FINANCIAL CHALLENGES OF SMEs DURING COVID-19 CRISIS: THE CASE OF SPLIT-DALMATIA COUNTY

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Abstract:
The purpose of the paper is to find out how COVID-19 has affected the sector of SMEs, especially in terms of its access to finance. In doing so we hypothesize that problems arising from both supply side and demand side of the business, have additionally restrained SMEs' access to finance, thus putting their short-to-medium term position to a threat. Research methodology includes descriptive statistical analysis of the results of a company survey of Croatian enterprises with respect to their current access to finance and expectations for the future. The survey was carried out on a sample of 40 small and medium sized companies in Split-Dalmatia County.
The findings show that companies do not perceive many of the business risks as particularly threatening to their businesses. Still, this survey reveals a presence of a series of risks closely related to the current situation caused by COVID-19. These include increasing production costs resulting from rising costs of labor, capital, raw materials and other inputs (e.g. transport and logistics services), followed by increasing tax burden and stagnating productivity. Together with increasing costs, a fall in demand on both domestic and foreign markets, as well as a resulting decrease in sales, announce further problems that call for a strong policy response in the future.
The main contribution of the paper is the finding that besides the problem of access to finance, the COVID-19 crisis has revealed other serious obstacles for SMEs which threaten to endanger the market position and competiveness of small business in the long run. By far the most serious problems for Croatian SMEs are that of a structural nature which include increasing costs and decreasing productivity. This research has additionally accentuated some serious obstacles from external environment which threaten to restraint SMEs' capacity to restructure and keep their competitive edge.
Keywords Small and medium sized enterprises, business climate, finance, COVID-19, Croatia, EU.

INTRODUCTION

Although COVID-19 crisis is not caused by some fundamental economic problem[1], its consequences can easily stretch over a medium-to-long term. Problems on both supply and demand side incorporating both breakup of supply chains, and fall in consumer confidence, have seriously hit business sector. They threaten to impair business expansion and create additional cost on public sector. All the above, together with series of lockdowns and 'new normal' of social distancing have led to deterioration in market access, fall in sales, stagnating profitability and surge in illiquidity. These circumstances harshly hit the most fragile, yet crucial part of economy – small- and medium-sized enterprises (SMEs) – which even in good times face serious obstacles to their business (Yoshino and Taghizadeh-Hesary 2018, Abraham et al. 2019). Meanwhile, small

[1] System risk of the financial sector, price bubbles, structural or technological setbacks, institutional weaknesses, accumulated macroeconomic losses, etc.

business is complex and fragile, since it incorporates companies with large differences in employment (micro vs. medium-sized), knowledge intensity (craft vs. IT sector), and growth potential (small scale family business vs. high technology sector). It also includes companies with strongly pronounced social function (e.g. woman-, or minority-led businesses), or strongly articulated development function (e.g. SMEs in lagging behind regions), (OECD 2021a).

Small business is of huge importance for the EU, since it creates 53% of total value added and makes 65% of total employment with an overwhelming share in the number of enterprises (99.8%), (European Commission 2021a). Drastic changes in economic environment, which started in early 2020 have reflected in EU in the disruptions in supply chains, fall in sales, series of payment deferrals and temporary operating at loss in the majority of SMEs. Accordingly, value added of SMEs in EU has shrunk by 7.6% in 2020, followed by a modest reduction in employment and number of enterprises by 1.7% and 1.3%, respectively. The last was mostly due to government interventions primarily targeted at securing jobs and helping businesses to overcome problem of liquidity. Further, COVID-19 has proven to have an asymmetric effect on EU countries. This asymmetry arises from both the structure of small business sector regarding predominant size of enterprises[2], economic sector in which SMEs operate and differences in national policy measures targeted to help SMEs. Although EU invests lots of effort to improve the state of its small business sector and unleash its development potential, it still does not pursue single policy towards SMEs. It rather offers a general framework and guidelines for national policy measures of the member states. Hence the differences in the level of development and reactions to pandemic across EU members.

This crisis has additionally stressed the main problems of SMEs with access to finance being the most prominent one. Weak equity position, information asymmetry and understaffing on one hand, with traditional reluctance of banks and other financial institutions to finance small business sector (especially at their early stage of development) on the other hand, will most probably continue to mark business environment for SMEs in the post-pandemic years. Despite some success in achieving better access to finance for SMEs across EU member states (mostly through public funds and government guarantee schemes) SMEs still face a serious problem of payment deferrals as the most usual reason of their insolvency (Commission of the European Communities 2008). This problem becomes even more serious if one takes into account low cash liquidity which SMEs usually have[3].

Recently, however small business globally shows some signs of recovery with 30% of SMEs reporting increase in sales, as compared to year before. Yet, it is reasonable to assume that termination of government intervention will put these positive developments to a halt and require from SMEs a swift reaction in form of company restructuring, finding new market niches with novel products and services, and better liquidity management. Taking into account recent data on a slowdown in registration of new business entities

[2] According the European Commission (2021a) larger companies among SMEs were better prepared and hence more efficient in adjusting to the new market conditions by offering new goods and services, as opposed to micro enterprises who responded to a new situation by temporary caesura of business operations, instead of restructuring them.
[3] According to OECD (2020) half of SMEs in the USA operate with cash reserves sufficient for less than 15 days.

and start-ups in 2020 (European Commission 2021a), one can expect new challenges ahead of SMEs in the following years.

Problems which Croatian SMEs face in their everyday business are very similar to those of their counterparts in other countries. Numerous empirical studies on Croatian small business, not specifically related to the COVID-19 effects, confirmed that, among other factors, access to finance acts as the most serious and limiting factor for the SMEs' growth and development (Prohaska and Olgić 2005, Ploh 2017, Knežević and Has 2018, Kolaković et al. 2019, Botrić and Božić 2017, Učkar and Grgić 2016, Pulišelić, 2012).

Taking all the above into account we hypothesize that COVID-19 has additionally challenged position of SMEs and especially their access to finance. In doing so, our aim is to find out the actual limitations of the SMEs' access to traditional sources of finance and identify whether their attitude towards alternative sources of finance has changed (see: CEPOR 2020). Further aim is to detect entrepreneurs' expectations for the future, since the intensity of this crisis allows us to assume that at least some of the effects will have lasting impact on the business. In order to achieve these objectives a company survey was performed in May 2021 on a sample of 40 SMEs from Split-Dalmatia County.

