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THE ENTREPRENEURIAL SOCIETY

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The Entrepreneurial Society

in Practice

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I. Introduction

Britain is now facing up to a number of key economic and social challenges which will help determine whether we enter the next century with the foundations in place to create and sustain a fair and prosperous society. The explicit aim of this chapter is to put forward a positive agenda for making Britain a "country of enterprise" in which all sections of society have the opportunity to display their entrepreneurial talents. By doing so we can help to secure a number of desirous objectives, not least increasing technological advancement, creating the industries of the future, reducing unemployment and regenerating stagnant communities. These aspects are all considered in detail subsequently.

For too long entrepreneurs have been viewed with suspicion by the Left as embodying the 'cult of the individual'. To the Right entrepreneurs have been seen as the prime facilitators of the move away from community based social and economic responsibility towards a society in which individuals provide only for themselves. Yet we choose not to take on board the misplaced and entrenched dogma of either, and simply define entrepreneurship as having the motivation and dynamism to innovate and make things happen. This is crucial to all enterprises, public or private, large or small, and equally to communities. With this in mind, our emphasis is very much on promoting entrepreneurialism through mutually beneficial collaborations between all sections of the business, public and social community.

In terms of how we set about this task, our approach was as diverse as the constituency we seek to promote. Broadly speaking we developed five key strands of research. Firstly we considered the evolution of public policy vis a vis small businesses and entrepreneurship over the last two decades to give us an historical perspective. We then considered what can loosely be termed 'the state of small business' as it exists in Britain today in terms of numbers, dynamics of entry and exit, sectoral composition and issues relating to survival and growth. At this stage we interviewed a substantial number of entrepreneurs, politicians, academics and individuals responsible for small firm development in a multitude of public, quasi public and private sector support
agencies. Fourthly, we surveyed all existing Training Enterprise Councils (TECs), Business Links (BLs) and Enterprise Agencies (EAs) with a view to building up a picture of exactly what support is currently on offer to entrepreneurs and potential entrepreneurs in Britain. Finally, we collected similar information for Japan, the US, Germany and France.

We now begin the main body of the chapter by initially defining the concept of the entrepreneurial society in terms of what it means to us. Having established this, we then move on to make a case for why we should be interested in promoting entrepreneurship in any case, and questioning whether there is a role for government in facilitating this process. We then provide a critical review of the evolution of public policy in Britain, before questioning whether our experiences are really so different from those of other developed countries. We then briefly discuss exactly what we know about the fundamental determinants of entrepreneurial success, defined loosely as those factors which enhance survivability in the first instance, and growth in the second, prior to our more detailed examination of 3 specific policy fields, namely education, advice, training & counselling, and finance. We propose some specific recommendations which we believe would help promote dynamic and sustainable entrepreneurship and secondly create a culture in which entrepreneurial activity in whatever form is positively encouraged and facilitated.

II. The Concept of the Entrepreneurial Society and its Rationale

The Concept:- In an entrepreneurial society, people with motivation and dynamism bring together resources and individuals to pursue their goals and so create wealth and jobs. The skills to do so are not just the presence of owner-managers but are crucial to the success of all enterprises, public or private. Indeed entrepreneurship is not necessarily about individualism. Experience shows the benefits of business people working in teams and developing peer networks. (Gavron et al, 1998)
Why Promote Entrepreneurship?

"A high rate of business formation and dissolution is characteristic of a dynamic economy. Changing tastes and preferences, new technologies, and changes in demography and geography are all accommodated by the entry and exit of firms."


This statement would cause considerable concern amongst UK policy-makers, who would tend to hold the view that the turbulence generated by the entry and exit of, essentially, smaller firms represents a waste of resources. Much better to try and 'pick winners', or offer large-scale subsidies to foreign owned multinationals to temporarily locate production in the UK. To an American the entry and exit of firms is interpreted as a sign of environmental dynamism, and as a means of facilitating change and ultimately economic growth. Yet failure does not carry the same stigma in the US as it does in the UK. There, to have tried and failed is seen as being a useful experience should one wish to try again. In this sense US entrepreneurial culture places a much greater emphasis upon the learning by doing experience in the belief that people will learn not to make the same mistakes again. By contrast, in the UK you tend to only get one shot. This was as true for access to government schemes in the 1980s as it is true for individuals seeking to obtain start-up funding from financial institutions.

