wsi. Artykuł opiera się na przeglądzie literatury na temat funkcjonowania instrumentów finansowych w unijnej polityce rozwoju. Jego celem jest ocena potencjału instrumentów finansowych we wspieraniu zrównoważonego rozwoju. Wyniki pokazują, że instrumenty finansowe mogą odgrywać istotną rolę w rozwoju obszarów wiejskich oraz przedstawiają zalecenia dotyczące poprawy ich atrakcyjności i skuteczności we wspieraniu wsi w UE.

Słowa kluczowe: instrumenty finansowe, obszary wiejskie UE, zrównoważony rozwój.