The concept of the research is resembled in its structure. Following the introduction, the second part presents findings of the most resent empirical studies on the impact of COVID-19 on SME's access to finance. In the third part a regulatory framework of the EU on small business is presented, together with an overview of the impact of pandemic on SMEs across EU member countries. Results of the analysis of the data obtained through company survey are presented and discussed in the fourth part, while the final part concludes.

1. SMEs' ACCESS TO FINANCE AND COVID-19 CRISIS

Small and medium-sized enterprises are traditionally in focus of policy makers because of their economic vulnerability on one hand, but also their relevance in generating value added and employment. Economic turbulence caused by COVID-19 has additionally complicated the position of SMEs and opened up a broad discussion on their real problems and needs[4]. A systematic overview of the effects of pandemic on SMEs is given in Ma et al. (2021).

A more thorough theoretical and empirical analysis can be found in Gourinchas et al. (2022) who carried out an *ex ante* estimation of COVID-19 on SMEs. Based on a calibrated theoretical model and a sample of 11 EU member countries they estimated an increase in company failure rate by 6.15 b.p. and a further drop in employment by 3.15 b.p. Their sectoral analysis revealed that least hit by the pandemic were sectors with good adaptability to remote work (high value added services, intellectual services, etc.) and which undergone a modest demand shock. Meanwhile sectors which experienced moderate supply shock and had stabile sector-specific demand (e.g. construction,

[4] Bartik et al. (2020) showed on a sample of 5,800 US SMEs that during the first month of the pandemic app. 40% of SMEs have temporarily ceased to operate, while full time and part time employment dropped by 30% and 60%, respectively.

health and social services, etc.), fared better, than e.g. customer-oriented services with no possibility for remote work. It is important to note that the estimated failure rates were not only sector-specific, but also firm-specific, since authors found out that good financial health of a company prior to breakout of COVID-19 certainly has helped these companies to be less affected by slack in demand during lockdowns. Bloom et al. (2021) come to similar conclusions about strong asymmetric effects of pandemic on US SMEs by emphasizing that large companies with large online operations fared much better, than smaller companies who operated offline.

This aspect is closely related with the most crucial obstacle to upgrading or upscaling of SMEs, which is access to finance. Corrredera-Catalán et al. (2021) give a systematic overview of the reasons behind financial institutions' reluctance to grant loans to small businesses. In their view, SMEs usually have low level of capitalization, low capital diversification, and sales revenues and profit sensitive to market volatility. Due to their informal organization and management, SMEs are usually considered to lack clarity of their long- and short-term business objectives. This, followed by unclear asset ownership and difficulties to strictly follow the rules for producing financial statements makes it quite difficult for banks to reliably assess SMEs' creditworthiness. Lack of credit history is considered an additional obstacle in that respect. This all makes the SMEs' position with banks less favorable in terms of more rigid conditions of granting loans (higher interest rates, shorter period of repayment), the need for large credit collaterals, or additional bank guarantees. The authors provide an example of Spanish public guarantee schemes, which efficiently helped local SMEs to bridge the liquidity problem, thus protecting SMEs from debt accumulation[5].

An interesting insight into the topic of SMEs' access to finance from the bankers' perspective is offered in Erdogan (2018) who provides answers to structured interviews held with 25 bank managers. From their perspective financial status of the potential client is crucial. This requires having reliable financial and accounting data which realistically reflect SMEs financial status. When granting loans banks prefer profitable and low indebted companies with strong equity base (potential for collateral), regular and stabile revenues and sufficient cash holdings. High liquidity is considered very important as an indication of no need for short-term loans[6].

Further problem is seen in unprofessional management of SMEs and a lack of long-term strategies and short-term operational plans. Hence, banks sometimes came across unrealistic expectations from SMEs regarding their planned activities and investment. Therefore, banks put strong emphasis on data management and correct financial reporting of their clients from small business. Good track record of previous credits certainly increases their chances to be considered for a loan. Creditworthiness is usually estimated not only on the base of financial data, but also on the base of commercial reputation of the company, on-site visits and information obtained through business intelligence. Some authors go even further and suggest the need for collaboration among

[5] Counterfactual argument which prove non-effectiveness of public policy during COVID-19 due to targeting of cash grants to strong and healthy firms, instead of to weakest ones can be found in Gourindas et al. (2022).
[6] However, Bartik et al. (2020) found out that the majority (50%) of US SMEs have cash reserves sufficient to cover up to two months of their regular business, while 25% of them proved to have cash reserves sufficient to finance less than one month of their business operations. Similar conclusion can be found in McGeever et al. (2020).

relevant stakeholders in the process of financing small business – SMEs, financial service providers and regulators (private sector) – in order to enhance its access to financial funds in a sustainable manner (Song et al. 2020, Didier et al. 2021).

Similar approach to the problem of financing small business can be found in Kumar Roy (2021) which focuses on bank management and their procedures of granting loans. They also stress poor financial data records of SMEs and their semi-formal character of management, and strict bank procedures in the process of client evaluation. This creates a huge structural gap between SMEs and financial institution elimination of which should include actions on both sides[7].

Wong at al. (2018) take an insider look into SMEs in their search for the explanation of the SMEs' weak access to external financing. In doing so they use a 'five-tribe' model to realistically design business environment in which financial decision making process of small business owners can be traced. The results of this unique experiment show that business owners' personal goals (e.g. life events, personal interests, role of family, lifestyle), attitudes (e.g. risk aversion) and perception of external business environment significantly impact their financial decisions. In other words, their pronounced risk aversion, as well as desire for stability of business and predictability of future events determine to a large extent their low demand for commercial loans and other sources of external financing. They are more prone to conservative financial management and stronger reliance on cash flow, liquidity monitoring and adopting effective cost control mechanisms. Finally, authors conclude that not all entrepreneurs strive equally strong to the growth of their businesses and investment. This is reflected on their business cycles which might differ from that of other companies and might not have a continuous transition to a higher stage of business (development).

A fully novel approach to identifying weaknesses in SMEs' financing, which offers a viable solution to it, can be found in Yang et al. (2021). This paper stands fully in line with other concepts which try to find solution to the problem of financing among all stakeholders of this specific business process and not only SMEs.

