Entrepreneurship and Local Economic Development

PROGRAMME AND POLICY RECOMMENDATIONS

OECD

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Publié en français sous le titre :

L'entreprenariat et le développement économique local

RECOMMANDATIONS DE POLITIQUES ET DE PROGRAMMES

Foreword

A raison d'être *of the OECD's Local Economic and Employment Development (LEED) Programme has always been the analysis of entrepreneurship strategies used to foster local job creation and economic growth. Over recent years the LEED Programme and its Partner organisations have sponsored numerous conferences and study projects on the themes of entrepreneurship and self-employment. This publication draws together a wide range of insights and sources of information on the local dimension of entrepreneurship gathered in the course of these activities.*

Across OECD member countries, the scope, number and growth of entrepreneurship and micro-enterprise support programmes is striking. Much of the policy interest reflects a belief that the creation of new firms will facilitate the achievement of important economic and social objectives. For instance, encouraging entrepreneurship is one of the four pillars of the European Union's Employment Guidelines. However, as this publication makes clear, despite widespread policy interest, few studies have systematically examined the relationship between the creation of new firms and local economic development, as distinct from national and regional economic development. In this connection, this publication describes the types of research that should be undertaken to bring about an improved understanding of the key policy issues.

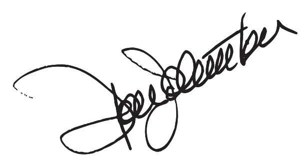
The book examines the principal channels through which the birth of new firms can impact on local economies. These include the creation of employment, increased tax revenues, the improved local provision of services, and positive effects on motivation. The factors that impede entrepreneurial activity in disadvantaged areas are also considered in detail. It is shown that, while enterprise creation can be critical to local economic development, the promotion of entrepreneurship does not constitute a developmental panacea. A number of potential limits to entrepreneurship-oriented strategies – and how these limits can be minimised – are discussed at length. When I was the federal Minister responsible for Economic and Regional Development in Canada 20 years ago, I would have found this study invaluable!

Perhaps the book's most valuable contribution is to detail the rationales for a set of programmes and policies towards local business creation and development. Comprehensive policy recommendations are offered for national and local levels of government. The recommendations concern three thematic areas: strategy, finance and programme design. It is my hope that these guidelines will assist local and central *governments in the design and implementation of cost-effective measures to foster entrepreneurship.*

This publication is one among a number of recent and forthcoming works on the local dimension of entrepreneurship prepared by the LEED Programme. LEED has recently produced studies on business incubation, youth entrepreneurship, social enterprises and micro-credit. Forthcoming work will assess the lessons learned from programmes adopted in the United States to finance entrepreneurship in distressed localities. And another study will consider how to evaluate the cost-effectiveness of entrepreneurship and other policy tools used by subnational governments. In undertaking this work, exchanges with leading enterprise development agencies across the OECD – through the LEED Partners Club and its Forum on Entrepreneurship – have provided a rich source of practical information. Such exchanges have also afforded a test of the utility and practicability of the formulated policy recommendations.

Donald J. Johnston

OECD Secretary General



Acknowledgement. *This publication has been researched and written by Alistair Nolan, an OECD staff member. Thanks are expressed for comments received from Professor David Audretsch, Dr. Peter Bearse, Rosalind Copisarow, Dina Ionescu and Professor Philip Shapira. Thanks are likewise due to Sheelagh Delf and Jennah Huxley for essential assistance in the formatting and preparation of this publication. The policy recommendations contained in this publication have been endorsed by the Directing Committee of the OECD's Local Economic and Employment Development (LEED) Programme.*

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Introduction and Summary

In many OECD member countries unemployment, ill health, poor quality housing, crime and social exclusion are concentrated in deprived local communities. Thousands of programmes have been experimented with as part of attempts to reduce joblessness and raise standards of living in distressed localities. Public schemes have tackled different aspects of the problem in different ways. Some facilitate the location of private sector investments in disadvantaged areas. Others upgrade labour force skills or assist job placements. Still other programmes prioritise property development as a regeneration strategy. One of the most widely used categories of scheme involves supporting the creation and development of new businesses. Indeed, fostering entrepreneurship is also one of the principal measures used to accelerate economic development in more prosperous localities. Entrepreneurship policies and the role of business creation in local development are the subjects of this book.[1]

Across the OECD the scope, number and growth of entrepreneurship support programmes are striking. Between 1987 and 1996 micro-enterprise programmes in the United States grew from fewer than ten to more than three hundred.[2] In France, the recently elected government of Jean-Pierre Raffarin has prioritised the establishment of new firms as part of its employment strategy, with the goal of creating a million firms over five years. Japan and other countries have established schemes to assist older age groups to embark on entrepreneurship.[3] A public initiative in Ireland has sought to encourage expatriate employees to return to set up firms. Expanding entrepreneurial activity is one of the four pillars of the European Union's Employment Guidelines. In the transition economies the creation of new firms is a fundamental underpinning to the development of a market-led economy. And bilateral and multilateral development agencies operating around the globe advocate micro-enterprise as a vehicle of poverty-alleviating development. Indeed, in October 2001 practitioners from a hundred and thirty-seven countries met in Mexico with the goal of extending micro-credit to one hundred million of the poorest people world-wide.[4]

For a variety of reasons, promoting entrepreneurship enjoys support from governments at both ends of the political spectrum. Pro-entrepreneurship policies have been embraced as a means of increasing economic growth and diversity, ensuring competitive markets, helping the unemployed to generate additional jobs for themselves and others (rather than share existing work), countering poverty and welfare dependency, encouraging labour market flexibility, and drawing individuals out of informal economic activity. In short, an enterprise imperative has been charged with addressing a broad array of economic and social aspirations.

Increasing rates of enterprise creation is now an almost universal concern for local authorities as well as for central governments wishing to accelerate development in disadvantaged localities. For example, in early 2000 the United Kingdom's Deputy Prime Minister announced far-reaching plans to revitalise the poorest areas of England by fostering enterprising communities. In this connection, the United Kingdom's Small Business Service has a specific remit to foster enterprise in disadvantaged localities and to attend to the needs of micro- and social enterprises. And in the United States, the renowned Harvard business theorist, Professor Michael Porter, has lent enthusiastic support to enterprise development as an inner city regeneration strategy, even establishing a specialised institute to further this goal.

However, given the widespread interest in promoting enterprise, it is perhaps surprising that few empirical studies have systematically examined the relationship between the birth of new firms and local economic change. This publication draws together and assesses the available research on entrepreneurship and local economies. Where relevant, insights are gleaned from the field of regional economics. Particular attention is given to self-employment. Until recently the study of self-employment occupied only a small place in mainstream labour economics. However, there is now a growing academic literature on various dimensions of self-employment. Policy lessons are sought for local authorities based on evaluations of a number of national self-employment support programmes and insights from the recent academic research.

Hundreds of books and information-brochures have catalogued local development initiatives across OECD member countries. This publication avoids the use of numerous case studies and programme examples. Rather, the emphasis is on identifying general principles, drawing lessons from theory, and deriving broad conclusions from exchanges with practitioners: all with the aim of informing policy. The book is divided into two parts. Part I contains six chapters that examine the evidence for entrepreneurship's impacts on local economies, as well as possible rationales for public policy. Building on Part I, the five chapters in Part II set out detailed policy recommendations and suggestions for future policy-related research. The following paragraphs summarise the key observations in each chapter of the book.

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Chapter 1 presents salient features of the relationship between company creation and national, regional and local economic performance. Across the twenty-nine countries surveyed in the *Global Entrepreneurship Monitor* – including twenty-two of the thirty OECD member countries – an average of just under ten per cent of the adult population were starting a new firm or owning an active business in 2001. At a macroeconomic level entrepreneurship is one of the keys to economic dynamism. Entrepreneurship accelerates the process of generating, disseminating and applying innovations in technology and organisation. This process of innovation is fundamental to sustainable growth. Company creation is in fact an essential carrier of structural change.

As previously noted, few studies have investigated empirically the relationship between the creation of new firms and local economic development. Considerably greater understanding exists of the interactions between entrepreneurship and national and regional economies. Differences in enterprise dynamics across distinct types of locality – the inner city, peripheral estates, places dependent on a small number of economic activities – are also under-explored.

Rates of enterprise creation differ markedly across *regions* within OECD countries. Determinants of rates of company creation across regions include demographics, unemployment, wealth, the educational and occupational profile of the workforce, the prevalence of small firms, the extent of owner-occupied housing, infrastructure endowment, and a region's history. Fast growing regions usually have high rates of enterprise start-up.

At the local level there appears to be a broad association between incomes and entrepreneurship. Nevertheless, this relationship is not straightforward. Areas of significant deprivation can also experience high rates of firm creation. There are a number of reasons why this can occur. For instance, businesses sometimes operate with weak links to local product and labour markets. Indeed, the text describes a variety of conceptual, measurement and labour market considerations that are likely to cloud statistical links between entrepreneurship and local employment outcomes. There are various channels through which the birth of new firms can positively affect local economic development. These include: employment and incomes growth, with indirect employment effects operating over time; increases in tax revenue, although of uncertain and possibly small magnitude; enhanced provision of services for local consumers and businesses, with increases in local income retention; and difficult-to-quantify but possibly important demonstration and motivational effects.

A set of related constraints can impede entrepreneurship in deprived localities

Chapter 2 describes a set of interrelated conditions likely to hinder entrepreneurship in disadvantaged areas. These obstacles influence both the extent and form of entrepreneurial activity. They also affect the likelihood that new firms, once established, will survive. Impediments to entrepreneurship in deprived communities are seen to include:

- limited social and business networks;
- low levels of effective demand in the local economy;
- the system of tenure and low value of housing;
- constraints in access to finance;
- a lack of work experience and skills among residents;
- a lack of role models – with respect to which the report examines various conjectures regarding the role of imitation in the spread of entrepreneurship;
- cultural obstacles, such as linguistic barriers and a lack of affinity with mainstream institutions;
- lack of personal motivation;
- sectoral clustering;
- high rates of crime;
- problems of transition from reliance on benefits; and
- inappropriate government regulation.

These obstacles are not exclusive to deprived localities. However, their prevalence, the likelihood that they will operate simultaneously, and their severity, are often greater in poorer communities.

Support for the unemployed to enter self-employment can be cost-effective if carefully targeted

Chapter 3 examines self-employment in national and local economies. The self-employed include individuals in diverse economic circumstances. In some cases self-employment can be described as a subcategory of entrepreneurship, but in many others it closely resembles waged and salaried employment. Some countries have seen their self-employment rates remain fairly stable over recent decades, while others have experienced dramatic change. For example, in Canada, between 1989 and 1996, over three-quarters of all new jobs were in self-employment. The rate of self-employment is the result of interactions among a number of economic, social and policy variables. This publication examines key propositions regarding the determinants of the level of self-employment. In so doing, emphasis is placed on identifying insights that the research on national rates of self-employment might provide concerning the links between self-employment and local economic change.

Most OECD governments have established schemes to assist the unemployed to enter self-employment. The principal features of these schemes, as well as trends in the modes of programme delivery, are set out in the text. The remainder of Chapter 3 seeks to assess the efficacy of self-employment support, based on a growing – but still rather limited – body of programme evaluations. It is seen that deadweight – a measure of the degree to which programme outcomes would have happened without the programme – can be high. But enhanced employability can also be significant. Other potentially important programme benefits are rarely measured. Some of these – such as effects on criminal behaviour, drug abuse, psychological wellbeing, and post-programme asset accumulation – are clearly of interest to local and national policymakers.