Equally as important to the case for promoting the formation of small, start-up businesses, and fostering their development is that new businesses can help create new industries, innovate, provide employment, regenerate stagnant communities and provide individuals with a positive career choice. Leadbetter (1997), for example, explicitly refers to the social entrepreneur who channels resources to resolve community based social problems. It is this interaction between economic and social aspects of entrepreneurship that allow this sector of the business community to tackle a multiplicity of objectives in a way that supporting larger firms cannot.
Is there a role for government?

Entrepreneurship is not simply about maximising profit; it is also about having the motivation to innovate and make things happen. Supporting entrepreneurs therefore does not necessarily imply subscribing to the cult of the individual. The net must be cast wider to incorporate networking and mutually beneficial collaborations between the entrepreneurs themselves, advisors and providers of finance. We must ask ourselves about the consequences of entrepreneurial activity, and specifically new business formation. What are the wider benefits which would justify public intervention to support this sector?

* **Increased Prosperity**: US evidence shows that healthy rates of new business formation precede high regional economic growth (Reynolds *et al.*, 1994).

* **Innovation**: New Technology Based Firms (NTBFs) appear to have a positive and highly disproportionate share of innovations. Without doubt they outperform more conventional small firms in terms of survival and employment generation (Westhead *et al.*, 1995, Garnsey, 1995).

* **Job Creation**: Evidence from Scottish Enterprise (1993) demonstrates that whilst rising local demand is necessary to tackle unemployment, it will have most effect only if it is associated with the birth of new firms at the local level.

* **Structural Change**: 50% of employees in the UK work in small firms. This has occurred for a variety of reasons, for example via an increase in subcontracting, technological diffusion, lower minimum efficient scales of production and by consumers becoming more heterogeneous in their tastes.

Essentially there is likely to be an increase in self-employment and numbers of small businesses irrespective of policy. On this the Institute for Employment Research (1996) estimate the increase to be in the region of 500,000 additional self-employed
individuals by the year 2000. The question for policy-makers is how do we nurture and support these people to their benefit and to the benefit of society in general.

III. The Evolution of Public Policy

The 1980s heralded the dawning of a new era in terms of the way entrepreneurship and small business was concerned. For a variety of reasons the newly installed conservative government wished to facilitate the shift away from large government, large firms and large unions towards a small firms based economy. Small firms policy in its infancy had two fundamental aims; (i) to increase the number of business starts, and (ii) to reduce unemployment. In practical terms the two were inextricably linked.

Policy at this time was explicitly focused on promoting business starts across the board. To this end policy initiatives were nationally imposed and administered by the Department of Employment and subsequently the Department of Trade and Industry. In terms of focus there were two key concerns; (i) to alleviate perceived financial constraints preventing business inception, and (ii) to reduce the income risk of starting a business.

By the early 1990s however, the pendulum had swung to the other extreme. Now the focus of policy was on promoting so called ‘growth firms’ usually defined as ‘existing firms with the desire and ability to grow’. In practice this was taken to mean 3 year old firms with at least 10 employees. To this end the nature of support shifted to the provision of advice and counselling in the belief that lack of human capital was fundamental to the lack of business growth. In parallel with this dramatic shift in emphasis, policy-making was also devolved to regional agencies through the Training Enterprise Council (TEC) and Business Link (BL) network.
In short this shift from the 1980s to the 1990s was thus,

1) START-UPS ⇒ EXISTING FIRMS
2) FINANCE ⇒ SOFT SUPPORT
3) NATIONAL ⇒ REGIONAL

To some extent this was driven by academic research, although at times misinterpreted by politicians, but also by a desire to cut expenditure on the support infrastructure. It also tends to reflect the belief that localised agencies are better placed to design support programmes which address the particular needs of small businesses in heterogeneous localities. Whilst this devolution of power has resulted in greater local accountability and heterogeneity of provision, an unfortunate situation exists currently in which sub-regions have to competitively bid for public funds to provide business support. Thus in many areas there is no provision of support for start-ups at all. This surely cannot be the right approach.