By taking into account huge importance of global supply chains, but also enormous possibilities of data collection and procession this paper proposes a supply chain finance for SMEs. The core idea of this new model is to enable financial institutions to gather all business data from one company, also including its relations with other down- and upstream business partners. Such an approach makes it possible to keep focus on business sustainability of an SME, while at the same time taking into account sustainability of business operations within a broader supply chain, which includes other SMEs as well. The process of granting loans to SMEs becomes not only easier and better targeted to the needs of small business sector, but also less risky and more cost-effective for the loan granting company (financial institution). As a result, optimum financing can be achieved with minimum marginal cost, while taking into account interests of both SMEs and financial institution.

[7] Innovation in financial instruments and digital technologies open up opportunities for financing business activities through channels other than traditional banking, or debt and equity finance (see: Harrison and Baldock 2015).

2. EU POLICY FRAMEWORK FOR SMEs

The founding document which set up a pathway to the EU policy framework for SME was European Charter for Small Enterprises (European Council 2000). Small Business Act (SBA) which followed in 2008, was designed as a policy framework to support gaining full potential of EU SMEs (Commission of the European Communities 2008). It introduced ten principles aimed at improving administrative environment one of which is facilitation of SMEs' access to finance and timely payments in commercial transactions. The main idea was to enable easier access to various novel sources of finance such as: risk capital, micro-credit and mezzanine finance, while improving entrepreneurs' understanding of different forms of financing and bringing their business skills to the level of financial institutions' standardized procedures (e.g. business and investment plans, etc.).

The most recent European policy document on SMEs – strategy for a sustainable and digital Europe – aims at making an easy transition of European SMEs to sustainable and digital business which should help them to eliminate quite a number of the existing obstacles (European Commission 2020a). This strategy is based on three pillars:

1. capacity building and support for the transition to sustainability and digitalization;
2. cutback of regulatory burden and improvement in access to markets and
3. improvement in access to finance.

Regarding the last pillar, European Commission makes efforts to facilitate diversification of financial sources for SMEs (other than traditional bank loans), through promotion of venture capital[8], improved access to state aid, gender-smart financing, promotion of women entrepreneurship, etc. This pillar also includes taking advantage of 'blockchain'-technology, which should streamline small business' intentions to having more abundant and easily accessible sources of finance. This approach introduces direct contact between SMEs and investors, while enabling SMEs to use easily tradable forms of finance (e.g. crypto assets and digital tokens) in the form of bonds. This will make a process of financing small business ventures much easier and cost-effective.

COVID-19 has severely hit small businesses all across Europe. As a consequence, value added of small business sunk deeply (Table 1). Despite temporary closedowns of many SMEs, employment figures were least affected by the crisis mostly due to a combination of monetary easing and public sector interventions (e.g. employment subsidies, postponed payment of taxes, social security contributions, etc.) in combination with strong financial boost form the EU level (OECD 2021b). Despite that countries report negative figures what best describes the intensity of shock that SMEs have gone through.

[8] It has been estimated that only 10% of businesses in Europe is financed through market finance models, as compared to 25% in the US (European Commission 2021a).

Table 1: **Business Indicators for SMEs in EU27 (change in %), 2019-2020**

country	number of enterprises	number of persons employed	value added	value added per person employed
	%	%	%	EUR in 2020
European Union	-1.3	-1.7	-7.6	40,000
Austria	-2.1	-2.3	-7.3	58,000
Belgium	0.6	0.2	-9.5	75,100
Bulgaria	-4.0	-4.4	-6.2	13,800
Cyprus	0.1	-0.7	-9.5	30,200
Czech Republic	-1.4	-1.4	-4.9	-
Denmark	-0.5	-1.2	-4.0	-
Estonia	-2.7	-3.4	-4.0	32,200
Finland	-0.3	-1.1	-2.3	64,600
France	-1.2	-1.7	-13.0	-
Germany	-0.8	-1.3	-3.9	47,900
Greece	0.6	-1.4	-19.7	11,400
Croatia	-0.5	-0.4	-7.6	20,600
Hungary	-0.7	-0.7	-10.5	40,000
Ireland	-1.0	-2.3	-11.5	-
Italy	-2.4	2.6	-11.5	38,300
Latvia	-2.1	-2.5	-4.0	-
Lithuania	-2.3	-1.6	-0.6	20,700
Luxemburg	2.4	1.6	-0.8	92,400
Malta	6.4	5.5	-15.0	-
Netherlands	0.6	-0.1	-1.3	63,400
Poland	1.1	0.2	0.0	20,700
Portugal	-3.4	-3.9	-10.1	23,300
Romania	2.0	1.1	-0.5	16,500
Slovakia	-1.5	-1.7	-1.8	19,300
Slovenia	-1.1	-0.6	-6.2	-
Spain	-4.1	-4.6	-16.6	31,100
Sweden	-0.3	-1.9	-1.4	-

Source: European Commission 2021b

European Union responded quickly to COVID-19 (European Commission 2020b) by the following actions:

- EUR 37 bn from the cohesion policy was directed to helping SMEs;
- EUR 1 bn from the EU budget was allocated as a guarantee to the European Investment Fund for financing working capital and
- exemptions from state aid rules have been defined:
  a) EUR 1.8 mn of aid in form of grants, tax and payment advantages, guarantees, loans and equity and

b) additional provisions (guarantees on loans, subsidized interest rates on loans, company recapitalization schemes through equity of hybrid instruments).

Additionally, EU has created a general recovery package[9] to improve economic and social consequences of COVID-19. This package included:

1. EUR 1.3 trillion planned within the Multiannual Financial Framework 2021-2027 out of which EUR 6.7 bn for support of European small business and
2. EUR 0.8 trillion from "NextGenerationEU" (Recovery and Resilience Plan from COVID-19) – reform package to accompany recovery measures[10].

Preference is given to SMEs based on 'green technologies', innovative start-ups, and SMEs with high capacity to innovate and stimulate private investment into R&D. In sectoral terms, special focus will be on tourism with the aim of raising productivity and international competitiveness by means of transition to green and digital technologies. A detailed breakdown of allocation for Croatia can be followed in Table 2.

Table 2: **Financial Allocations for Croatian Small Business from "NextGenerationEU", 2022**

category	amount (EUR mn)
facilitation of access to finance for SMEs	146.0
grants for start-up funding	18.8
consultancy and training for start-ups investment skills	7.9
business consultancy for the improvement of management skills in SMEs	3.9
commercialization of SMEs' innovations	50.4
green transition for SMEs in tourism	82.9
TOTAL	**309.9**

Source: European Commission 2022

[9] Numerous studies confirm that privately owned institution usually fail to make an efficient access to sources of funding for SMEs (e.g. Jones-Evans 2015, Belghitar et al. 2021).
[10] Allocation of EUR 580-962 mn is planned for Croatia to address structural weaknesses and administrative burden as well as weak access to finance for SMEs. This will be realized through sector-specific grants (e.g. tourism), concessional loans and equity instruments with emphasis on green technologies ('green transition'), (European Commission 2022).