A broad conclusion from the available research is that self-employment support can raise incomes and provide a cost-effective alternative to paying unemployment insurance, but only for a small subsection of the unemployed. This generally includes the more motivated and persons with work experience and accumulated human and financial assets. Reductions in the *duration* of unemployment for those already unemployed can be an important result. Programme costs are often low, especially when financial assistance replaces payments of unemployment insurance. While net job creation is generally small, the net cost per job created can also be low by comparison with other labour market policies. Schemes are less helpful for those who have experienced longer periods without work.

Promoting entrepreneurship offers important potential benefits, but also has a number of limitations

Chapter 4 examines the strengths and weaknesses of enterprise promotion as a local development strategy. While enterprise creation and development is clearly a critical component of local growth and development it does not constitute a developmental panacea. A number of the potential limits to entrepreneurship-oriented strategies are assessed in detail, as described below.

Entrepreneurship-centred policy inevitably favours those who possess superior financial, human and social assets. When entrepreneurship programmes expand and eligibility is extended positive impacts often weaken as marginal participants are attracted. The promotion of self-employment and micro-enterprise should not be viewed as a solution to social exclusion for large numbers of individuals. Businesses that employ others also tend to be run by entrepreneurs from among the better qualified. And the job creation brought by increased levels of entrepreneurship need not contribute to a significant expansion in employment opportunities for the most disadvantaged in the labour market.

In addition, entrepreneurship cannot address all the problems of disadvantaged areas. Poor localities are often characterised by multiple and inter-related forms of distress. The causes of this distress are many. Enterprise creation and development can clearly operate on a number of these variables, but not on all of them. In areas of concentrated poverty a range of other actions besides business support – such as in housing, education, health and policing – is also required. The success of programmes in affecting area development also depends greatly on initial conditions, as well as on factors outside of local control (such as interest rates and the state of the macro-economy).

Pro-entrepreneurship policies also require extended time-horizons. The encouragement of entrepreneurship is unlikely to yield major benefits in the short-run. Entrepreneurship strategies, then, should be policy constants rather than responses to short-term employment crises.

Competition from start-up firms can also cause losses of output and/or employment among existing enterprises. Unfortunately, this displacement effect is likely to be greatest among the types of firms typically present in poor localities – those in mature, low-growth, easy entry markets. These are often firms in which skill and capital requirements are relatively limited. However, displacement is not uncomplicated. For instance, it is conceivable that displacement could be negative. This might happen if some of the unemployed and those initially displaced receive jobs in newly created firms. Economic gains might also result if new firms are more efficient than those they displace. Also critical to the magnitude of displacement effects is the state of demand and supply in local markets. And displacement outcomes are likely to vary over time: as new firms mature they tend to diversify their customer bases and gradually reach out to wider regional, national and international markets.

Employment creation is often modest, and should not be the only policy concern

The magnitude of direct employment effects will generally be small, especially over the short-term. This reflects the small average size of start-ups, low enterprise survival and growth rates, displacement effects, and deadweight in programme outcomes. Self-employment support programmes in particular tend not to produce a large multiplier effect, because the self-employed do not hire large numbers of additional workers. But this and other parts of the report note that an unqualified focus on employment outcomes is mistaken. Enterprise creation is part of a broader process in which financial, human and other resources should be efficiently reallocated from declining firms and subsectors to uses that markets value more highly. In practice, entrepreneurship support has at least as much to do with changes in productivity and incomes as with employment creation.

Policy-makers naturally wish to know who is recruited when new firms are created. Do locals or non-locals fill vacancies? A typical figure from metropolitan areas is that local residents fill around one in five new openings. This ratio is sensitive to the occupational structure of employment growth and the specific characteristics of local labour supply. A number of reasons are described why individuals living in inner-cities might not be excluded from jobs located in their own neighbourhoods, even when employers hold negative views of inner-city residents as potential employees. A further consideration regarding local employment impacts is that there is differential mobility among persons with higher and lower levels of skills. This means that, all things considered, vacancies that require high skills are more likely to be filled by labour in-migration. Furthermore, the welfare effects of job creation are unlikely to be the same for persons with different levels of skills. For jobs at the lower end of the labour market it is probable that a larger share of the wage represents a gain in welfare. So local projects that generate employment for the under- and unemployed need not be justified solely in terms of their redistributive impact: this impact is less likely to be curtailed by labour in-migration, and could also be associated with relatively high gains in economic efficiency.

A further consideration is the quality of employment. People who are self-employed often register higher levels of job satisfaction than employees. However, the self-employed are highly heterogeneous. They comprise groups as diverse as well-remunerated corporate financial advisors *and* part-time providers of child-care. For some, self-employment is a state analogous to disguised unemployment; an option adopted for lack of a better alternative. And many features of self-employment are undesirable, such as low and volatile earnings, long working hours, an often greater exposure to physical hazard, as well as reduced forms of social protection. Improving the quality of work and standards of living for many among the self-employed is an important policy challenge.

Rationales for policy are numerous, but not all are equally strong

Chapter 5 focuses on the economic rationales for public policies that encourage self-employment and entrepreneurship in local economies. A detailed review is presented of the empirical and theoretical studies of purported failures in markets that support entrepreneurship, in particular in markets for financial, industrial real estate, business development and training services. Abstracting from the operation of these specific markets, other arguments for supporting entrepreneurship are also examined. These arguments rely variously on claims relating to:

- the fact that new business creation can itself affect the behaviour of other potential entrepreneurs (for example, by providing role models);
- path dependency in local development shaped by low current levels of entrepreneurship;
- the role of business creation in reducing the social costs of unemployment;
- the creation of other benefits – not directly related to employment or regeneration – that would not have arisen in the absence of policy (such as efficiency gains from stimulating collaboration among firms); and
- discrimination on grounds of race, gender, age or disability, particularly in connection with the treatment of loan applications by banks.

It is shown that some of the often-cited justifications for policy rely on limited evidence. It is important that governments, whether local or central, also be concerned with policy failures. That is, they need to correct policies that impede the efficient functioning of markets or worsen existing market failures. Regulatory measures and land-use planning that disadvantage smaller firms are cases in point. A range of policy options is described that is unlikely to lead to policy failure.

It is unlikely that access to credit is always a constraint

Various conclusions are drawn from the assessment of policy rationales. As regards finance, it is clear that the market for credit for small firms does not function as a textbook market should. That is, projects are not funded regardless of the resources of the proprietor. On the contrary, collateral-based lending predominates. Various forms of evidence are described which support the hypothesis of failure in this market. However, it is also seen that a considerable weight of empirical and theoretical research suggests that market failure is not decisive. Indeed, increasingly, analysts are coming to the view that while some worthwhile projects – proposals with a positive net present value – do go unfunded, market failure in the provision of debt is not widespread. When it occurs it may be specific to particular modes of finance and is unlikely to be systemic. One mode of finance in which constraints may be serious is the supply of the smallest-sized loans. Collateral is not taken by banks for these loans because the costs of assessing the collateral's worth, and collecting it in the case of default, are too high relative to the size of the loan. In this connection, when banks assess loans based on personal credit history, and there are borrowers who combine potentially viable projects with poor credit histories, then public intervention can be valuable. A range of issues in the design of micro-lending is discussed in Chapter 9.

More problematic than the supply of credit may be the provision of small amounts of equity, especially for start-ups. This is largely a consequence of the fact that for venture capitalists the costs of managing investments are more or less invariant with respect to the size of the deal. So small-scale investments are relatively unattractive. In addition, there are often superior risk-return opportunities in investments in management buy-outs and business development. Scale issues are also important because small venture capital funds – which supply the bulk of venture capital for start-ups – are limited in the degree to which they can diversify their investment portfolios. They thus incur relatively greater risk than larger funds. Furthermore, and less frequently mentioned in policy debates, demand factors can also constrain firms in adopting optimal financial structures. A greater willingness on the part of entrepreneurs to accept external equity would facilitate growth and survival for many small firms. Demand for external equity might be increased through education and tax incentives. Evidence is presented suggesting that a lack of good projects is a prime constraint on the expansion of venture capital activity.

Markets for business services and workspace might not serve all firms equally well

Many persons who start a business have only a vague conception as to how they will undertake the formation of the enterprise and its management. External business advice is essential. Whether markets work well in providing business services to new and small firms is a contested subject, but market failure may be less frequent than is sometimes claimed. The Internet is augmenting information supply to new and small firms, and many providers of technical and managerial information have a strong interest in demonstrating products, equipment and services to potential small-firm clients. In addition, manufacturers associations, chambers of commerce, universities and other bodies often provide a broad range of technical and managerial services tailored to small-firm requirements. Nevertheless, survey work conducted by the North American Business Incubators Association has found a shortage of private advisory services during the very earliest stages of enterprise creation. Alleged imperfections in this market have both demand and supply dimensions. Both sides of this market are examined in the text. It is likely that constraints in this market, while probably of decreasing significance for small firms as a whole, may be an obstacle for the smallest companies. There is also likely to be geographic variation in the extent and severity of any difficulties, with urban areas usually having a greater availability of private business services.

For a variety of reasons, small firms may express insufficient demand for training. The opportunity cost of time spent being trained may be especially high in a small venture, while training can be expensive. Owing to high rates of turnover among managerial staff, small firms may have particular concerns about their inability to appropriate the benefits of investments in training. Indeed, the share of managers undertaking formal external training is a positive function of firm size. Entrepreneurs in some small firms may also be unaware of the types of training that have greatest potential impact on firm performance. Conversely, on the supply side of the training market, the training provided is sometimes inappropriate to the specific needs of the smallest firms. In part this is because providers of training face high costs in tailoring programmes to the diverse requirements of numerous small firms.

The supply of industrial real estate is often problematic. Providing accommodation for small firms frequently holds little attraction for private investors without public support. In economically distressed areas there may be difficulties in securing tenants – especially if auxiliary infrastructure is poor – as well as long time periods in recovering investment outlays. Moreover, investment opportunities with higher returns frequently exist in other forms of real estate. There can also be serious problems in the supply of industrial accommodation in dynamic property markets. These difficulties principally relate to the superior returns available from using real estate for office space and/or housing. Furthermore, corporate property investors are often averse to the risk which unknown business propositions – such as enterprise start-ups – entail. They sometimes demand a quality of covenant from prospective tenants that many new ventures cannot meet, even if these have business plans accepted by external financiers.

Overall, the strongest grounds for intervention to encourage entrepreneurship appear to be the correction of failures in a number of specific markets on which entrepreneurs depend. Policy justifications premised on employment effects appear weak. This is because employment creation from new firm births tends to be small over the short-run, while there is only a limited population for which enterprise support is a cost-effective alternative to unemployment insurance. Policy arguments based on regeneration externalities are weakened by a lack of empirical studies on the links between local enterprise demographics and local economic development. It may be that displacement effects in poor communities are of sufficient magnitude as to seriously blunt the regeneration impact of pro-entrepreneurship strategies, especially where strategies focus on facilitating the transition from unemployment to self-employment. This is a field in which further research could have practical implications for policy. Where discrimination exists – such as against minorities, women or the disabled –

corrective and preventive policies are essential (indeed, preventive policies might be justified everywhere).

Once it is decided that there are economic grounds for public action, intervention at the subnational level may have particular advantages. The combination of major spatial variations in entrepreneurial activity, and the scope for superior resource mobilisation and allocation through local programmes, highlights the importance of local flexibility in the design and implementation of policy.

Mainstream support services should be adapted to the requirements of target groups

Most countries operate specialised schemes to assist business creation and development in target population groups and firms. These include programmes designed for women, ethnic minorities, youth and social enterprises. Entrepreneurial activity in a number of these target groups has grown significantly in recent years and is often closely linked to local communities. Chapter 6 briefly reviews what is known about entrepreneurship in these target groups and firms. It then considers how local authorities should design and implement such specialised initiatives. The emphasis is placed on selectively adapting aspects of mainstream support services, rather than establishing programmes exclusive to the target groups. Operating most businesses requires a set of generic skills – preparing business plans, keeping company accounts, managing cash flow, etc. – that do not call for separate support structures. The concept of separate programmes might also be considered to run counter to the goal of mainstreaming some target groups in economic and social life. And for development agencies with limited budgets separate programmes can involve wasteful duplication of overhead costs.