IV. Is the UK Experience Different from Other Countries?
There are three key facts which underpin any cross-country comparisons. The first is that UK birth rates of new firms are fairly comparable with other European and North American countries. The second point is that our business cessation rates are the highest in the developed world (OECD, 1994). The caveat is that only 17% of start-ups subsequently end up either bankrupt or insolvent. Furthermore the average outstanding debt to financial institutions is a paltry £200. This information is often misrepresented by academics and politicians alike who tend to use the word failure, which implies there was no choice in the individuals decision to exit, instead of cessation which implies a very different thing. For example voluntary exit is particularly prevalent among founder entrepreneurs who having grown their business to a substantial size then seek to realise their capital gains by selling the business on
(Westhead and Wright, 1997). The truth is that business cessation is a combination of bankruptcy, insolvency, involuntary exit due perhaps to a lack of demand, voluntary exit due to better outside alternatives and voluntary exit with realised capital gains. Quite clearly the use of the term failure is a misnomer for many business exits.

The next big question is; are our policies any different from those in other countries? To explore this issue we briefly outline the nature and focus of start-up support in three developed economies, namely France, the US and Japan.

**France:**- Here we find strong linkages between public and private sector agencies at the local and national level. The focus currently is very much on training and they appear to have had considerable success with pre-start training, virtually doubling the survival rates of those individuals who go on to start a business. However, this is supported by the provision of a well developed and sophisticated programme of financial support, including both debt and equity financing.

**US:**- Policy intervention in the US dates back to the 1950s. There is a tremendous diversity at the public and private level in terms of what types of support are offered. Importantly, there is a much stronger role for academia. For example the Small Business Development Centres (SBDCs) provide pre-start support for potential entrepreneurs via the university network. The results are extremely promising in that 1 year post start-up the average firm has created 2.6 new jobs at a net cost of only $1,750 per job (Chrisman and Katrishen, 1995). If the UK could parallel this success in the average year, with our start-up rate, we could generate between 600,000 and 1 million gross new jobs. There is also an unparalleled level and diversity of support for NTBFs in the US. The Small Business Investment Company (SBIC) programme, dating back to 1958, has supported such household names as Intel, Federal Express, Apple and Sun Microsystems.

**Japan:**- Again small business policy dates back to the 1950s. Here the focus is very much upon human resource development. But in Japan this entails supporting not only the entrepreneurs themselves but managers and workers. In short on enhancing the
human capital and hence efficiency and productivity of the whole firm not just the owner-manager. This ethos is encapsulated in the Japanese saying that ‘a company is only as good as its people.’ Yet this emphasis on human resource development is also complemented by a wide range of financing initiatives.

In contrast, UK policy has focused explicitly upon the individual entrepreneur, has been by comparison relatively short in terms of the duration of support offered, has been either money or training and has tended to exclude academia. This is further compounded by the 30 year time delay in recognising the need to incorporate smaller firms into our industrial strategy. In fact the most prominent current issue on the Labour Party small business agenda is late payment of trade debt. In Japan a ‘Law on the Prevention of Delay in Payment of Subcontracting Charges and Related Matters’ was enacted as far back as 1956.

V. What Do We Know About the Determinants of Success?
In terms of moving towards an agenda for policy in the future we must first look at what we know about the determinants of success in the small business sector. Here we present a checklist based upon a review of the small business literature. A fuller account of all the issues raised in this article is given in our book for those with more than a passing interest in such matters.  

* Human Capital

* Previous small business experience
* Professional / Managerial experience
* Marketing skills
* Vocational qualifications
* Size of entrepreneurial start-up team

2 The book is titled ‘The Entrepreneurial Society’ and is available from the Institute for Public Policy Research.
Financial Capital

* Balanced mix of debt and equity
* Access to seed capital for NTBFs

Other Factors

* Niche products
* Appropriate advice
* Exporting

These sorts of findings indicate not only the breadth of support needed to create a vibrant, sustainable and dynamic small business sector, but the complementarity between the different strands of support that is required. To this end it is unlikely that a single agency can hope to fulfil these requirements. The lessons from abroad suggest that the support infrastructure must integrate public, quasi-public and private sectors to be effective. In addition there must be a continued devolution of policy-making to take into account the particular needs of different localities. However, this must be co-ordinated on a national level to ensure rapid evaluation and dissemination of 'best practice' or indeed 'worst practice'.