Measures undertaken by Croatian government complemented that of the EU. The common denominator of all the reform activities in Croatia was reform of regulatory framework which includes: reform of tax system, elimination of administrative and parafiscal charges, deregulation of services sector and elimination of the widespread practice of undeclared work. In comparison to other EU member countries it can be said that Croatia did very well throughout the crisis during 2019-2020 with just a modest reduction in the number of enterprises and employment (Table 1). This was mainly a result of the government action plan during the crisis, but also of reforms, which have commenced before the crisis. Access of Croatian SMEs to finance and venture capital[11] has improved although it is a hurdle to further SMEs development.[12]

3. ANALYSIS OF THE SMEs ACCESS TO FINANCE – CASE OF SPLIT-DALMATIA COUNTY

Forthcoming analysis presents results of a company survey carried out in May 2021 in Split-Dalmatia County. A web-link to online questionnaire was initially sent to 100 SMEs randomly selected from a company database of Split-Dalmatia County, by criterion of employment (less than 250), (European Commission 2003). In two weeks 40 SMEs sent back their responses what makes a response rate of 40%. A questionnaire is structured in three chapters. The first chapter includes company information and description of their business. The second chapter focuses on the impact of COVID-19 on business, with emphasis on access to finance, while the third chapter targets SMEs' business expectations for the future (Annex 1).

The aim of the survey was to gain a thorough insight into the effects of COVID-19 on SMEs in the region of Split-Dalmatia County and to gather entrepreneurs' own assessments on the current situation and the expected developments for the future. This region is the largest and one of the most populated counties in Croatia. However, it lags behind the leading Croatian counties according to some key economic indicators. It achieves about 80% of Croatian average GDP/*capita* (2018), but it does better when it comes to international trade with a share of 4.5% in national trade volume in goods and a 20% share in total tourist overnights in Croatia (2019). Strong reliance of local economy on tourism is resembled in the structure of the survey sample, which includes almost half of SMEs in accommodation and food services, while the remaining part encompasses SMEs from manufacturing (Table 3).

[11] European Investment Fund, Croatian Bank for Reconstruction and Development (HBOR) and Croatian government have set up a joint project to establish a new venture capital fund – *"Pokretanje novog fonda rizičnog kapitala"* – aimed at supporting both innovative start-ups and companies already established on the market through equity investment.

[12] The main improvements occurred through loan programs for working capital, private investment and investments in rural development by Croatian Bank for Reconstruction and Development (HBOR 2022).

Table 3: **SMEs According to Economic Activity (NACE Rev. 2), 2021**

NACE Section / Division	Share (%)
I Accommodation and food services activities	47.5
16 Manufacture of wood and wood products	15.0
31 Manufacture of furniture	15.0
33 Repair and installation of machinery and equipment	5.0
26 Manufacture of computer, electronic and optical products	2.5
27 Manufacture of electrical equipment	2.5
32 Other manufacturing	12.5
TOTAL	**100.0**

Source: European Commission, Eurostat 2008
Questionnaire, authors 2022

The structure of the survey sample according to the size of enterprises is well balanced and includes 26 micro enterprises, 7 small and 7 medium-sized enterprises, what makes 65% of micro enterprises (up to 10 employees) and 45% of small and medium-sized enterprises (10-249 employees). Further, 40% of enterprises in the sample is established in the period 1990-2010, while the remaining 60% was founded during the last decade (2011-2021), what makes a balance among enterprises in terms of the length of their presence on the market. Half of the surveyed enterprises operates only on domestic market. Among those engaged in international trade the greatest part (30%) achieves one third of their income on foreign markets (Table 4).

Table 4: **SMEs According to the Share of Exports in their Income, 2021**

Share of exports in total income	Share (%)
0%	50.0
1-25%	12.5
26-50%	7.5
51-100%	30.0
TOTAL	**100.0**

Source: Questionnaire, authors 2022

Finally, the greatest part of surveyed SMEs is owned by natural persons (55%), followed by companies owned by one or more natural or legal persons (20%), craft (17.5%) and companies owned solely by legal persons (7.5%). Questions in the questionnaire were answered mostly by owner–manager (50%), followed by responses given by financial and/or accounting manager (35%), and general manager (15%).

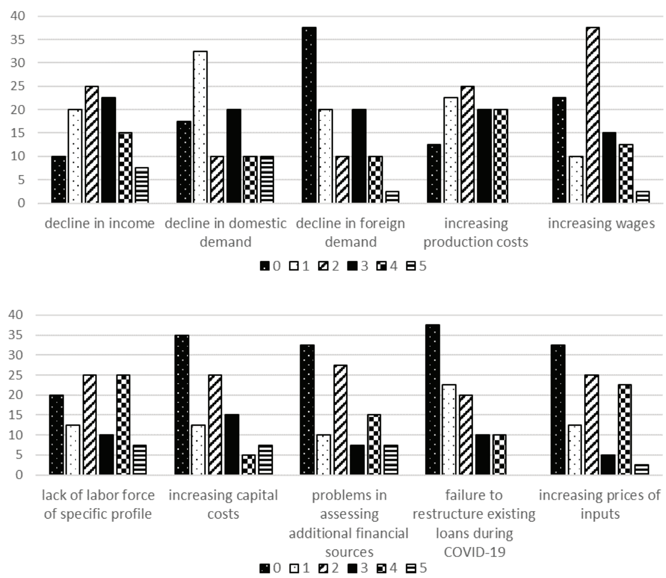
Regarding the problems which enterprises have encountered in the first year (Figure 1) of pandemic (May 2020–May 2021) the questionnaire is centered around following topics: production costs, income and profitability, and access to production factors (finance and labor force).