However, adapting mainstream programmes, or giving them new areas of emphasis, can be valuable. For example, peer-group support and networking among women has produced important benefits – such as increased confidence and improvements in the quality of projects. The frequent problem of a low take-up of mainstream advisory and support services among ethnic minority groups suggests that proactive outreach to these communities may be necessary. Language skills might also be emphasised in addressing the needs of some ethnic minority businesses. Mentoring and advice will be critical for young people in order to make up for limited prior experience in business. And networking – including with for-profit companies – could help compensate for the small size of social enterprises, for example in making joint approaches to banks. Hiring staff from target populations to operate support services can also help to break down communication barriers, where these exist.

Part II of the book presents a detailed discussion of policy recommendations on entrepreneurship and local development. Several of the recommendations primarily serve to chart the limits of policy. This is necessary as inappropriate expectations can lead to resources being used in unproductive ways. Other recommendations are more prescriptive as regards the specifics of programme design and operation. The recommendations are organised around three themes: strategy, finance and programme design. Each recommendation is addressed to the level of government that possesses the relevant policy competence: national, national and local, and local. The overarching challenge that the guidelines seek to meet is to maximise the advantages of increased entrepreneurship while minimising the drawbacks.

Important policy trade-offs are inevitable

Policymakers are seen to face a number of important strategy choices. For instance, it is likely that the greatest contribution to overall employment creation will come from the entrepreneurs who have the highest probabilities of success. However, a policy of focusing support on this group will entail high deadweight. This is because the individuals most likely to succeed are also those who are likely to enter entrepreneurship in the absence of support. Lower deadweight might be achieved by promoting enterprise among the unemployed and low-income groups – if programmes cause individuals to enter into business who were less likely or able to become entrepreneurs. But orienting policy in this way will have the drawbacks of higher rates of enterprise displacement and more limited employment creation. So a dilemma facing policymakers is that there is a trade-off between deadweight and enterprise success or – stated in other terms – between equity and employment. One way to attenuate this trade-off is to focus on identifying and lowering barriers to entrepreneurship that do not bear a systematic relationship to enterprise viability, such as gender and racial discrimination. Similarly, support can be focussed on barriers that do not always indicate a low likelihood of business success, such as the lack of an adequate credit history. Such approaches could facilitate entry among persons who have viable projects. Programme deadweight might thus be reduced without raising rates of enterprise failure. However, even if such a targeting strategy is successful, some degree of trade-off will still remain.

Another widely debated policy choice concerns whether to direct support to established firms and/or enterprises with high growth potential, or whether to prioritise support for the creation of new enterprises. Focusing assistance – particularly advisory services – on newly created businesses has been argued against essentially for two reasons. The first is that failure rates are significantly lower in established enterprises. So there will be resource waste if programmes support new firms because, as a group, these have high mortality. The second is that only a small number of more mature fast-growth enterprises account for the bulk of private-sector job creation. However, there are a number of counter-arguments to a blanket policy of prioritising incumbent enterprises. Firstly, if programmes can enlarge the pool of high-quality new firms then the number of fast-growth job-creating firms is also likely to rise. Second, some of the alleged failures in the markets important to entrepreneurship are probably more serious at the early-stages of a business venture. Third, with the passage of time the firms that grow tend to become less embedded in local economies. They sell and source a larger part of production and inputs in out-of-area markets. Consequently, new rounds of enterprise creation could bring specifically local economic impacts. Furthermore, proposals to target advice on fast growth companies also have drawbacks, depending on how the advice is delivered. For instance, identifying potential fast growth firms is uncertain. In addition, a policy of targeting based on growth potential could entail significant redundancy, because fast-growth firms are more likely than other enterprises to identify and develop their own private sector information sources. And growth-based targeting would lead to controversial inequalities in access to services. For instance, in line with the research described in Chapter 6, if priority were given to growth prospects, female entrepreneurs would be excluded from service support more often than males.

Accordingly, it may be advisable for policy to facilitate high-quality start-up *and* support existing small firms. As outlined in the text, the appropriateness of a balance between the two must depend on specific local circumstances.[5] At the same time, arguments against support for early-stage firms need to be taken seriously, with measures adopted to minimise the resource waste that a concentration on start-ups could involve.

The goals of strategy and policy must be clear

Chapter 8 presents recommendations on strategy for both central and local governments. Emphasis is placed on the need to make the strategic and policy goals of enterprise support explicit. In many countries an ensemble of programmes and institutions aims to meet diverse and changing objectives that may not be mutually coherent. Different goals are frequently pursued simultaneously, with little strategic specification. A transparent and logical alignment is needed between programmes and objectives. Making strategies explicit will also help to assess their feasibility prior to implementation, to make policy trade-offs clear, and to provide a framework for evaluations of policy. To help avoid duplication and competition among programmes it is also important to consider incorporating new aims into existing institutions, rather than creating new organisations.

Chapter 8 also stresses the importance of adopting a commercial approach in providing services to expand entrepreneurial activity. If properly harnessed, the creativity, resources and know-how of markets can provide powerful support to policy. However, local and regional policymakers often appear to overlook the role of markets. Adopting a commercial orientation will help to avoid the displacement of private suppliers and the crowding out of private-sector jobs. It will also help to reduce unfair competition between programme beneficiaries and non-beneficiaries. Furthermore, attending to market signals is likely to increase the probability that programmes are relevant. And working through markets can mobilise resources additional to those of the public sector. A market orientation also has the potential for greater sustainability and therefore larger overall impact. Evidently, as described in various parts of this book, the public sector must perform critical functions that markets cannot. Indeed, in general terms, and whatever the particular cause(s), local economic distress represents a market judgement. Markets have judged that a particular location is not an attractive place to invest in or recruit from. The public sector is essential if this judgement is to be modified.

Various relatively inexpensive initiatives are open to policymakers seeking to promote public awareness of entrepreneurship and enhance its social legitimacy. However, impacts may be modest, and more research is needed to assess the overall effectiveness of schemes to foster attitudinal change. It is important that micro-enterprises are given proper attention in the system of enterprise support. While they are often the target of dedicated programmes, the smallest firms can effectively be omitted from some mainstream policy measures. Accordingly, across a range of institutions supporting entrepreneurship, attention may need to be drawn to the particular needs and opportunities facing the smallest size class of firms. Benefits traps that discourage enterprise also need to be identified and redressed. If benefits arrangements respond slowly to the changed circumstances of potential recipients then individuals may be discouraged from moving into more productive activities, especially when earnings are likely to be low and/or uncertain. This issue can assume particular significance in poor communities where a significant proportion of residents receive social or unemployment insurance benefits. However, the extent to which the design and operation of the relevant benefits are the responsibility of local authorities varies from country to country, and in many cases the key benefits are a remit of central government.

Access to training services and new communications technologies is important

Policy should seek to facilitate access to training as a means of enhancing enterprise performance. Many firms fail for reasons that do not reflect the underlying viability of the business idea. Basic managerial deficiencies account for a large part of new and small firm mortality. From a local development perspective, improving enterprise survival times can afford greater opportunity for the creation of work-related skills, increased tax revenues and a larger local economic impact. Training has a role to play both in reducing enterprise failure and improving a range of business outcomes. For instance, studies suggest that some micro-business owners do not enlarge their firms owing to problems associated with employee management and recruitment. In part this reflects insufficient time to train new recruits, but it can also be a symptom of the cost and difficulty of identifying suitable external training. Research on the impacts of different forms of training on enterprise performance produces some surprising and occasionally conflicting results, and these are considered in the text. For incumbent firms, general training has been found to have a greater effect on productivity than specific training. Training may also be more relevant to start-ups than established enterprises, owing to the fact that entrepreneurs in new firms face a more or less common set of managerial challenges. And training organised to meet distinct group needs appears to be particularly effective. Counselling is preferable for established firms, as these are likely to need more differentiated forms of assistance.

Policy should encourage small-firm usage of the Internet by taking government on-line and promoting awareness of new information and communications technologies (ICT). Early research suggests important benefits for small-firm exports, job creation and productivity from increased use of ICT. Indeed, the greater becomes the use of ICT in everyday and business life the more marginalised will be those persons and firms with limited or no access to ICT systems. Many of the policy measures enabling greater up-take of ICT among new and small firms are in the remit of central governments (such as measures to ensure transaction security). However, local authorities can take some helpful steps. For instance, policy initiatives can raise awareness of the benefits of electronic commerce, provide training, award the adoption of new technologies, and ensure the availability of specialised advisory and support services. The transition to on-line provision of government services can encourage small firms to explore Internet-based business opportunities. Small firms that engage with (local) public authorities via the Internet also experience a demonstration of this medium's utility, as well as gaining familiarisation with certification and security systems.

Despite the fact that the promotion of business creation usually has a relatively small impact on employment growth there is some room for improving local employment outcomes. Enhancing the quality of entrepreneurship will itself play a role. And scope sometimes exists for improving the effectiveness of local labour market intermediaries engaged in job training and placement, including decentralised public employment services, local partnerships and community organisations. In addition, it should be ensured that entrepreneurs are made aware of wage subsidy schemes that some governments provide for employing new workers.

The second part of Chapter 8 focuses on specifically local strategy considerations. Local strategy should seek to ensure the availability of business premises offering affordable and flexible rents. The lack of suitable premises is a key reason why micro-enterprises migrate from under-supplied localities. However, the policy response need not involve government investment in incubator-type buildings. This is a capital-intensive use of public funds, with limited prospects of cost recovery through onward sale of the property. A preferred alternative may be for public authorities to guarantee the rents of a privately funded building. Practice shows that this can be a low-risk undertaking if tenant firms are well selected. Another way to address the problems of managing small-firm workspace is to provide incentives for the scaling up of commercial investments in industrial real estate. Providers of accommodation for small firms can better diversify risk, and achieve various economies of scale and scope, if they supply more units of varying sizes in different sites. Inducing private efficiency gains by encouraging such diversification and expansion could translate into a greater availability of accommodation for small companies.

A range of measures is available for improving access to finance

Chapter 9 provides a set of detailed recommendations on expanding access to debt and equity for new and small firms. The purposes and key design features of credit guarantee schemes are described, and it is observed that some regional differentiation in the terms of these schemes may be helpful. Because of the critical importance of scale in the operation of venture capital funds, and the small volume of potentially viable deals at the local level – especially in poorer communities – regional approaches are most appropriate when public authorities promote venture funds. Equity investment might be encouraged through education and tax incentives – in order to alleviate demand-side constraints. However, for local authorities the greatest policy payoff may come through support to networks of so-called "business angels". Business angel networks aim to match informal investors with ventures seeking small amounts of equity finance. Business angels generally invest in the early stages of enterprise start-up, often in firms not yet ready for formal venture capital. Such investors frequently bring significant knowledge and experience to the investee firm and are not averse to investing in technology-based firms. Unlike the formal venture capital industry, business angels are geographically dispersed. They also invest locally. From a policy standpoint, an information barrier may exist in the market for informal venture capital. For instance, business angels are usually reluctant to publicise their willingness to invest and entrepreneurs are disinclined to reveal innovative ideas. Information and search-cost barriers on both the supply and demand sides of this market are described in the text. These barriers can be lowered through support for business angel networks.