VI. Education, Culture and Entrepreneurship

The fact is that a substantial proportion of British people would prefer to pursue an entrepreneurial career path. Blanchflower and Oswald (1998), for example, report that 48% of Britons, given the choice, would choose self-employment over waged employment. This is an enormous number of people who harbour entrepreneurial ambitions, however latent. This begs the question as to why so few go on to do so. Here we argue that the education systems potential contribution could be fundamental not only in supporting people who then go on to become self-employed to be better at
it, but in terms of creating a cultural environment conducive to raising awareness of self-employment as a very real career option. The key stumbling block at the moment appears to be the lack of integration of what can loosely be termed ‘commercial awareness’ into the debate on the national curriculum. This is particularly strange given that the self-employment option has now been included in the Welfare to Work initiative.

Mini Enterprise - Bradford & District TEC

* Aim - to develop the curriculum and expand students experience of the real world of business, whilst raising younger peoples awareness of entrepreneurship as a potential outlet for their creative abilities

* Target group 9-13 year olds

* Based on public and private sector collaboration

This contrasts quite distinctly with the experience in many European states, for example the Netherlands, Germany, Austria, Sweden, Denmark and Switzerland where entrepreneurial skills and culture are promoted through the education system. Here the system is better placed to advance individuals up the ladder of formal education than into the work arena. However, there are schemes currently existing in the UK which tackle this issue head on, and with a considerable degree of success. The first is Mini Enterprise and the second Young Enterprise. Both are outlined in the shaded boxes.

Young Enterprise

* Aim - to give students the chance to set up and run their own companies, improve their business knowledge and develop their wider personal skills.

* Annually, more than 33,000 students from 1,700 schools take part with some 2,500 business starts.

* Funded by private business, central government and TECs.
favourable view of the potential that entrepreneurship offers as an alternative career option. It is crucial however, not to simply allow these schemes to operate in isolation within the education system. What we must seek to create is a nationally co-ordinated ladder of learning which encompasses cultural change vis a vis the role of entrepreneurship in society alongside the delivery of the practical skills relevant to an entrepreneurial career path. This would include an element of commercial skills training on teacher training courses to fill the supply side gaps, the setting up of students (particularly university students) entrepreneurs clubs to promote networking.

On the issue of graduate start-ups, for example, student surveys show that around 50% of graduates are likely to become self-employed or start their own business (Westhead, 1997). Thus alongside entrepreneur clubs there must be a more proactive role for Industrial Liaison officers, linking in potential entrepreneurs from the graduate community to the wider business support infrastructure. To summarise the key concepts discussed in this section before presenting our practical policy recommendations for promoting entrepreneurship through the education system we simply argue that policy in this area needs to become more imaginative, and that the education system needs to come to terms with the fact that many university and school leavers today and in the future will pursue entrepreneurial career paths. To fail to make adequate provision for this is to fail these individuals. Likewise to ignore the latent talents of our younger generation by not providing an outlet for their creative abilities and aspirations is closing the door on a wealth of potential talent.

Policy Recommendations

* Promote projects which develop business skills amongst younger children
* Include commercial competence in teacher training courses
* Develop entrepreneur clubs at higher education institutions
* Promote entrepreneurship as a positive career option
VII. The Provision of Advice, Training & Counselling

In section (vi) we laid the foundations for an entrepreneurial society in terms of setting a positive agenda for promoting cultural change via the education system. Here we advance a little further along the ladder to business start-up by considering exactly what types of practical support is offered to potential entrepreneurs and start-up entrepreneurs in the early stages. The focus here is on soft support, defined as non-financial support measures. Here we discuss the role of Personal Business Advisors (PBAs), mentoring, business incubators and team building initiatives, all issues related to enhancing the human capital of entrepreneurs at start-up and in their formative years when they are most vulnerable to failure.

In broad terms, pre-start training and advice have two effects. Firstly, they better prepare entrepreneurs for the rigours of business life. Secondly, they act as a self-screening mechanism by deterring those most likely to fail. In both cases this type of support bridges an information gap. In the latter case pre-start advice allows potential entrepreneurs to make a better informed decision as to their suitability for an entrepreneurial career path. In many cases this pre-empted possible ill judged business starts which subsequently fail at great economic and social cost to the individual concerned.