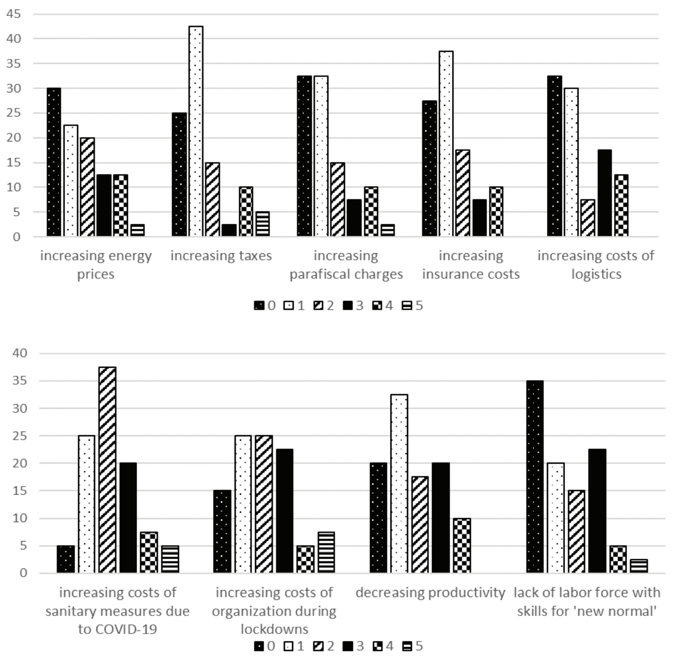
Decline in income is for some of the surveyed enterprises (25%) seen as a relatively small problem usually present in regular business; similar response is also given for increasing production costs. However, when we consider together responses rated by 3, 4 and 5 (referring to big, very big and extremely big problems, respectively), we find out that as much as 45% of enterprises in the sample consider decline in income a serious problem. This finding is fully in line with other empirical studies dealing with initial effects of COVID-19 on SMEs (e.g. Bartik et al. 2020, McGeever et al. 2020 , Ma et al. 2021). Similarly, significant portion of enterprises (65%) consider that increase in production costs is problematic, while only 30% of them take increase in wages as too high and a danger to regular business.

As far as cost of inputs are concerned almost one quarter of SMEs assess increase in input prices as a very big problem which potentially puts business at risk if present over a longer period. Meanwhile, energy prices did not pose a serious threat to small business of Split-Dalmatia County in the period under observation (2021), because 72.5% of the respondents did not find energy prices to pose an obstacle for normal business; 30% of them appraised these problems as not problematic at all, while 22.5% and 20% consider them a very small and small problem, respectively.

During the first shock of pandemic the surveyed enterprises have gone through a modest decline in foreign demand, as compared to a slightly stronger rated fall in demand on domestic market (Figure 1). This can be explained by 'structural asymmetries' of the surveyed sample and a large proportion of companies in tourism and hospitality industry which, in this case, rely more on foreign markets. This finding aligns with that of Gourinchas et al. (2022) who analyzed sector-specific responses to the pandemic shock.

Figure 1: **Problems of SMEs during the Period May 2020-May 2021**





Legend: 0 – no problem, 1 – negligible problem, 2 – small problem, 3 – large problem, 4 – very large problem, 5 – extremely large problem
Source: Questionnaire, authors 2022¶

Tax burden has been evaluated mostly as not problematic, since 25% of all respondents considered that taxes do not disturb regular business, while 42.5% consider them a very small problem with no significant impact on regular business (Figure 1). Parafiscal charges, usually seen as the least business-friendly aspect of doing business in Croatia, and especially so for SMEs, are recognized either as no problem for business by one third of the enterprises, or just a small problem with no serious impact by another one third of enterprises. This is confirmed by the findings of European Commission (2022) which identified positive efforts of Croatian government in easing tax burden, however with still high parafiscal charges that continue to burden small business.

Although no enterprise in the sample evaluated increasing insurance costs and costs of logistics as an extremely big threat to business, 30% of SMEs consider rising costs of logistics as big and very big problem, which threatens to put business at risk.

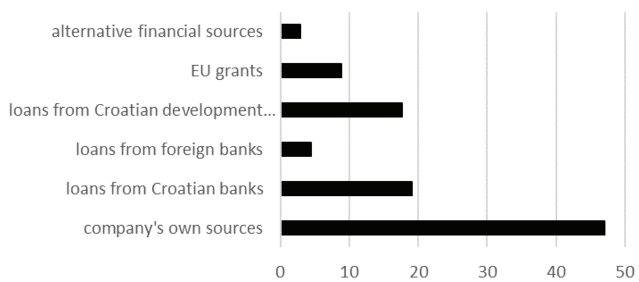
Anyhow, doing business and organization of (on site) work during pandemic and repeated lockdowns have reflected in increasing business costs. Some 30% of enterprises assess costs of sanitary measures against COVID-19 a big-to-extremely big problem on one hand, while on the other hand 40% of respondents do not consider these additional costs as particularly threatening for business. Appraisal of the cost of organization of work during lockdowns is similar and considered as no significant hurdle for regular business. The problem with the 'missing' labor force which possesses skills for online work is obviously present, but on a lower scale, since 35% of SMEs sees no problem in it, while almost one quarter (22.5%) believes it is a very big problem which demands special measures for its elimination. In similar vein, Ma et al. (2021) identified staff problems as crucial for doing business in the coming years, along with the constraining effects of the rising business costs.

Finally, the quality of the access to traditional financial sources has been relatively positively rated by local SMEs. In that respect about 30% of the respondents consider both increasing capital costs and access to finance as not disturbing for business, while almost 40% of them did not come across any significant problems in an attempt to restructure their loans during first year of pandemic. This probably resembles a positive effect of government intervention measures which helped Croatian SMEs to easily go through an initial shock caused by COVID-19.

However, 30% of respondents consider capital costs a threat for their business (rated as big, very big, or extremely big problem), followed by the same share of responses which report problems when trying to access additional financial sources during the first year of pandemic. Findings by Corredera-Catalán et al. (2021) and Erdogan (2018) are in line with present conclusions as they discuss specific characteristic of SMEs' which reflect their weak prospects for obtaining bank loans.

From Figure 2 one can see that in almost 50% of cases SMEs of Split-Dalmatia County rely on their own sources in financing their business activities, while in app. 20% of cases they use commercial loans (mostly from Croatian banks), followed by 17.6% of cases in which SMEs rely on loans granted by Croatian development banks (HBOR) and agencies. EU grants make just a little less than 10%, while use of alternative financial sources (venture capital, business angels, etc.) achieves only a negligible share of 2.9%. Obviously, Croatian companies in this survey prove to be more conservative and prone to traditional forms of finance, thus possibly resembling the interplay of the entrepreneurs' personal attitudes, on one hand, and their business goals and priorities on the other, as explained also in Wong et al. (2018).