Successful micro-lending requires specialised skills and knowledge

The book highlights that while micro-credit programmes are extremely widespread, examples of successful schemes are rare. Micro-lending is seen to operate with diverse objectives and operational arrangements. Important benefits have been reported from a number of micro-credit schemes. For example, reliance on public assistance has fallen significantly, while enterprise profitability, equity growth and take-home pay have risen strongly among clients of various major micro-credit programmes in the United States. In transition economies small firms have been brought into the formal economy. And increased employability has been registered among borrowers, especially when lending has been accompanied with training and mentoring. Positive psychological impacts have also been described from being entrusted with loans. And a frequent additional benefit is the business and support networks that schemes can create among borrowers.

However, micro-lending entails complex institutional and policy challenges. Problems of low programme sustainability and subsidy dependence are common and have a variety of causes. These include deficiencies in engaging prospective borrowers, flawed programme administration, and problems of risk management and transaction costs minimisation. The design and implementation of micro-lending initiatives needs careful attention if initiatives are to be effective and sustained. Factors important in programme design are described in some detail, following the work of Bhatt and Tang (2001) and others. Observations are organised around four areas in which improved practice is often necessary. These are: the choice of lending technique; the appropriateness of the financial products offered; the provision of non-financial services; and management procedures. The possible advantages of a system of income-contingent loans are also described, as proposed by Chapman *et al.* (1998).

Policy should be attentive to the wider issue of a lack of banking facilities in deprived localities. An under-supply of banking outlets could affect enterprise creation both because of problems of direct access to financial services and because individuals who do not have a relationship with a bank typically experience greater difficulty in obtaining bank loans. Financial liberalisation has placed many mainstream banks under acute competitive pressure, with a result that some are closing branches in local communities. The text describes key aspects of legislation in the United States designed to address under-lending in poor communities. Some countries provide banking facilities through post offices and public banks. And agreements might be encouraged among commercial banks to ensure at least one common banking outlet in small communities. Local public authorities might also commit to bank with a particular institution in exchange for an undertaking to remain in the locality.

It is important that local authorities work with local banks and other financial intermediaries to facilitate entrepreneurs' access to finance. Collaborative arrangements can offer advantages for both parties. Each organisation can provide services in which it has a distinct competence, while overhead and operational costs as well as risk can be shared. Furthermore, banks already possess loanable funds, while establishing loan funds on a greenfield basis can be protracted and costly for a support programme.

Business development agencies and local authorities can also consider the promotion of mutual credit guarantee associations. These aim to facilitate the access of firms with viable projects to bank lending from which they would otherwise be precluded. They do this by guaranteeing repayment of a part of loan losses incurred by banks. The goal is similar to that of guarantee funds, although the method of operation differs. In the mutual guarantee associations members provide a common guarantee for a loan to a single borrower. Risk is thus spread over the association members. Advantages of guarantee associations are that members working in the same industry may be able to evaluate a loan's risk more accurately than a bank, while peer pressure can help effect repayment. Mutual credit guarantee associations operate widely today in France, Italy, Japan and other countries, although there are striking differences in their prevalence between northern and southern Europe. For instance, hundreds of thousands of Italian small firms receive funds backed by mutual guarantee associations, while such schemes are barely present in the United Kingdom. In areas with little or no prior experience of these arrangements the public sector might disseminate information and possibly fund feasibility work. However, mutual guarantee associations might not be suitable for all contexts. Where mutual undertakings are unfamiliar to the local or national business culture their establishment might be time consuming and attract few participants. Countries with more developed banking systems might also deem these schemes unnecessary.

The scope and manner in which public support is provided needs careful design

Chapter 10 concentrates on key issues in the design of a range of enterprise support initiatives. Flexibility should be ensured in the operation of self-employment support programmes. For example, modalities for paying monetary assistance could vary according to the financial circumstances of individual participants. There is some evidence of greater survival rates when monetary assistance is disbursed as a lump sum, which in part reflects the enhanced ability of lump-sum recipients to establish larger non-service sector ventures. And self-employment and micro-enterprise support programmes should be designed such that budgets and capacities can be expanded during economic downturns, which usually raise demand for programme services. In supporting entrepreneurs, providing advice and counselling through a comprehensive system of public outreach is both costly and unnecessary. The aim should be to establish a system of numerous visible points of referral to commercial and not-for-profit sources of advice and information. Temporary public support to expand the availability of some types of advisory service might be warranted where this aims to increase awareness (and absorptive capacity) among small firms regarding the commercial merit of adopting particular business practices (such as ICT and its emerging applications).

Pre-start advisory and screening services appear particularly important. The effect of pre-start advice is to identify less viable business plans, to caution prospective entrepreneurs and to improve the viability of nascent firms (a well-prepared business plan for instance can facilitate access to finance). The potential benefits of pre-start advice are highlighted by evidence that the self-employed tend to be excessively optimistic about their business prospects. Persons who have been unemployed for some time will generally require more pre-start training. Charging for business planning assistance is also likely to greatly decrease take-up by the unemployed.

Various measures could help to reduce the problem of displacement

As discussed in Chapter 2, an important policy concern is that new firms might displace employment and output in existing enterprises. It was also noted that enterprise displacement is likely to be greatest among the types of firm typically present in poor localities. To help counter displacement, policy should ensure a strong marketing component in assistance programmes. This can help to diminish competition for local market share. In addition, enterprises that serve wider geographic markets regularly show superior performance across a range of parameters, including growth and survival.

Restricting the terms of business support might also serve to mitigate displacement by encouraging the creation of ventures with a larger average size of initial investment. However, as discussed in Chapter 10, strategies to increase average firm size or screen for sectoral type can have drawbacks. For instance, they will tend to channel support to persons who are likely to create a venture without the programme. Restrictive measures may also lower access for women and poorer income groups that usually undertake smaller projects.

An interesting area to focus on is the encouragement of team-based firms. Firms established by groups of entrepreneurs tend to exhibit greater longevity and more rapid growth, other things considered. Only a minority of all new firms will comprise team-starts. And the creation of co-operating teams that embody complementary skills can be challenging. Nevertheless, team-oriented initiatives appear promising in building viable firms likely to contribute to job creation.

The public sector also has a catalytic role to play in establishing private-sector-led networks. There is growing evidence that entrepreneurs who develop and maintain ties with other entrepreneurs outperform those who do not. Networks facilitate the identification of business opportunities, improve access to resources, and support enterprise management. Networks can allow rapid learning – and small companies appear to favour the peer-based learning that networks permit. Networks can also facilitate the reconfiguration of relationships with suppliers. In some instances networks have even led to a new division of labour among a group of firms, allowing individual companies to reap economies of scale and scope. Networks involving small and large firms can also help small enterprises to reach international markets more quickly and at lower cost and risk. This is an outcome that is clearly of direct interest to local policymakers.

However, business networks are not a panacea for new and small firm development. The formation of structured and durable systems of collaboration is often problematic. Many network-building initiatives have come to nothing because they presented the private sector with a set of pre-ordained services. It is likely that structuring schemes around goals and needs determined by businesses would yield greater impact. Accordingly, it is recommended that policy seek to create informed demand for network services through programmes of awareness raising. A degree of public financial support is to be expected in feasibility work, start-up activities and the costs of network brokerage. Policy also needs to be patient, with a period of three to four years often required for the establishment of a significant business network programme. And as with many enterprise development schemes the quality of programme management is critical. Persons with direct experience of small firm development should be employed as network brokers, providing advice and – if necessary – a neutral source of mediation for firms hesitant at the prospect of co-operation.

Proper evaluation and monitoring are essential

Public policy must entail a clear commitment to evaluation and monitoring. The paucity of reliable evaluative research on support for entrepreneurship strikes a marked contrast with the large sums spent on such schemes. The evaluation deficit is doubly regrettable in that local development initiatives are often intended to fulfil pilot or experimental functions. This, indeed, is one of the claimed justifications for local development approaches *per se*. But this experimental function is nullified when programmes are not properly evaluated. In fact, wasteful innovation is a weakness of much local development activity. This weakness is compounded by inadequate evaluation.

As discussed in Chapter 10, there are a number of reasons why institutional resistance to evaluation appears common. Drawbacks to the use of different evaluation parameters, such as the rate of business survival and the cost per job created, are considered at length. It is also noted that schemes sometimes have long-run indirect effects on individuals and communities that can be difficult to measure. It is likewise shown that evaluating and monitoring programmes against the wrong criteria might limit the chances of eventual success. Problems in identifying the genuine incremental impact of policy – by comparing the targets of policy with suitable comparison groups – are also described, along with ways to approach these technical challenges. An outline is presented of the strengths and weaknesses of different evaluation methodologies – experiments, quasi-experiments and participant opinion. Various forms of evaluation need not be prohibitively expensive. Collecting the right data from the inception of a programme can lower evaluation and monitoring costs. Standardising the data required from implementing bodies could also lower the costs of data collection and interpretation.

Closely related to the subject of evaluation, stress is placed on the importance of selecting appropriate measures for monitoring programme performance. The choice of such measures will determine programme outcomes in diverse and significant ways. When the continued funding of a programme depends on its record of meeting performance targets, inappropriate yardsticks can have serious and sometimes unforeseen consequences on implementation and effectiveness. The selection of performance measures is also seen to be critical in focusing programmes in order that they achieve overarching goals such as maximising additionality

– the degree to which results would not have occurred otherwise – and minimising enterprise displacement.

Better evidence could lead to better policy

Chapter 11 describes the types of research needed to improve understanding of the key policy issues. One of this book's recurrent themes is that despite widespread policy interest in fostering entrepreneurship, empirical research on the impacts of business creation on local economies is scarce. Case studies that simply describe programmes, institutions and enterprise conditions at a given point in time are already numerous and would add little to the current body of knowledge. Instead, longitudinal studies are needed in specific localities examining the key aspects of enterprise demographics and local economic and labour market performance. Such studies would ideally be undertaken using similar methodologies. In this connection, the OECD Secretariat is well placed to facilitate, oversee, standardise and help ensure the policy relevance of such studies across some or all of its member countries. Such a process could involve minimal financial outlay for individual OECD member countries, but could make a potentially important contribution to policy-relevant knowledge.

In undertaking such work data should be collected through channels that allow inclusion of the micro-enterprises that often operate below the notice of statistical agencies. Assessments of the broader economic and social multipliers of enterprise creation would be valuable. These could include impacts on local service provision and tax revenues. Incremental effects in the labour market could focus on changes in employment and wages and benefits over the short and long-term. Attention should be given to impacts on persons in different parts of the wage distribution, as well as the unemployed, with an assessment of the ways in which employment creation affects the labour market status of local residents and in-migrants. Studies could go beyond the use of gross statistics, considering the distinct effects of enterprise size and sectoral type. Ideally, a number of studies would be undertaken in different types of locality, such as outlying estates, inner city areas, remote rural localities, and towns dependent on a small number of economic activities.

A greater understanding is also needed of the effects and optimal operational modalities of different types of enterprise support. For instance, for self-employment initiatives, additional research would be helpful on whether there are significant differences in programme outcomes if financial support is provided in the form of either lump sum or ongoing payments. Evidence on other effects of self-employment support would also be valuable, such as post-programme asset accumulation and psychological and physical

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wellbeing. Other commonly used programmes, such as business advisory services, management training and micro-lending, require further analysis and evaluation. For a range of programme types it would be useful to have more data not just on the cost per net job created but, in addition, the costs of providing employment per person removed from the unemployment register. Such assessments could be of great help in allowing public bodies to better allocate their limited budgets.

For ease of reference the book's policy recommendations are summarised here in Box 1 (and again later in Box 5).