We begin by outlining the nature of the business support infrastructure as it exists today. TECs and Business Links are at the hub of this infrastructure on the ground, although five different departments are involved at the Ministerial level of government. The remit of TECs is to set key priorities and objectives for local business support development and delivery, for which funding is provided in the main by the Department for Education and Employment. However, only 10% of total TEC funding (this part provided by the DTI) is for enterprise. Thus the overwhelming majority of TEC funding and support is for workforce training, not entrepreneurship development programmes. Business Links, as their name suggests, provide the core level of support for enterprise. Their original remit was to provide a ‘One Stop Shop’
or a single point of access for business support. Later this was somewhat redefined and resulted in BLs focusing on existing businesses by providing advice & counselling through the PBA network. Somewhat surprisingly, the DTI required that BLs should become self-funding within three years of inception, although this was relaxed last year.

In terms of the PBA and how they fit into the support infrastructure, it is likely that for any entrepreneur walking through the door of a Business Link the initial contact will be with a PBA whose remit will be to provide independent advice to suit the clients needs. As to who they are, they tend to be generalists whose main objective is to identify and prioritise needs before referring clients on to specialist advisors. Typically, they will have owned or managed a small business or been a consultant to them. In terms of the approach, it is very hands-on. However, concerns have been expressed about their calibre (Bank of England, 1997) and questions have been raised about the relevance of what are perceived in many cases as outdated business skills to the modern economic environment. In defence of the PBA concept you are extremely unlikely to attract the best recruits for an average annual salary in the region of £25,000.

So are there tangible benefits associated with pre-start advice and counselling, given that the issue of quality is resolved? Broadly speaking the answer is yes. In the US and France pre-start advice and training has been shown to have a positive, and significant impact on business survival. Interestingly, the US research shows that pre-start advice was more beneficial than post-start advice. This was attributable in the main to its role in screening out unsuitable individuals. In France the results are dramatic and show that survival chances increase by over 60% if individuals receive pre-start advice and training. In the UK schemes such as the MIDAS initiative (see below) also support the rationale for the provision of extensive pre-start support.
MIDAS Initiative - University of Central England

* A programme of training, consultancy support, start-up and incubation for senior managers committed to the creation of team-based starts.
* Focuses on experienced managers, professionals, engineers and scientists with clearly defined skills who are currently employed but actively considering starting a business.
* Collaboration and funding were secured from 3 local TECs, Birmingham Council, Midland Bank, Price Waterhouse and Eversheds.
* Between 1995 and 1996, 13 companies started and generated 100 jobs.

For those not familiar with small business start-ups, the typical start would only generate 1 additional job over this sort of time scale. Thus the scheme highlights the potential benefits that well designed and co-ordinated initiatives can achieve in this arena. Equally as important is the collaboration between local government, academia, the small business support infrastructure and the private sector. It also emphasises the advantage team starts have over individual starts, particularly in terms of coverage of core managerial functions.

**Mentor Networks**

The simple fact is that aspiring entrepreneurs are more favourably disposed to taking advice from their peers than men in grey suits. As such, the formation of networks of mentors might be a logical place to begin to encourage entrepreneurs to tap into the system of advice and support. In many ways this would be complementary to the role of business angels. Importantly, with such networks of current and retired small businesspeople in place, it would then be relatively painless to extend their role to include the proposed university entrepreneur clubs and school based initiatives. In many cases this sort of peer networking relationship might naturally evolve into non-executive directorships, which can be an important step towards removing managerial constraints apparent in start-ups and early stage firms.
Medilink

* A region wide network scheme based in Sheffield with the explicit aim of advancing the interests of the medical technology sector in the area.
* It provides a forum for medical companies, hospitals, universities and business support agencies to exchange information and to work together to generate new business opportunities.
* The evidence suggests that this group has played an important role in promoting innovation and small business development in the sector.

The Business Incubator

'Perhaps the ultimate form of support is the incubation unit which provides everything needed to get an enterprise up and running' (Gavron et al, op cit,p.88).

