By Simon Lewis

There is more than one reason why Europe’s economic recovery from the financial crisis has lagged so far behind the US. But at the heart of the European malaise is a shortage of equity capital for small and medium-sized enterprises (SMEs).

This was acknowledged in a Green Paper on Capital Markets Union from the European Commission and is the central conclusion of an in-depth study, Bridging the Growth Gap, we have produced with The Boston Consulting Group (BCG), comparing Europe’s capital markets with the similar-sized US economy. This deficiency in Europe is a major obstacle to growth, holding back entrepreneurialism and innovation.

Small businesses play a vital part in Europe’s economy. They employ 88m people across the 28 European Union member states, or more than 65% of the workforce. Yet compared to the US, there are relatively few small companies that make it through to become big businesses. Without greater access to risk capital this is unlikely to change, as only equity funding is suited to the risks of backing fast-growing, young businesses and supporting them to the next level.

Europe’s over-reliance on debt

In aggregate, Europe’s SMEs do not suffer from a shortage of capital. In fact, our analysis shows that Europe’s SMEs receive considerably more financing from banks, non-banks and governments than their US counterparts. The outstanding stock of SME finance stands at €2.0tn compared with €1.2tn in the US. The problem is that bank financing accounts for such a large proportion of this.

This over-reliance on debt is a feature of the European economy and is reflected in the structure of the financial system. For example, Europe has only three-quarters as much equity capital – €10tn versus €19tn in the US. The structure and sources of finance are also different. In Europe, regulated insurers and banks are the main suppliers of funding whereas in the US funding sources are more diverse. Private pension funds and fund managers play a bigger role in the US and their risk appetite is greater. US pension funds and fund managers typically invest more than half their assets (53%) in equity versus 37% in Europe.

In the United States, small businesses can also call on a far broader range of funding sources. Friends and family provide 33% of SME financing in the US, compared to just 9% in Europe and, in 2013, business angels in the US invested €20bn in SMEs versus only €6bn in Europe. The private equity and venture capital sector is also much more developed in the US. For instance, VCs invested €26bn in US SMEs in 2013 versus only €5bn in Europe.

This type of funding brings other benefits. VCs and business angels play a valuable role in the rapid evolution of the latest-generation entrepreneurial companies in the US. In addition to providing capital, they help with strategy and business contacts. Often, they are successful entrepreneurs in their own right and their expertise is invaluable to young businesses.
The problem in Europe is partly one of demand. As part of the research, BCG canvassed the views of 30 leading global asset managers controlling €9tn of funds under management. Many talked about a culture of risk aversion in Europe; they felt the under-developed nature of alternative financing sources, such as venture capital and angel investors, resulted partly from a strong preference for bank lending on the part of SMEs.

**Creating an appetite for equity finance**

Part of the solution is to foster a stronger culture of responsible risk-taking and innovation among SMEs and SME investors to create a bigger appetite for equity finance. Educating SMEs and potential investors about the benefits of Europe’s dedicated SME exchanges, such as the London Stock Exchange’s AIM market or Euronext’s Alternext would help. The route to the equity market for SMEs should also be made easier by addressing regulatory barriers such as the different national rules and requirements for prospectuses, which make Europe such a fragmented market. This is something that Lord Hill, the EU Commissioner, has said he plans to address under the Capital Markets Union proposals.

Turning to incentives, aligning the tax treatment of debt and equity would make SMEs more likely to raise equity capital. Currently, unequal rates of taxation discourage European firms from raising equity. German dividends, for example, are taxed at 50%, while debt is taxed at 25%. Greater use of the Allowance for Corporate Equity, in practice in Belgium and more recently in Italy, together with capital gains exemptions for equity sales by SMEs, were also suggested by interviewees. These options are certainly worth exploring.

The western world’s economy is operating at two different speeds. Europe is struggling to grow and avoid deflation, while the United States has returned to expansion, helped by the vigour of its young, entrepreneurial businesses. A culture of equity financing in Europe will help to breed, and grow, young companies and to foster growth and jobs.

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