As described in different parts of the text, this book is one of a number of OECD/LEED publications produced in recent years that examine various dimensions of entrepreneurship. This book also draws on an ongoing series of seminars, conferences and fora that address issues linked to enterprise creation and employment. For example, various papers cited in this report were first presented at The International Conference on Self-Employment, which took place in Burlington, Canada, in September 1998. The Conference was organised jointly by the OECD's LEED Programme, the Canadian Employment Research Forum, and the Canadian International Labour Network. For further information on recent and forthcoming events dealing with the themes treated in this book readers are invited to visit the LEED website at *www.oecd.org/els/leed*

Box 1. Summary of policy recommendations

Strategy *(For both national and local levels of government)*

- Make the strategic and policy goals of enterprise support explicit.
- Do not view the promotion of micro-enterprise as a solution to social exclusion for large numbers of individuals.
- Adopt a commercial approach to service provision.
- Promote public awareness of entrepreneurship using a variety of media.
- Ensure that micro-enterprises are given proper attention in the system of enterprise support.
- Identify and redress benefit traps that can discourage enterprise.
- Facilitate access to training as a means of enhancing enterprise performance, job creation and survival.
- Encourage small-firm usage of the Internet by taking government on-line and promoting ICT awareness.
- Expect limited short-term employment creation from entrepreneurship promotion, but examine measures to enhance local employment impacts.

Strategy *(For the local level of government)*

- Seek to ensure the availability of business premises offering affordable and flexible rents.
- Make local regulations current and minimise their burden on enterprise.

Finance *(For the national level of government)*

- Consider introducing regional flexibility in the terms of national loan guarantee schemes, reflecting regional differences in the real value of the housing stock.
- Consider the creation of incentives for bank support to micro-finance initiatives.
- Pay careful attention to the design and operational characteristics of micro-finance programmes.
  - ❖ Consider using income-contingent loans
- Ensure effective enforcement of anti-discrimination laws in bank lending.
- Address the broad issue of a lack of banking facilities in deprived localities.

Box 1. **Summary of policy recommendations** *(cont.)*

Finance *(For the local level of government)*

- Work with local banks and other financial intermediaries to facilitate access to finance for entrepreneurs.
- Consider the promotion of mutual credit guarantee associations.
- Encourage equity investment through education and information, and support networks of business angels.

Programme Design *(For both national and local levels of government)*

- Consider incorporating new objectives into existing institutions rather than creating new organisations.
- Ensure flexibility in the operation of self-employment support programmes.
- Design self-employment and micro-enterprise support programmes such that budgets and capacities can be expanded during economic downturns.
- Aim for visible points of referral to professional advisors, as comprehensive programme outreach by public bodies is costly and unnecessary.
- Ensure access to high-quality pre-start advisory services.
- Carefully select monitoring and performance measures as these shape programme outcomes in diverse and important ways.
- Systematically evaluate programmes and policies and ensure that evaluation findings inform policy.

Programme Design *(At the local level of government)*

- To help counter displacement effects ensure a strong marketing component in assistance programmes and consider restricting the terms of business support.
- Encourage the creation of team-based firms.
- Examine where the public sector can play a catalytic role in establishing private-sector-led networks.
  - ❖ Implement broad campaigns to introduce the networking concept to businesses.
  - ❖ Expect to provide some financial support in feasibility work, start-up activities and the costs of network brokerage.
  - ❖ Work with realistic time-frames.
  - ❖ Ensure the presence of experienced network brokers.

Notes

1. Despite its overarching presence in market-based economies, entrepreneurship is a surprisingly elusive concept. Definitions have proved hazardous unless framed in general terms. In part this reflects differences in the qualities that commentators have ascribed to entrepreneurs – such as risk-friendliness – prior to defining entrepreneurship. There is no common agreement on what would constitute a reliable set of indicators of entrepreneurship. For varied reasons, some analysts have emphasised rates of enterprise start-up. Some have focused on owner-managed small and medium sized enterprises, and still others concentrate on fast-growing firms, both new and established. None of these perspectives completely encompasses the state of entrepreneurship: each takes an aspect of it. In this report entrepreneurship is understood simply as the act of identifying and seizing new business opportunities (OECD, 1998). The analytical focus is placed on the creation of autonomous new firms and the development of self-employed, micro and small enterprises, particularly during the early years of trading. It is recognised of course that there are important differences among some countries in how "self-employed" and "small-scale" enterprises are defined.
2. Schreiner (1999).
3. In Japan, for example, in the face of concerns over joblessness among persons in their early sixties, and a rising burden of pensions payments, the Labour Ministry will provide significant subsidies for the start-up of businesses established by three or more people over the age of sixty. Up to five million Yen covering two thirds of start-up costs will be made available following submission and approval of a business plan and an investment of at least three million yen on the part of the entrepreneurs (*Financial Times,* 27/01/2000).
4. "Globalizar la solidaridad", *El Pais,* 13/10/01, page 17.
5. Resolution of this ongoing debate in enterprise support policy also requires better evaluative research. A reason that is often cited for not concentrating on start-ups is that the resources involved will be wasted when vulnerable recipient start-ups cease to trade. This implies that it is known by how much and in what ways different forms of assistance affect the recipients. If, for instance, it were clear that programmes had little influence on survival rates then the rationale for a focus on incumbents would be greatly strengthened. In fact – and as stressed at various points in this book – there are relatively few careful quantitative evaluations of the incremental impacts of enterprise development programmes.

PART I

EVIDENCE AND THE BASIS OF POLICY

Abstract. *In many OECD member countries economic and social distress are concentrated in deprived local communities. Thousands of programmes have been experimented with as part of attempts to raise standards of living in disadvantaged localities. One of the most widely used categories of scheme involves supporting the creation and development of new businesses. Part I draws together and assesses the available research on the relationship between entrepreneurship and local economic development. Interrelated conditions are identified that are likely to hinder entrepreneurship in disadvantaged areas. These obstacles influence both the extent and form of entrepreneurial activity in poor areas. Key propositions are examined regarding the links between the rate of self-employment and local economic change. The strengths and weaknesses of enterprise promotion as a local development strategy are explored at length. A comprehensive assessment is made of the economic rationales for public policies that encourage entrepreneurship in local economies. And a detailed review is presented of the empirical and theoretical studies of purported failures in markets that support entrepreneurship, in particular in markets for financial, industrial real estate, business development and training services. Many countries operate specialised entrepreneurship programmes for women, ethnic minorities, youth and social enterprises. Part I reviews what is known about entrepreneurship in these target groups and firms. It then considers how local authorities should design and implement such specialised programmes.*

ISBN 92-64-19978-0
Entrepreneurship and Local Economic Development
Programme and Policy Recommendations

PART I

Chapter 1

Local Economic Development and Entrepreneurship

Macroeconomies and entrepreneurship

Across the twenty-nine countries surveyed in the 2001 *Global Entrepreneurship Monitor* – including twenty-two of the thirty OECD member countries – an average of just under ten per cent of the adult population was starting a new firm or owning an active business. At a macroeconomic level it is increasingly clear that entrepreneurship is one of the keys to economic dynamism and job creation (Reynolds *et al.*, 2001). The birth of new firms fuels the drive for efficient resource use by raising the degree of product market competition (with possible benefits for consumers). At least as important, entrepreneurship accelerates the process of generating, disseminating and applying innovations in technology and organisation. This process of innovation is fundamental to sustainable growth. Company creation is in fact an essential carrier of structural change.

As part of the OECD Growth Project the OECD Secretariat has examined the micro-economic underpinnings of productivity change in a set of ten OECD member economies (mostly for the period 1989-94). This research is one of the few studies of its sort to use a common multi-country analytical framework. The findings suggest that for seven of the countries studied new firms represent a significant source of overall productivity growth. However, the contribution of new firms was not the same across all industries. The role of company creation in raising productivity was particularly significant in newer industries such as information and communication technologies (OECD, 2001).

The quantitative importance of new firms in employment creation can also be significant. From 1970 to 1985 new businesses accounted for twenty-seven per cent of annual job creation in manufacturing in Canada, and twenty-one per cent in the United States (Baldwin *et al.*, 1995). Acs (1999) and others argue that enterprise creation was critical to differences in the record of private-sector job-creation between Europe and the United States through the 1990s. Across the countries studied by the OECD (OECD, 2001) some five to ten per cent of employees are directly affected by enterprise creation and exit each year.

More broadly, a sizeable literature suggests that a dynamic small firms sector brings with it particular micro- and macroeconomic benefits. For instance, Robbins *et al.* (2000) highlight the role of small firms in maximising the utility of labour and capital through their use of secondary resources in the marketplace (such as first-time labour market entrants). They also emphasise the highly self-adjusting character of small firms in the face of changes in resource costs. The inference drawn is that a population of dynamic small firms will help to attenuate trade-offs between employment and inflation. In this connection, the authors found that in the United States, States with high proportions of employment in small and micro-enterprises have experienced higher productivity and growth of State income, and lower wage inflation and unemployment.

Examining the impact of entrepreneurship on local economies

As a means of generating jobs and raising incomes, increasing rates of enterprise creation is an almost universal concern among local authorities. Along with efforts to attract investment, stimulating entrepreneurship is one of the two pillars of most local and regional development strategies. Nevertheless, few empirical studies have systematically examined the relationship between the creation of new firms and local economic development. A greater understanding exists of the interactions between enterprise births and national and regional economic development. Consequently, much that is written on the encouragement of enterprise as a local development strategy is based on inference from national and regional data and analyses. Such inference is not always reliable, as some aspects of the relationships between firms and local economies do not operate in the same way over larger areas.

Variations in business activity across distinct types of locality have also been under-researched. Local areas with distinct characteristics exhibit markedly different enterprise demographics. For instance, within urban areas the inner city may be home to a large number and variety of firms. However, peripheral estates often contain fewer companies. Inner city districts may be near to high-income markets, transport facilities and business contacts, all of which are conducive to enterprise survival and growth. Large urban areas can provide easier access to public and private business support services. And commercial opportunities and the density of networks are usually more limited in rural areas than in urban centres. Patterns of enterprise can also differ in local areas that depend on a small number of dominant economic activities, such as mining towns.

Enterprise birth rates differ greatly across regions

Rates of enterprise creation differ markedly across *regions* within OECD member countries. Some regions have annual firm birth rates two to six times higher than others (Reynolds *et al.*, 1994). Significant influences on enterprise creation can vary from one region to another, and have been shown to include the following:[1]

- demographics, as more densely populated areas, regions with young populations and urban areas tend to start more firms;
- unemployment, which for different reasons can both encourage and diminish rates of company creation;
- wealth, with more affluent areas expected to have high rates of enterprise creation owing to higher levels of demand and a greater availability of capital;
- educational and occupational characteristics of the workforce. For example, there is a positive link between the proportion of managers in the workforce and the level of firm creation (Gavron *et al.*, 1998);
- the prevalence of small firms, it being argued that employees in small businesses will aspire to own other small businesses;
- the extent of owner-occupied housing, given that property is an important source of collateral for the financing of enterprise start-up (and development); and
- infrastructure endowment, which is positively associated with investment demand. For example, public traffic infrastructure has been important in determining the distribution of start-up activity across Germany's regions (Egeln *et al.*, 1997).

The presence of large numbers of firms working in the same sector may also promote entrepreneurship (Garofoli, 1994; Reynolds, 1994). While impossible to fully capture in quantitative terms, a region's history might play a role, particularly if imitation is instrumental in the spread of entrepreneurship (see Chapter 3). In most cases the direct influence of public policy on regional start-up rates appears negligible.

Regional growth is broadly associated with enterprise creation

Evidence suggests that fast-growing regions tend to have high rates of enterprise formation. Based on an analysis of data from close to four hundred labour market areas across the United States Reynolds (1994) tentatively concluded that high business birth rates precede increased regional net job growth. High rates of enterprise creation were found to play a statistically significant role in regional growth in Sweden (Davidson *et al.*, 1994). And Ashcroft and Love (1996) showed a strong positive relationship between employment change and new firm formation across English counties in the 1980s. In the United States, the underpinning to federal entrepreneurship strategies was provided in part by the statistical work of David Birch. Birch (1987) – the statistical basis of which has been the subject of some debate among economic geographers – identified business formation and the growth of small firms as the major factor differentiating growing and declining regions.