In terms of the nature of support provided by business incubators, it ranges from premises and shared secretarial/administrative facilities, through to training and in many cases financial support. What they hope to provide is a fast track for companies to reach the developmental stage where they are capable of generating wealth and employment. The key is creating an environment conducive to high growth which ultimately manifests itself by increasing regional prosperity. In line with this aim, many current initiatives of this type are focused on biotechnology and information/communications based start-ups. Other aims, notably pursued through the EU Business and Innovation Centre network, are directly aimed at encouraging innovative enterprise in regions suffering from structural economic problems. In such areas, schemes focus on diversifying industrial activity and creating new growth industries capable of generating and sustaining skilled employment. Here the emphasis is also on ability to export.
Do business incubators work? Here again there is growing evidence that they do. For example, EU-BICs are directly responsible for the creation of several thousand new and innovative businesses across Europe. More importantly from a policy angle is the fact that start-up survival rates are demonstrably higher as is their employment creation potential. For example EC-BICs achieved start-up survival rates of 88% compared to 50% for a matched sample of unsupported starts. At St.Johns Innovation Centre in Cambridge, identical start-up survival figures of 88% were recorded, which exceeded even the figure recorded for high-tech starts in Cambridge as a whole. Further, the 64 companies located there employ a total of 1,000 staff with a combined annual turnover of £50 million.

*Spin-Outs*

The concept of the business spin-out is embedded in the concept of efficiency, and entrepreneurialism. With reference to the latter, the basic argument is that as firms evolve over time and increase in size there is a requirement for more formalised information systems and managerial structures which allow centralised decision-makers to adopt formalised or routinised responses to external shocks which impact upon the firm. This is characterised by a shift from an entrepreneurial or informal style of management and decision-making towards a more formal, bureaucratic style. The effect of such a shift is that entrepreneurial activity within the firm (often called intrapreneurship) is often quashed. Thus the dynamism and entrepreneurial vision which drove the firm on in the early stages of its life-cycle is often lost as entrepreneurs are replaced by formal managerial functions. Regarding efficiency concerns basic industrial economic theory tells us that once firms are able to exert some degree of market power then the requirement to be efficient in terms of producing the lowest cost output possible for a given set of factor inputs is removed. One particular scheme, the Enterprise Factory (EUROSME) tackles these efficiency concerns head on with a new and innovative approach towards industrial regeneration. A brief outline is provided in the box below.
* Arose out of the concern that Jarrow had the highest rate of male unemployment in the UK.

* Based on two economic postulates:

1) That large firms need to concentrate on core competencies in order to be globally competitive, and;
2) That spin-outs could create more growth than the same functions within the parent.

* Takes non-core functions out of large firms, develops them and sells them on to regional entrepreneurs or via MBOs (Management Buy Outs).

* The transaction provides investment funds for the next phase of 'cold' spin-outs.

This fundamental belief that non-core competencies could be placed on the open market to improve productivity, strengthen competition and increase the birth rate of new firms in the locality is arguably the line that industrial policy-makers should have been adopting since the decline of UK manufacturing in the early 1970s. The evidence to date suggests that the schemes designers were correct. Case studies of spin-outs show that substantial increases in productivity have been achieved.

Yet the key to the schemes success is the nature of the support provided to spin-outs. Typically the new spin-outs are micro-businesses with around 3-4 employees. They are located in the Enterprise Factory and provided with central services covering a wide range of managerial and human resource development. Alongside this, advanced market research techniques are used to identify commercial opportunity. On average spin-outs remain in the factory for 2 years or until they have grown to a stable size of 10-20 employees with sufficient growth potential. They are then sold off to the management team or to local entrepreneurs, thus creating and sustaining wealth within the region.
In this section we have considered issues relating to training, advice & counselling in a wide variety of contexts. As is evident from the case studies of specific initiatives this is an area in which many innovative and diverse approaches have been adopted. What is patently obvious is that the best of these schemes have achieved outstanding success, not only in terms of enhancing survival prospects, but in terms of promoting and accelerating growth and wealth creation. A positive outcome has been the dramatic growth in the capability of supported firms to create and sustain high levels of new job generation. A further desirable outcome has been the endogeneity of growth within the region in which the scheme was initiated. Surely organic growth in this context is more efficient than subsidising foreign direct investment from multinationals with no more than a passing allegiance to the regions in which they temporarily locate.