Figure 2: **Structure of Financial Sources of SMEs (%), 2021**

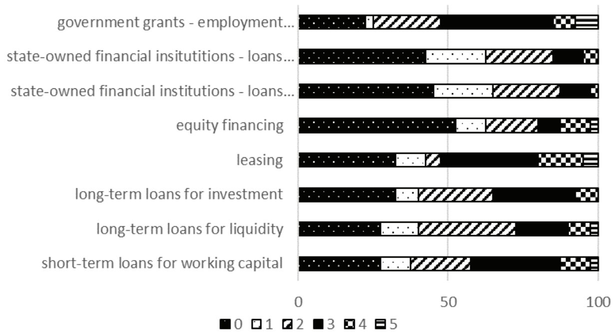


Source: Questionnaire, authors 2022

Predominant reliance on company's own sources and absence of interest in using innovative forms of business financing of SMEs in Split-Dalmatia County is further corroborated by responses to the question about companies' readiness to use innovative instruments of business financing. Accordingly, as much as 68% of respondent said that there are no forms of financing, which they had not used so far, meaning they have no interest in stepping out of traditional models of (bank) financing. Only one third of the surveyed enterprises expressed their desire to use novel forms of financing with which they have no previous experience. The main reason for latter group of enterprises are: complicated administrative procedure and high cost (47.7%), difficulties in accessing specific sources of finance (27.3%), scant knowledge about these specific types of finance (15.9%) and poor information (9.7%).

These results are additionally confirmed by the data in Figure 3 which refer to current accessibility to various external sources of finance and reveal a relative conservative approach of local small business sector to financing.

Figure 3: **Assessment of Current Availability of Various External Sources of Finance, 2021**

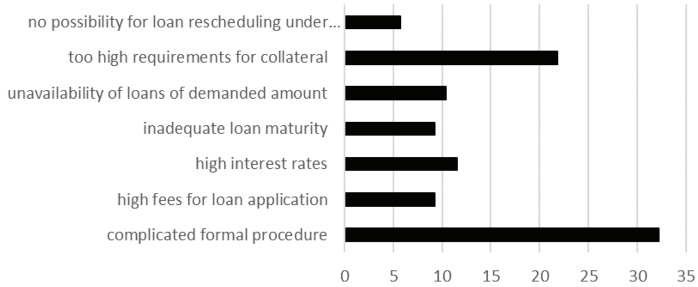


Legend: 0 – no information, 1 – very bad, 2 – bad, 3 – good, 4 – very good, 5 – excellent
Source: Questionnaire, authors 2022

Local entrepreneurs from Split-Dalmatia County in general gave a fairly good assessment on the availability of various forms of external financing. The most often response was 'no problem' with notably high share with equity financing (app. 50%). Taking into account information asymmetry typical for SMEs, this probably reveals the lack of interest for this specific form of financing by local entrepreneurs, rather than good information and knowledge about this specific form of financing (see: Wong et al. 2018). Presence of small and large problems regarding access to external finance can be identified with loans for liquidity, working capital and investment, as well as with short-term loans.

When it comes to reasons for the lack of adequate external sources of finance more than half of all responses emphasize the problem of complicated formal procedure (32.2%) and too high requirements for collateral (21.8%) which is fully in line with previous empirical literature (e.g. Didier et al., 2021). Further problems for local SMEs are high interest rates and unavailability of loans of the demanded amount. An important problem identified by the survey are high fees for loan application and loan maturity, which does not always correspond with the needs of SMEs and their individual business cycles. (Figure 4).

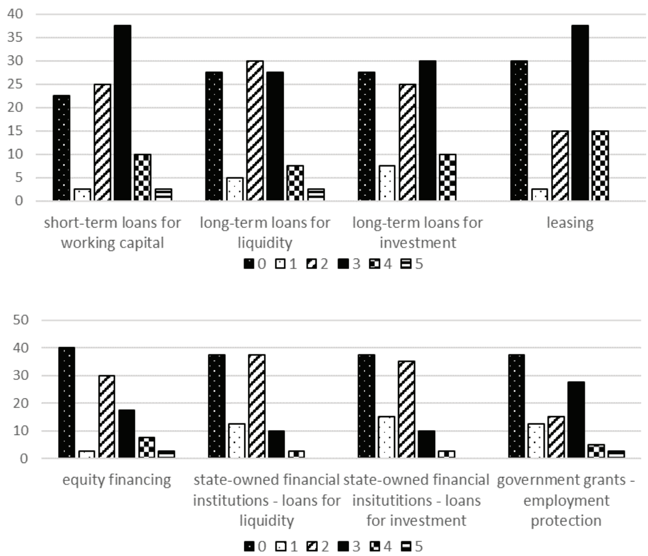
Figure 4: **The Reasons for Lack of Adequate External Finance, 2021**



Source: Questionnaire, authors 2022

Regarding expectations on the availability of finance in the future, it can be seen from Figure 5 that the number of entrepreneurs with no insight into that approached 40%. This is clearly seen with equity financing, but also with models of financing liquidity and investment form state-owned financial institutions. The second most often response of these forms of financing is 'bad' which means that entrepreneurs of small business sector generally consider access to finance as a significant obstacle for their business. Expectations of the availability of short-term loans for working capital, as well as long-term loans for investment and liquidity are good, whereas entrepreneurs rate accessibility of leasing as the best.

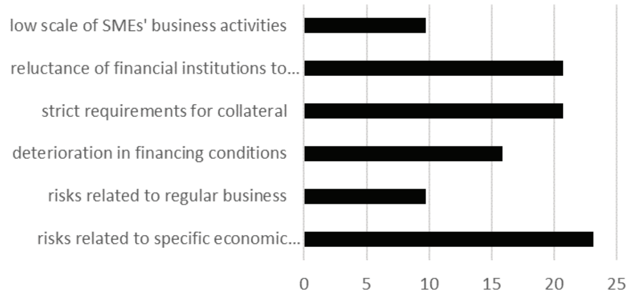
Figure 5: **Expectations on the Availability of Finance in the Future, 2021**



Legend: 0 – no information, 1 – very bad, 2 – bad, 3 – good, 4 – very good, 5 – excellent
Source: Questionnaire, authors 2022¶

When trying to assess risk related to poor access to finance in the future the majority of enterprises in the sample put sector-specific risks at the first place (Figure 6), which is fully in line with Gourinchas et al. (2022). This finding stands in line with the structure of our data sample and predominant reliance of local economy on tourism which is very sensitive to external shocks (e.g. pandemic, war, etc.). Highly ranked among expected risks in the future is reluctance of banks to lend money to SMEs, followed by too high requirements for collateral, which SMEs usually cannot meet. Entrepreneurs' expectations on the deterioration of the conditions (requirements) for bank lending and increase in general business risk add further to generally bleak prospects for the near future (Figure 6).