However, the evidence is not uniform. For example, Fritsch (1997) found no significant relationship between start-up activity and employment in (West) German planning regions. In another study examining (West) German planning regions Audretsch and Fritsch (forthcoming) showed that neither a high rate of enterprise births, nor a high rate of entry and exit combined, were sufficient for growth. The authors likewise observed interesting changes over time. The rate of company creation had no significant influence on the growth of employment during the 1980s. But regions with higher start-up rates did have higher employment growth during the 1990s. This was explained as reflecting change in "growth regimes".[2] New *and* incumbent firms had made significant contributions to economic development at different times. These findings suggest that in some locations large firms will make a greater contribution to growth, while in others a more important impact will come from small firms. By implication, a policy setting that facilitates entry and attends to the needs of incumbent firms appears advisable.

In summary, the evidence suggests that the creation of new firms is positively associated with the growth of regional economies. New firms in manufacturing appear to make a particularly important independent contribution to regional growth (Reynolds, 1994). However, the level of enterprise births is itself an outcome influenced by other causes of growth. Enterprise creation therefore appears to be a necessary if not sufficient condition of regional growth.[3]

Few studies have examined entrepreneurship and economic development across local areas

As previously mentioned, there are few empirical assessments of the impact of entrepreneurship on local economies. However, data from the United Kingdom broken down by local authority area show a broad tendency for disadvantaged areas (assessed on a multiple index of deprivation that includes unemployment) to have comparatively low levels of enterprise births (Westall *et al.*, 2000). Nevertheless, this relationship is not straightforward. Some areas of significant deprivation were also seen to experience high rates of firm creation. Indeed, fourteen out of the twenty most deprived Local Authorities in the United Kingdom were found to have an income per capita in line with or above the European Union average.

The relationship between firm creation and employment in local economies is often uppermost in the concerns of policymakers. Some of the regional and local studies already cited suggest that the connection to net job creation is ambiguous. In fact, a number of conceptual, measurement, and labour market considerations will make a straightforward relationship between firm creation and local (un)employment hard to detect. For example:

- Causation between enterprise creation and unemployment is likely to operate in both directions. Rising unemployment can stimulate the birth of new firms because for a part of the workforce the opportunity cost of becoming an entrepreneur will fall. Conversely, a low rate of job creation, which is affected by the level of company births, also influences the rate of unemployment.
- Gross statistics can hide the sectoral mix of enterprise formation. This mix might affect employment growth. For instance, new enterprises in manufacturing typically have more employees than new firms in the service sector. And highly innovative companies might be associated with growth-inducing "spill-over" effects.
- Much micro-enterprise activity is below the notice of statistical agencies. In the United Kingdom data on value-added tax (VAT) registration fails to capture businesses with an annual turnover of less than fifty-four thousand pounds. Such statistical oversight limits understanding of the impact of entrepreneurship on poorer locations, because it is here that micro-entrepreneurial activity is particularly common. Indeed, data collected by banks on the opening of new accounts show a wider geographical spread of business activity than is indicated by VAT registrations.
- Adjustments in rates of labour force participation and/or population change resulting from migration and commuting (particularly at the local level) will influence the rate of registered unemployment. Whatever its source, employment growth is not a sufficient condition for a reduction in regional or local unemployment (this is illustrated quantitatively in "Disparities in Regional Labour Markets", in OECD [2000]).
- Because of migration and travel-to-work patterns the link between new firms and unemployment might be sensitive to where a locality is. And because internal migration propensities appear to vary across national labour markets the relationship between employment outcomes and enterprise creation across local economies might depend on the country being examined. Similarly, this relationship could change over time in any given country. For instance, the implementation of policies that lower the transaction costs of buying or renting accommodation could facilitate internal migration, weakening the link between local job creation and local employment.

- Variation in key features of the population from one place to another – features such as educational attainment or incidence of long-term unemployment – would also affect correlations between entrepreneurship and changes in local labour markets.
- Access to factor markets is also uneven across locations. For instance, in most countries there are significant regional disparities in the supply of formal venture capital. Similarly, infrastructure endowment and the quality of public programmes and institutions can differ from one area to another. All such inter-location differences can affect the size and growth of new firms.
- The local geographic units from which start-up data is collected might easily include both rich and poor adjacent neighbourhoods. This could lead to an inaccurate depiction of the underlying relationships.
- The phenomenon of co-existing growth and unemployment in local and regional economies, which is not uncommon, also reflects the fact that businesses sometimes operate with few links to local product markets, while salaries may be spent outside of the locality. This implies that a given rate of enterprise creation in localities with different local supply and retail opportunities is likely to have different local multiplier effects.

The above are just some of the considerations which suggest that the relationship between entrepreneurship and (un)employment across local economies will reflect a broad range of influences. Careful controls would be required to identify this relationship statistically, and there would be significant challenges of interpretation. By examining a number of localities in detail over time – which has rarely been done – the relationship between new firms, local economic growth and a range of labour market outcomes might be pictured more clearly. In this connection, the next section considers the mechanisms through which entrepreneurship can impact on local economies.

Channels through which entrepreneurship can shape local economies

The principal routes through which the birth of new firms can affect local economic development include:

- Employment and incomes growth

  The investments made in establishing and enlarging new firms create jobs for owner-managers and employees. Income multiplier effects will follow for the surrounding community (but their magnitude varies greatly from place to place). Some analysts argue that small firms tend to stay within their original locality or region, and that many inject income into the area by selling to wider markets. However, newly created companies tend to serve local markets initially, reaching more distant markets as they mature. Research suggests that small and micro firms are more likely to employ local staff. The self-employed are also strongly linked to place, which largely reflects the personal services orientation of many self-employed businesses (Blanchflower, 1998). However, as discussed later, the setting up of new firms generally induces only small direct employment creation, especially over the short-run. Indirect employment effects will occur over time as workforce skills increase with periods in employment and self-employment. The creation of skilled employment in new firms might also provide incentives for individuals to invest in training.

- Increases in tax revenue

  Growth in the tax base can stem from increases in personal incomes, corporate profits, consumption, property values and payroll payments. However, there is great variety in tax autonomy among sub-national governments (OECD, 1999). In many fiscal jurisdictions growth in various sources of tax revenue will accrue to central and regional levels of government, rather than local authorities. Furthermore, the size of changes in the tax base brought about by new firms is likely to be small over the short-term. This is especially so where policy has promoted entrepreneurship by providing tax exemptions or holidays, as is common in "enterprise zone" schemes. In addition, a major expansion of enterprise activity might require some increase in public spending on services. To the extent that enterprise creation is associated with poverty reduction – an effect that is usually limited – local authority spending on welfare-related services may fall. But much of this welfare expenditure will have been financed by higher levels of government.

- Improved service provision and local income retention

  The creation of new firms can enhance the provision of local services such as retail facilities. A scarcity of such services characterises many distressed communities. For instance, a survey of twenty poor localities in the United Kingdom found that none had a supermarket or similar shops, and only five had a chemist or a launderette (Cabinet Office, 1998). Indeed, a premise of many community development programmes is that growth will be stimulated if opportunities can be provided for money to circulate longer in the local economy. An increase in the local supply of services can help to retain incomes in the locality. More broadly, enterprise creation could also raise demand for business services. A corresponding expansion in the supply of such services might make a locality a more attractive place for others to start or locate a firm in.

- Demonstration and motivational effects

  The birth of new companies might influence people's motivation. The presence and significance of this effect is of course difficult to quantify. However, anecdotal accounts suggest that a positive influence on

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expectations is possible. In this connection, studies of inner-city deprivation in the United States and elsewhere have stressed the socially corrosive effects of a lack of employed role models (Wilson, 1996). Positive role models may be particularly important in countering ethnic and gender discrimination (Reynolds *et al.*, 2001). The possibility that imitation is important in spreading entrepreneurship is discussed in the next chapter.

In a related field, a growing literature on so-called "social capital" highlights the economic assets inherent to social relationships. Economic benefits are held to derive from such phenomena as social ties, sense of purpose, role models and social cohesion (OECD, 2001a).[4] While the theoretical and empirical basis of the social capital literature is not fully fledged, some of the insights it provides add weight to the view that an expansion of productive enterprise could have welcome demonstration effects in distressed areas.

It should be noted that some of the above effects – particularly employment and incomes growth, and increases in tax revenue – can also result from growth in existing local firms.

Inner city regeneration and enterprise development: a focus of increasing policy interest

Amongst others, Michael Porter (1995) has in recent years brought attention to the commercial advantages of America's inner cities, and the importance of exploiting these as part of a programme of economic revitalisation. These advantages are held to include: frequent proximity to high-income markets and transport networks; population densities permitting high levels of consumer spending per unit area; and a labour force with skills which, while often moderate, are valuable to significant numbers of firms. As described in detail in this publication, scope certainly exists to further urban regeneration through pro-business strategies. However, Westall *et al.* (2000) note that Porter's analysis is of limited relevance to some areas of urban disadvantage. Peripheral housing estates, for instance, are often distant from city centres and poorly served by public transport. Their residents may experience multiple forms of deprivation, including extended periods without work, and sometimes have limited prospects in the mainstream labour market. The ways in which such characteristics can impede entrepreneurship in local economies are considered in the next chapter.

Notes

1. See Storey (1994) and Reynolds *et al.* (1994) for reviews of a variety of studies.
2. The authors derive the concept of a "growth regime" from the theoretical and empirical literatures examining technological innovation under different forms of industrial organisation.

3. By contrast, there is strong evidence that location affects enterprise growth and survival. Storey and Wynarczyk (1996) and Littunen *et al.* (1998) show that location is a factor in explaining the longevity of young businesses. For instance, in the United Kingdom, firms in remote rural areas and urban locations have been less likely to grow rapidly (Storey, 1994).

4. For instance, a commercial environment characterised by mistrust could require that entrepreneurs make unproductive investments in mechanisms to defend against the potentially opportunistic behaviour of counterparts. Similarly, in low-trust environments the time spent by entrepreneurs in monitoring the behaviour of workers and partners might be significant, and is time unavailable for innovation. In economies with little social cohesion resources can be employed unproductively on a range of services and behaviours to protect property rights. Government policy may also have added credibility in high-trust economies. And the quality of policy might be superior in localities with a strong civic tradition and a high degree of political participation.

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ISBN 92-64-19978-0
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PART I

Chapter 2

Barriers to Entrepreneurship in Disadvantaged Local Economies

A set of interrelated conditions hinder entrepreneurship in disadvantaged areas. These obstacles affect the extent and form of entrepreneurial activity. They also influence the likelihood that such activity will be successful once begun. Indeed, a number of studies show that start-ups in disadvantaged areas tend to have slightly higher failure rates than elsewhere. Most of the barriers to entrepreneurship are not exclusive to disadvantaged areas. However, they are often more pervasive and severe in poorer localities. Key impediments to entrepreneurship in deprived communities are described in this chapter.

Limited social and business networks

In distressed areas social and business networks are often limited. The unemployed frequently have few social networks. Unemployed men tend to meet predominantly with other unemployed men (Gallie *et al.*, 1994). They often lack the information and contacts that can present a route into unskilled and semi-skilled work (Smith, 1999). Ownership of a car or even a telephone – both important tools in building networks – is often less prevalent among the long-term unemployed. The scarcity of networks is highly significant for business, with various strands of research demonstrating that entrepreneurs who maintain and develop contacts with other entrepreneurs tend to be more successful than those who do not (see Chapter 10).

Low levels of effective demand in the local economy

Low levels of effective demand are a symptom of low incomes and savings in the local population.