**Policy Recommendations**

* Ensure that there is a basic level of pre-start advice provision available to all potential entrepreneurs across Britain.

* Promote networks of mentors throughout the UK from then ranks of the 4 million existing small business owner-manager and the thousands of retired business people.

* Encourage the formation of private sector entrepreneurs clubs.

* Increase the level of support for business incubators with appropriate provision for innovation depending upon specific local circumstance.
VIII. Finance

Finance is perhaps the most contentious issue for small businesses. Survey after survey tells us that small businesses are unhappy with providers of debt and equity finance for a variety of reasons. At the academic level the issue is just as hotly debated. On the one hand we have the credit rationing lobby and on the other the no-rationing lobby. Indeed the roll call of entrants into the academic debate reads like a who’s who of finance. So it is perhaps best to begin with a few relatively uncontentious stylised facts about small business financing;

1) High-technology start-ups in particular and more generally high-tech small businesses are consistently identified as the most constrained small businesses in terms of their ability to access either debt or equity finance in the UK.

2) The overwhelming majority (over 80%) of small business loans in excess of £15,000 involve the posting of assets (collateral) to a value which exceeds the total loan value, often by a factor of 2 or 3 times.

3) Around 10% to 20% of small businesses who apply for bank funds are refused. Further a substantial number who are successful do not receive the full amount they requested.

4) The cost of bank debt very rarely exceeds 3 percentage points over base rates.

5) Only 5% of total UK formal venture capital goes to seed or early stage investment.

In terms of how potential entrepreneurs perceive finance constraints, Blanchflower and Oswald (1998) report that of the 15% of employees who had seriously considered starting their own business, some 51% had not done so due to capital constraints. I guess the big issue for us here (at least initially) is not whether the finance gap is real, but the fact that if potential entrepreneurs believe it is and are prevented from advancing their ideas further then we are losing a potentially valuable economic
resource. Even at the post-start stage, undercapitalisation is widely cited as a major contributory factor in failure.

At the heart of the debate is the relationship between risk assessment and information. Clearly, there are difficulties in determining start-up businesses chances of survival and hence ability to repay loans. This is presumably why the incidence of collateral is so high. Yet the imposition of collateral requirements obviates the need for banks to monitor or properly evaluate loan decisions. This is where the public sector has an important role to play. Firstly, by increasing the quality and volume of information flows between banks and potential borrowers banks may be better placed to evaluate lending propositions. Secondly, if finance is linked with the provision of advice and training then we are addressing the quality of entrepreneur issue head on. It is perhaps this lack of complementarity between human and financial capital that has characterised the policy arena to date and arguably contributed to the rather intransigent and hostile relationship between banks and entrepreneurs (Middleton et al, 1992). An example of such a mutually beneficial collaboration is provided by the Business Development Loan Fund (see box below).

The Business Development Loan Fund - Business Link Oldham

* The Fund aims to assist the start-up and growth of small businesses, co-operatives and community enterprises in the locality.

* Joint venture between Oldham Council and 3 banks.

* Grants are matched by a low interest, unsecured loan from one of the banks.

* Applicants are assessed by a panel of local authority and bank representatives and must demonstrate the viability and job generation potential of the business.

* Successful candidates are offered free advice, counselling and support on a continued basis.

In such cases the involvement of the TECs or Business Link has altered the risk profile of the entrepreneurs as perceived by the banks. This has resulted in lower cost finance,
and more generally greater availability of loan packages. These sorts of outcomes have the potential to generate positive and long-term benefits to both firms, banks and also local communities. Indeed one of the centrepiece schemes dealing with the perceived gap in the financing of small businesses, the Loan Guarantee Scheme, has now begun ten pilot projects incorporating TEC and BL advice into the loan package. We await the results of the evaluation with anticipation.

Regarding equity finance, once again it is the difficulty in assessing the viability of proposals, particularly high-tech, which is the greatest obstacle for start-ups. On this the costs of 'due diligence' make it unprofitable to make investments below £100,000. Consequently venture capitalists tend to favour MBOs and MBIs. A further issue is the high internal rates of return (IRR$s) demanded by venture capitalists for high risk start-up proposals. Here the long lead times associated with high-tech R&D militate against investing in this type of firm. In addition, the venture capitalists lack of technical skills often represents a significant barrier to funding. Wrapped up in all of this is the widely held perception that high-tech small businesses are the most risky. Research suggests that this is quite clearly untrue (Westhead et al, 1995).