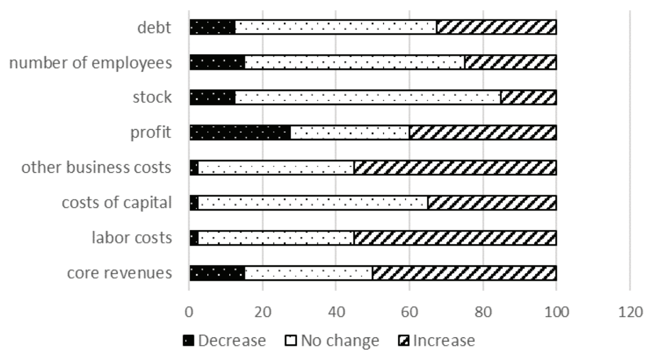
Figure 6: **The Reasons of the Expected Weak Access to Finance in the Future, 2021**



Source: Questionnaire, authors 2021

These findings are corroborated by the entrepreneurs' estimations and their general expectations on the business conditions in 2022 (Figure 7).

Figure 7: **Business Expectations for 2022**



Source: Questionnaire, authors 2022

Generally, local entrepreneurs of SMEs in Split-Dalmatia County expect *status quo* in their business in 2022. The comparison of the number of answers with positive expectations ('increase') with those expressing negative expectations ('decrease') shows that the majority of surveyed SMEs expects a further increase in labor costs and other business costs. This finding stands fully in line with previous results on increasing costs of production factors. Meanwhile, half of SMEs expects an increase in core revenues. Overall, in all other business indicators local entrepreneurs do not expect significant change, either positive or negative.

CONCLUSION

Empirical literature proves that COVID-19 has caused strong asymmetric shocks across SMEs, determined by type of their economic activity, the size of the enterprise, the ability to adapt to new conditions and finally the quality of business before outbreak of the crisis. These circumstance came as just another problem to that of poor access to finance as a determining factor of their growth and development. On the EU level the existing regulatory framework on small business proved to be a good basis for a solid coordinated policy response to problems caused by the pandemic. However, financial boost from the EU and national governments were intended to help SMEs with the acute problem of liquidity, and ease the pressure on jobs and employment. In that way, these measures helped a huge number of SMEs to keep afloat, yet without tackling the main problem of their access to finance.

This is explicitly confirmed by the results of a company survey carried out in May 2021 on a sample of 40 SMEs from Split-Dalmatia County. The most striking finding of the survey is a strong contrast between entrepreneurs' fairly good assessment on their current business and negative evaluation of both the access to finance and expectations for the future. For the first year of pandemic Croatian SMEs reported a serious decline in income, followed by an increase in production costs and especially costs of inputs. Other costs like energy prices, cost of transport and logistics, and taxes did not affected small business much in 2020-2021. Anyhow, poor access to labor force with specific skills and IT-knowledge proved to be a serious obstacle for their business, and taking into account the structural character of this problem it is reasonable to assume it will be present in the future too. Regarding the structure of the local economy which strongly relies on tourism it is reasonable to assume that business figures, and hence SMEs' assessments, would have been much worse without influx of foreign tourists.

Meanwhile, assessment on the access to finance is quite good what can be explained from several aspects. First, pandemic has put all long-term business plans and investment decisions to a halt, thus temporarily creating a lower demand for external financing. Second, during that period SMEs have received significant amounts of capital for liquidity and keeping employment safe from the government, while financial institutions themselves reacted promptly and made possible reprogramming of loans. However, conditions for obtaining a loan, in particular interest rates, are rated as a very big burden for small business.

As for the structure of financial sources SMEs from Split-Dalmatia County still heavily rely on their own company sources and different forms of traditional bank loans, while much less on EU grants and alternative sourced of finance. This conservative approach to financing business activities is additionally confirmed by the great majority of the surveyed enterprises who expressed no interest in using alternative sources of finance. Taking into account specific nature of these novel models of finance (direct contact between investor and investing company, clear statements on long- and short-term business objectives, etc.) and usually informal character of management in SMEs, this finding comes as no surprise. The same applies to EU funds as a source of finance who demand clearly stated business objectives of the investing company and following of strict formal procedures in the process of granting a loan.

Local SMEs, who mostly rely of well-known traditional forms of finance, find external sources of finance easily accessible, but are seriously dissatisfied with the conditions for obtaining a loan. The main remark goes to a complicated formal procedure and high demands for loan collateral which SMEs, due to their low equity, low capitalization and low diversification of capital, usually cannot meet. Other objections refer to the amount of loan, interest rate and loan maturity which usually do not follow business cycle of the SMEs and hence cannot serve a proper means of business expansion and development.

The main problem arises from the fact that a significant number of SMEs in the sample have no expectations on availability of finance sources in the future, what indirectly points at their poor information. Having said that, this means that not only financial sector bears a responsibility for improved access of SMEs to finance, but also small business sector needs to show more initiative in trying to bridge this gap. Local SMEs have rated lower their expectations about availability of funding from state-owned financial institutions (e.g. development banks) and government grants. As the main reasons for that they stated the expect increase in sector-specific risks, strict procedure of financial institutions (collateral and reluctance of banks to do business with SMEs) and expected deterioration of conditions on financial markets. As for general business conditions, SMEs from Split-Dalmatia County expect further increase in the costs of production factor, but otherwise do not expect significant changes in their business in comparison to the first year of pandemic.

To conclude, SMEs still face too strict conditions of obtaining a loan, a problem that will be even more pronounced in the following years because of deterioration in general business conditions and poor business indicators of SMEs realized during first years of pandemic. Meanwhile, SMEs from the region heavily rely on traditional sources of financing and less on alternative financing models. The reasons for that are both scant knowledge about possibilities offered through these new sources of finance and poor information about possibilities in this field. Low expectations about future prospects for external financing and strong reliance on state-owned financial institutions require a change in policy approach towards SMEs. It should aim at helping SMEs to meet strict demand and formal procedures required not only by commercial banks, but also by other investors ready to lend their money to promising ventures.