The value and system of tenure of housing

In many deprived areas the value of housing is low and/or potential entrepreneurs live in rented accommodation. This can constrain enterprise creation owing to the fact that housing is an important source of collateral for financing the establishment (and development) of new firms.

Constraints in access to finance

The problem of constraints in access to finance has a number of dimensions. On the one hand, limited financial assets among poorer groups can restrict the ability to post the collateral required in loan applications. In addition, finance for enterprise creation typically comes from own-resources, family members and friends. But in deprived areas many of these persons will have low incomes and limited savings. This could constrain start-up and/or necessitate a greater reliance on bank lending. Poorer individuals may also have a limited history of banking. Lacking a sound relationship with a bank, their credit scoring is unlikely to be favourable. Research has shown that the duration of an entrepreneur's prior unemployment can be important in determining the size of the initial investment in the new business (Cowling and Hayward, 2000). The longer–term unemployed may also have smaller cash reserves with which to cover working capital. Consequently, persons who have experienced longer episodes of unemployment may establish firms in sectors with low capital requirements and minimal barriers to entry. Such firms are usually exposed to acute competition and generally have low rates of survival.

Another side of the financing issue relates to discrimination. For a variety of reasons some ethnic minorities are concentrated in particular localities. In some countries there is robust evidence that certain minority groups have unequal access to bank lending. For example, Blanchflower *et al.* (1998) assess whether the likelihood of receiving loan approvals in the United States varies across different racial groups with identical financial backgrounds. Using data from the Federal Reserve Board and the Small Business Administration, the authors examine whether minority-owned firms that are similar to non-minority-owned firms in all other observable respects are more likely to be denied credit. The analysis suggests that businesses owned by African-Americans, and to a lesser extent Hispanics, are less likely than similar white-owned firms to obtain credit. This rigorous study also provided qualitative evidence that minority-owned firms are much more likely to feel discouraged in obtaining credit to finance entrepreneurial activities.

Lack of work experience and skills amongst residents

It is clearly not the case that all persons in disadvantaged areas lack labour-market and/or entrepreneurial skills. But in many poor localities individuals with the relevant skills and experience are relatively scarce. Entrepreneurs tend to gather business ideas from previous work history. For example, in line with many similar surveys, Fielden *et al.* (2000) found that over eighty per cent of entrepreneurs had created businesses based on previous work experience. Populations comprised of individuals who have never worked, or whose work history is limited, are likely to produce low numbers of viable business proposals.

Skills and experience are also crucial to enterprise survival. For example, Cressy (1999) has shown that after controlling for the effects of human capital, financial capital is a relatively unimportant determinant of business longevity. Those who enter self-employment from unemployment tend to operate more short-lived ventures than those who enter from employment. And Cowling and Hayward (2000) showed that enterprises established by the short-term unemployed are more likely to survive than those created by the long-term unemployed. The authors identified a threshold effect at twelve months of prior unemployment, beyond which the probabilities of business survival fell sharply. The duration of unemployment was also seen to be critical in determining the level of enterprise capitalisation. Other empirical literature – such as Evans and Jovanovic (1989) and Bates (1997) – also suggests a fundamental role for the human capital of the entrepreneur.

Past experience in the same industry in which the entrepreneur is starting is also a key factor in business survival. For instance, in a study of one thousand seven hundred new firms in Upper Bavaria Brüderl and Preisendörfer (1998) found industry-specific experience to be the most important among a number of human capital variables in terms of enterprise duration and growth. Such considerations are again directly relevant to those who attempt entrepreneurship with a limited record of previous employment. Furthermore, studies in the field of industrial organisation suggest that it is in firms in low technology sectors that prior experience has a relatively greater impact on the likelihood of survival (Caves, 1998). Such low-technology sectors predominate in poorer localities.

Research suggests an important role for inter-family transfers of skills and knowledge in determining whether individuals enter self-employment (see Laferrere and McEntee [1995] for a study using French data). However, opportunities for inter-family transfers of skills may be few if a spouse is unemployed, as is frequent in poor households. Better educated entrepreneurs appear better able to deal with government regulation in a cost-effective manner (Bearse, 1988). And work experience in a small firm also appears to be associated with increased interest in becoming a small-business owner (Storey, 1994). All of these considerations highlight that entrepreneurial inertia is likely in communities in which unemployment has been common and protracted and average levels of human capital are low.

Lack of role models

The diffusion of entrepreneurship appears to involve an element of imitation. If this is the case, a lack of entrepreneurial role models may have important repercussions in local economies. Inference from various strands of enquiry points to the probable importance of imitation. For example, in the United States, between 1970 and 1991, having a husband who was self-employed in the previous year nearly doubled the likelihood that a woman would enter self-employment the following year (Bruce, 1998). This probability rose further if a husband was self-employed at the time a woman was contemplating a transition to self-employment. Surveys elsewhere find a strong inter-generational component in the transmission of entrepreneurship, with entrepreneurs often coming from families with prior experience of business ownership. For instance, a recent examination of successful inner-city firms in the United Kingdom found that almost half the entrepreneurs surveyed had immediate family members who had owned a business (Ramsden *et al.*, 2001). In France, in the early 1990s, around eighty per cent of recent entrepreneurs came from entrepreneurial families (APCE, undated). Similarly, in Sweden, individuals trying to start a business are more likely to have self-employed parents (Delmar and Davidsson, 2000). And people who just know an entrepreneur are more than twice as likely to enter business as those who do not (Reynolds *et al.*, 2001).

Undoubtedly, the results of such studies have much to do with the transfer of skills from actual to potential entrepreneurs, rather than the effects of imitation. However, it is plausible that imitation is also exerting an influence. Indeed further support for the imitation hypothesis is provided by evidence that children's intentions to enter self-employment are affected by whether they consider their self-employed parents to be successful or not (Scherer *et al.*, 1991).

Evidence for a role for imitation can also be gathered from a different field entirely. Audretsch *et al.* (2002) examined the impact of the Small Business Innovation Research programme in the United States. The commercialisation of research brought about by this awards programme was found to have had an important secondary effect. That is, following examples of success, other scientists had been induced to attempt entrepreneurship. And from still another area of enquiry, Audretsch and Stephan (1996) showed that demonstrations of entrepreneurial success were important in creating clusters of scientists in biotechnology firms. Indeed, numerous accounts of the development of local concentrations of firms cite the demonstration effect exerted by even small numbers of successful entrepreneurs. Such effects have in some cases lead to the economic specialisation of entire localities.[1]

Bringing together all of the suggestive trails of evidence noted above leads to the conclusion that imitation might well have a significant independent influence on start-up decisions. Therefore, in places where rates of enterprise creation are low – and if imitation is important – low rates of future start-up should be expected, other things considered.

Cultural obstacles

Cultural obstacles can include linguistic barriers and residents' lack of affinity with mainstream institutions.

Lack of personal motivation

Low levels of personal motivation can be a result of extended unemployment or inactivity.

Sectoral clustering

Poorer localities often contain a disproportionately large share of firms in mature, low-growth, easy entry markets. These are industries in which skill and capital requirements are relatively limited and in which barriers to entry are low. The phenomenon of sectoral clustering has important implications for policy. In particular, it relates directly to the severity of enterprise displacement effects that might arise following the promotion of entrepreneurship. These effects are discussed in detail in Chapter 4.

High rates of crime

Crime is often a serious concern for persons living in disadvantaged locations. Crime also forces companies to invest in unproductive assets such as security systems. And fear of crime can discourage skilled and more mobile workers. Research on successful inner city companies has identified actual and perceived crime and vandalism as a constraint on business (Ramsden *et al.*, 2001).

Problems of transition from reliance on benefits

The complexity of benefits regimes, and problems in making the transition from reliance on benefits, can pose obstacles to entrepreneurial activity. Becoming self-employed can involve the loss of a range of benefits associated with unemployment insurance, housing, local taxation, school meals, maternity leave, dental and other forms of health care (although various self-employment support schemes ensure the retention of different forms of income and social insurance). Persons considering the creation of an enterprise might find themselves worse off initially if benefits are terminated prior to receiving income from the firm. Exclusion of the self-employed from a range of in-work benefits may also discourage some of the unemployed from attempting self-employment.

The way in which the legitimate benefits claims of self-employed applicants are treated can also be a disincentive. As their incomes are liable to fluctuation, and may be difficult to document, the claims of the self-employed

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can be subject to unusual delay. If benefits arrangements respond slowly to the changed circumstances of potential recipients, individuals may be discouraged from moving into more productive activities, especially when earnings are likely to be low and uncertain. And an inadequate availability of easily understood information can lead to uncertainty among some persons regarding the benefits they would be entitled to should they opt for self-employment. Such so-called "benefits traps" can also encourage businesses to trade illegally.

Typically, the share of households in which both partners are unemployed and/or receiving benefits is relatively high in poor localities. Complex economic and social dynamics can result for households in which both partners receive benefits (which might be assessed on a number of criteria on both an individual and a family basis). These dynamics can create a disincentive for enterprise and work.

The self-employed may also be required to complete an onerous number of administrative and benefits-related forms for local and national authorities. In the United Kingdom, Duggan (1998) observed that: "the self-employed may have to account for themselves at different times, in different ways and under different rules to the Inland Revenue, VAT officials, the Department of Social Security, local authorities, and other agencies…" If government agencies fail to harmonise their information requirements, as well as the methods they use to assess income, some individuals may be discouraged from formal self-employment and business ownership. Furthermore, the reporting burden is often greater for the self-employed with employees.

In localities where a significant fraction of residents receives social benefits or unemployment insurance the issues described here may assume particular significance. However, the extent to which the design and administration of the various benefits in question are the responsibility of local authorities varies from country to country.

Government regulation

The costs of registering a new business are negatively related to enterprise creation (Djankov *et al.*, 2000). Indeed, business start-up costs have been tentatively linked to variations in employment levels across a number of major OECD economies (Fonseca *et al.*, 2001). Government regulations determine the administrative burden of starting and managing an enterprise. They can also influence the terms of access to finance and the availability of alternatives to entrepreneurship.[2] Studies coincide in finding that regulatory burdens have the greatest effect on smaller firms. For example, in Australia Chapman *et al.* (1998) observe that the internal costs of taxation compliance are disproportionately high for small firms. Even the understanding of tax compliance can be problematic (Fielden *et al.* 2000). In many OECD countries proposals for regulation that might impact on small firms now require a Regulatory Impact Analysis. And in recent years almost all OECD member countries have adopted measures to reduce the regulatory burden on small enterprises.

Countries vary as regards the presence of legal or regulatory barriers to self-employment. For instance, in the United Kingdom it is legally possible for anybody to establish themselves in self-employment in almost all sectors, except for the accounting, legal and medical professions. This is unlike the situation prevailing in Germany where occupational qualifications can be a pre-requisite to entry. The sheer diversity of institutions and regulations that the self-employed may need to deal with can be daunting. Chapman *et al.* (1998) describe how in Australia "The institutional framework regulating micro-enterprises owned by the self-employed is highly dispersed among a vast group of federal and local public authorities". Regulations were here seen to cover issues as diverse as labour rights and benefits for salaried workers, social security, a housing fund, health and safety, training, environmental provisions, sanitary and quality measures, federal and local taxes, intellectual property rights and in some instances price controls and site rules.