In terms of an agenda for resolving this impasse, perhaps the most promising line is through the promotion of informal venture capital investments via networks of business angels (BAN$s). On this, Harrison and Mason (1996) identify three characteristics of business angels which are fundamental to promoting equity investment to the small business sector. These are; they invest in precisely those areas where institutional providers are reluctant to venture; they are geographically dispersed and favour localised investment, and; they bring with their investments expertise in the form of commercial skills and business contacts.

Business angel networks (BAN$s) have been the most prevalent means of stimulating informal equity investments in smaller firms. As a rule they are not-for-profit organisations, often funded through public or quasi-public agencies (TECs and BL$s). Most commonly they provide 'matching' services for business angels and small firms seeking investment. Of the 37 BAN$s existing in the UK in 1995, 24 were public sector
or not-for-profit. Typically these were found in the least profitable areas of the small business sector and were often very localised offering relatively small amounts of equity. On balance however, the dramatic growth in business angel activity has not really generated funds on the desired scale, nor has it promoted huge increases in numbers of investment in small businesses. The evidence for this is quite strong. For example, the 5 DTI Informal Investment Demonstration Projects only made 64 investments totalling £3.6 million in 3 years. Even the largest single fund of its type, the Midland Enterprise Fund has only completed 95 investments since 1994, although a high proportion, 38%, has gone to start-up and early stage development.

So why is there such a disappointing lack of activity in the sector? The business angels put it down to a lack of viable investment opportunities. In terms of how this issue might be addressed there are several strands of enquiry which deserve consideration. The first would be to initiate an Equity Guarantee Scheme (EGS) along the lines of SOFARIS in France or BTU in Germany. Here the government acts as a guarantor for a specified percentage of the total business angel investment in return for either a fee income or a small stake in the business. This type of scheme appears to have been successful in Europe by reducing the perceived risk associated with equity investment in smaller firms. An EGS might have several positive outcomes. For example it might increase the number of active business angels; increase the number of investments that business angels make; increase the flow of investment from existing venture capital funds; reduce the risks associated with investing in start-ups and high-tech firms; reduce smaller firms reliance on debt finance. Other areas in which public intervention might prove to be beneficial is in the setting up of a national database of business angels and small businesses looking for equity funds. This could be administered through the existing network of TECs and BLs. The main advantage of such a network would be to remove the informational problems which often prevent the supply-side (the business angels) from ever meeting the demand-side (the firms looking for investment).
Policy Recommendations

* Promote the creation of strategic partnerships between public and private sector support agencies and providers of debt and equity finance.

* Establish a national database for business angels and investment opportunities.

* Pilot an Equity Guarantee Scheme

* Promote finance packages which involve an element of advice and training to enhance survival prospects thus increasing the flow of funds to firms and reducing the requirement for collateralised lending.

IX. Conclusion

We have put forward a positive agenda for promoting an entrepreneurial society in which individuals and groups of people with the desire to create or innovate have the ability and support to do so. This we believe underpins our ability to address many of the economic and social problems we currently face. The creation of a dynamic and sustainable entrepreneurial base, embedded in a society which is broadly supportive in a cultural sense of entrepreneurial activity, is fundamental to this. In this chapter we critically reviewed the state of entrepreneurship in Britain and considered whether current public policy is effective in terms of addressing the primary concerns of entrepreneurs. In many cases we found that policy was innovative, diverse and flexible. Yet the overwhelming evidence suggests that the approach has been uncoordinated and consequently has resulted in rather disparate coverage across geographical regions and industrial sectors. We argue firstly that policy can do more. As entrepreneurs must embrace change so must policy-makers. There is also a clear need to maintain a coherent and global strategy for the development of the small business sector per se. Only by setting goals and objectives and then integrating these
into an overall industrial and social strategy can we begin to formulate anything like this. As banks have allowed natural and beneficial alliances to evolve with other key players in the business support infrastructure so must policy-makers.

Bibliography