To the best of authors' knowledge this is the first study to address early effects of COVID-19 on Croatian business sector and SMEs in particular. Besides pointing at already existing problems (e.g. access to finance) it reveals some 'structural' challenges of SMEs which represent the main scientific contribution of the paper. These challenges, that will mark the future of small business sector, include lack of skilled labour force, low capabilities for technological and organizational restructuring and low capacities to cope with rising costs of inputs, and especially energy prices. The main limitation of this research is its focus on a relatively small region. Therefore, extension of the survey sample in terms of both territorial coverage and the number of enterprises would make it possible to analyze more thoroughly asymmetric effects of COVID-19 across different sectors and company size. This opens up avenues for further research.

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ANNEX: Questionnaire for SMEs (Split-Dalmatia County, May 2021)¶

COMPANY INFORMATION

1. Position of the responding person in the company:
- owner – manager
- general manager
- finance and/or accounting manager.

2. Legal form of business:
- company owned by natural person
- company owned by one or more natural or legal persons
- company owned by legal person.
- craft

3. Year of the establishment: __________.

4. Predominant type of economic activity (NACE Rev. 2):
- C Manufacturing
  10 Manufacture of food products
  11 Manufacture of beverages
  12 Manufacture of tobacco products
  13 Manufacture of textiles
  14 Manufacture of wearing apparel
  15 Manufacture of leather and related products
  16 Manufacture of wood and of products of wood and cord, except furniture; manufacture of articles of straw and plaiting materials
  17 Manufacture of paper and paper products
  18 Printing and reproduction of recorded media
  19 Manufacture of coke and refined petroleum products
  20 Manufacture of chemicals and chemical products
  21 Manufacture of basic pharmaceutical products and pharmaceutical preparations
  22 Manufacture of rubber and plastic products
  23 Manufacture of other non-metallic mineral products
  24 Manufacture of basic metals
  25 Manufacture of fabricated metal products, except machinery and equipment
  26 Manufacture of computer, electronic and optical products
  27 Manufacture of electrical equipment
  28 Manufacture of machinery and equipment n.e.c.
  29 Manufacture of motor vehicles, trailers and semi-trailers
  30 Manufacture of other transport equipment
  31 Manufacture of furniture
  32 Other manufacturing
  33 Repair and installation of machinery and equipment
- I Accommodation and food services activities.

5. Number of employees (end of year): ___________.

6. Share of income from exports (end of year):
- 0%
- 1-25%
- 26-50%
- 51-100%.

INFORMATION ON BUSINESSES DURING COVID-19 PANDEMIC

7.What kind of problems did you come across in the last 12 months? Give your own assessment according to the following scale:

0 – no problems
1 – negligible problems without significant impact on business
2 – small problems usual in regular business
3 – large problems which demanded special measures for their abolishment
4 – very large problems which put business at risk if arising over a longer period
5 – extremely large problems which put business at risk immediately upon occurrence

	0	1	2	3	4	5
Decline in income						
Decline in demand on home market						
Decline in demand on international market						
Increasing production costs						
Increasing wages						
Lack of labor force of the desired profile						
Increasing capital costs (loan repayments, etc.)						
Problems in accessing additional financial sources						
Failure to restructure existing loan during COVID-19						
Increasing prices of inputs (raw materials, intermediate goods, etc.)						
Increasing energy prices						
Increasing taxes						
Increasing parafiscal charges						
Increasing insurance costs						
Increasing costs of logistics (transport and shipment)						
Increasing costs of sanitary measures due to COVID-19						
Increasing costs of organization during lockdowns						
Decreasing productivity						
Lack of labor force with competences for work under 'new normal' (virtual environment, remote work, etc.)						

INFORMATION ON THE ACCESS TO FINANCE AND EXPECTATION FOR THE FUTURE

8. Which financial sources do you mostly use? *(multiple answers allowed)*

- own sources
- loans from Croatian banks
- loans from foreign banks
- loans from development banks and other agencies in Croatia (HBOR, HAMAG-BICRO)
- EU grants (EU funding).
- alternative financial sources (venture capital, business angels, etc.).

9. Are there some sources of finance which you do not use at the moment but would like to do so in the future?

- yes (which ones): ____
- no.

10. If your answer to the previous question is yes, then explain the reasons for not using these financial sources? *(multiple answers allowed)*

- scant knowledge about specific types of finance
- poor information
- difficulties in accessing specific sources of finance
- complicated administrative procedure and high cost.

11. Please assess current availability of external sources of finance according to the following scale:

0 – no information
1 – very bad
2 – bad
3 – good
4 – very good

5 – excellent.

	0	1	2	3	4	5
Short-term commercial loans for working capital						
Long-term commercial loans for liquidity						
Long-term commercial loans for investment						
Leasing						
Equity financing (venture capital funds, business angels, etc.)						
State-owned financial institution grants for liquidity						
State-owned financial institution grants for investment						
Government grants for employment protection during COVID-19						

12. What are the reasons, in your own opinion, for current lack of external sources of finance? *(multiple answers allowed)*

- complicated formal procedure (‘paperwork’)
- high fees for loan application
- high interest rates
- inadequate loan maturity (short period of repayment, no grace period, etc.)
- unavailability of loans of demanded amount
- too high requirements for collateral
- no possibility for loan rescheduling under crisis.

13. Please provide your expectations on the accessibility of finance in the future according to the following scale:

0 – no information
1 – very bad
2 – bad
3 – good
4 – very good
5 – excellent.

	0	1	2	3	4	5
Short-term commercial loans for working capital						
Long-term commercial loans for liquidity						
Long-term commercial loans for investment						
Leasing						
Equity financing (venture capital funds, business angels, etc.)						
State-owned financial institution grants for liquidity						
State-owned financial institution grants for investment						
Government grants for employment protection during COVID-19						

14. What are the reasons of the expected problems regarding access to finance in the future? *(multiple answers allowed)*

- risks related to specific economic activity (e.g. services sector)
- risks related to regular business (e.g. narrow market niche)
- deterioration in financing conditions (high interest rates, short loan maturity, etc.)
- strict requirements for the collateral
- reluctance of financial institutions to lend money to SMEs
- low scale of SMEs’ business activities (measured by the income per employee).

15. Please provide your expectations for the business year 2022 according the following criteria:

	Decrease	No change	Increase
Core revenues			
Labor costs			
Costs of capital (e.g. interest rates)			
Other business costs			
Profit			
Stock			
Number of employees			
Debt			

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