The current study found little systematic assessment of the impacts on business of specifically local regulation. An exception is Bearse (1988). Commissioned by the Minority Business Development Agency, this study involved over a thousand small firms throughout the United States. While unable to directly measure regulatory costs, the report concluded that owing to the gradual accretion of state and local regulations the burden of compliance has an adverse effect on a significant share of the nation's small and minority firms. Survey responses consistently rated State and local regulation as among the more serious problems facing small and minority business owners. Scarce management resources were shown to have been be diverted from enterprise growth to regulatory compliance. Forty per cent of respondents indicated that they spent significantly more time on regulatory compliance than on marketing or business development. Of the diverse forms of regulation, insurance was the most problematic. This was followed by, in descending order of importance: contract bidding procedures, bonding, tax reporting, financial regulations, business certification, labour regulations, inspections and building codes, licensing, land use and zoning regulations, and business permits. Problems were also found to include a lack of information for businesses on State and local regulations and too little help from some government officials.

Rigid local ordinances on business activity in the home can also hold back home-based entrepreneurship (Phillips, 2002). In an era of growing e-commerce and professional home-based enterprise some of these regulations might be outmoded.

Notes

1. For instance, Mirandola, a town near to the Italian city of Bologna, is home to one of the largest clusters of biomedical firms in Europe. Yet this agglomeration has only emerged during the past thirty years. Its development stems largely from the example of a single entrepreneur who switched from working in the textiles sector to making moulded plastic products for local clinics.
2. Internationally, the regulation of entry is a sensitive indicator of economy-wide regulatory burden. Regulating the creation of new firms can also be of greater benefit to the regulators than to society (Djankov *et al.,* 2000).

ISBN 92-64-19978-0
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PART I

Chapter 3

Self-employment in National and Local Economies

Self-employment and entrepreneurship are not perfectly interchangeable categories. Some among the self-employed engage in activities that bear many of the hallmarks of entrepreneurship. They develop business plans, acquire and exercise skills characteristic of business managers, make significant financial investments, seek decision-making autonomy, and employ others (during the 1980s and 1990s around a third of the self-employed in OECD member countries were employers, although this figure varies considerably by country). However, conditions of work for large numbers of the self-employed differ little from those experienced by employees. Indeed, in most countries being self-employed confers fewer social benefits than are available to employees, as well as entailing the loss of unemployment insurance. In some instances employers have forced self-employment status on employees with the aim of eliminating financial obligations associated with waged and salaried labour. Accordingly, it is mistaken to equate all self-employment with entrepreneurship. However, supporting entry into self-employment has often been a part of a broader drive to foster entrepreneurship. For this reason this chapter considers the role of self-employment in national and local economies, as well as the scope and effectiveness of policy aimed at encouraging self-employment.

Across OECD member countries approximately thirteen per cent of the non-agricultural labour force is self-employed.[1] However, the rate of self-employment, and its rate of change, vary considerably from country to country. For instance, only a little more than five per cent of Norwegians were self-employed (outside of agriculture) in the late 1990s. This compares with approximately twenty-five per cent in Turkey and Mexico.

The level of self-employment is an outcome of interactions among diverse economic, social and policy variables. Attempts to isolate the relative importance of the principal determinants of the rate of self-employment occupy a large literature. On some issues this literature is still inconclusive. The most frequently examined determinants include the phase of the business cycle, changes in economic structure, fiscal policy, demographics, education, the effects of new technologies, evolving forms of industrial organisation (such as the contracting out of services), government regulation, and policies to facilitate self-employment. The relative magnitude of these influences is considered in OECD (2000). A review of the literature on the causes of self-employment in OECD member countries is beyond the scope of this publication. However, a number of the key propositions are briefly described in this chapter. Emphasis is placed on what insights the research on national rates of self-employment might provide regarding the links between self-employment and local and regional economic change.

Macroeconomic conditions

Cross-country comparisons show that self-employment generally declines with increases in per capita income. However, this relationship is not necessarily found across low and high-income regions within countries. For example, wealthier regions in the United Kingdom generally have higher shares of male self-employment (Robson, 1998).

A large body of research has examined connections between the business cycle and self-employment entry. There are two key inter-linked contentions. The first concerns the extent to which self-employment is encouraged by business opportunities created by economic growth. The second concerns the degree to which recession induces self-employment, as an alternative to unemployment. When growth is slow or negative self-employment might also rise if the expected probability of remaining employed falls and if the relative returns to self-employment rise (on account of reduced demand for waged labour). Adding a further distinction to the analysis, Cowling and Mitchell (1997) showed that a high rate of firm creation is associated with changes in the duration of unemployment – rather than the stock of unemployed. This suggests that self-employment might be functioning as a form of disguised unemployment for persons on the margin of the labour market. Whether either of the two broad influences predominates – the pull effect of growth, or the push effect of recession – has not been conclusively established (Blanchflower, 1998). However, while economic growth and recession can both result in increased entry into self-employment, it is likely that a period of economic expansion is important for newly established businesses to survive (Duggan, 1998). Furthermore, as most new firms initially serve local markets, fluctuations in regional and local demand will be particularly important in determining local rates of enterprise creation, survival and growth. This is especially so for the businesses of the self-employed because these tend to provide services that are not easily traded over space.[2]

To the extent that local and regional economies experience workforce migration the applicability of such models of self-employment determination is limited. In the face of local recession, for example, individuals might expand their search for jobs to a wider geographic area (although the most disadvantaged in the labour force are often constrained in doing so). By commuting or migrating, individuals in search of work might fill vacancies outside of the locality, rather than entering self-employment locally. However, the debate on the rate of self-employment and the business cycle illustrates that changes in aggregate demand can have ambiguous effects on self-employment entry, which local and regional policymakers should be aware of.

Many of the self-employed are also heavily dependent on borrowing, especially during the early stages of business creation. Consequently, high interest rates may deter entry into self-employment. Indeed, Parker (1996) found that a high rate of interest limits self-employment in both the short- and long-run.

Structural economic change

The macroeconomic transition to increased service-based activity affects rates of self-employment. This is because the service sector accounts for much higher shares of self-employment than either manufacturing or agriculture (in both of which high minimum efficient scales of production are frequent).[3] Evidently, local economies need not possess a sectoral composition of output similar to the national average. Agriculture, manufacturing or services might predominate locally, with an attendant effect on the local rate of self-employment. On account of their small size, local economies can also experience quite rapid changes in the sectoral origin of output. This has sometimes been the case following major factory closures.

Examining structural change from a regional perspective in the United Kingdom Robson (1998) estimates that growth of one per cent in the share of agriculture, forestry and fishing in regional income will lead to a rise in self-employment among males of just over three per cent. A one per cent increase in the share of construction, distribution, hotels and catering in regional income will cause self-employment among males to rise by just over four and a half per cent.

While the sectoral distribution of self-employment is fairly constant – usually being concentrated in distributive trades, tourism, catering, construction, and property and business services – there is some diversity and change over time. For example, in Italy, in the manufacturing sector, there has been an increase in self-employment in recent years resulting from outsourcing, restructuring, and subcontracting. By contrast, in agriculture and commerce – which have traditionally included large numbers of self-employed – a process of rationalisation has led to a decrease in the importance of self-employment (except for emerging activities based on communication and information services) (Belussi, 1998).

Demographics

Self-employment generally rises with age. The young have higher rates of self-employment entry. However, these are offset to varying degrees by higher rates of exit (see Lin *et al.* [2000] for evidence from Canada). Self-employment also tends to be higher among men than women. By inference, higher rates of self-employment might be expected in localities where older age groups form a large share of the population. Policymakers can also expect higher levels of demand for self-employment-related start-up services in localities where younger age groups predominate.

There is some diversity across population groups in terms of what motivates a transition to self-employment. For example, differences exist between men and women in the causes of self-employment, particularly with respect to the presence of young children. Having young children appears to encourage women to undertake self-employment instead of waged employment (possibly because being self-employed is a more flexible form of paid labour market activity). Spouses of the self-employed are themselves especially likely to be self-employed. Indeed, for a number of reasons marriage or cohabitation appears to increase the propensity for self-employment. For instance, hiring a spouse can circumvent problems of monitoring the behaviour of employees. Spouses or cohabitants can sometimes combine financial resources for investment purposes. And a partner's stable income can make it easier for the other partner to stay in self-employment (Lin *et al.*, 2000). The personal stresses of self-employment might also be mitigated by a partner's support.

In some countries ethnicity bears an important relationship to self-employment. For example, in the United Kingdom there is a higher proportion of self-employment among ethnic minorities compared to the general population. And in the United States self-employment is more common among whites than African-Americans. The mechanisms through which ethnicity affects self-employment may be many, and research is inconclusive. Both push and pull factors are likely to play a role. Higher levels of unemployment among some minorities – or discrimination in the wage labour market – could push greater numbers into self-employment. On the other hand, strong support networks, traditions of self-reliance and entrepreneurship, an ability to target niche markets, and other positive factors might pull some minorities into self-employment (these questions are considered in more detail in Chapter 6). As many minority populations are geographically concentrated, entrepreneurship among minorities is a frequent local policy concern. Indeed, many micro-enterprise programmes focus on the needs of minorities, especially in inner city areas. And as described in Chapter 2, particular attention has been drawn to claims that some ethnic minorities suffer discrimination in access to credit.

Technological change

Technological change might facilitate self-employment, especially for businesses intensive in information exchange. New technologies can permit certain forms of self-employment to develop more easily in locations distant from customers. For example, in the United Kingdom, job losses in manufacturing from the mid-1980s to the mid-1990s were concentrated in large cities and urban areas. During the same period the greatest expansion in private services took place in new towns and mixed urban and rural localities. One factor driving this spatial transition was technological change that allowed service providers to locate at a distance from end-users (Smith, 1999). Many service-sector activities in which the self-employed are frequently found also lend themselves to provision through new telecommunications technologies.

Education and training

OECD-wide data suggest that both the least and the most educated individuals have the highest probabilities of being self-employed (Blanchflower, 1998). This finding is indicative of the diverse motives for becoming self-employed. In the United States, Robinson and Sexton (1994) showed that the self-employed have more years of formal education than employees. However, in Canada, Orser and Hogarth-Scott (1998) found no direct relationship between educational attainment and self-employment status. And French data indicate that a person is less likely to move into self-employment if obtaining a higher level of education (Laferrere and McEntee, 1995). Some research indicates that the effect of education on self-employment entry also varies by sector. By contrast, vocational skills appear to significantly increase the probability of self-employment (Blanchflower and Meyer, 1994; Chapman *et al.*, 1998).

An important consideration for local and regional policymakers is that education and training will increase trainees' potential returns in waged and salaried labour, other things considered. They may even serve to lower rates of self-employment (especially if an increase in education affects earnings in self-employment less than earnings in waged employment). This suggests that raising levels of self-employment should not be treated as an objective in itself. Indeed, in many cases increased welfare among local residents could be associated with decreased self-employment. This observation underscores the broader point – developed in various parts of this book – that the relationship between increased entrepreneurship and improved local welfare is unlikely to be straightforward.

Tax policy

Increases in rates of income tax can encourage self-employment.[4] The self-employed potentially find it easier than employees to under-report income and over-report expenditures, and thereby register an artificially lowered taxable income. The self-employed can also enjoy tax exemption on certain important expenses, such as household outlays if the business is home-based.

Using cross-section data from 1983 to 1994, for Canada and the United States, Schuetze (1998) showed that higher income tax had played a key role in increases in male self-employment. Pissarides and Weber (1989) found that tax evasion has in the past been important in the United Kingdom, estimating self-employment incomes at one hundred and fifty-five per cent of those reported. Chapman *et al.* (1998) show that Australia has experienced a pronounced growth in the number of incorporated owner/managers. In 1997 the incorporated group constituted almost thirty per cent of the total, compared to around ten per cent in 1978. The authors link this trend to an after-tax disadvantage for waged and salaried workers.[5]

Social policy

Social policy is not formulated with a view to influencing rates of self-employment. However, reduced access to pensions as well as health and social insurance are major considerations for those contemplating self-employment. In Australia, for example, less than a quarter of (unincorporated) self-employed women were covered by superannuation in 1992. And in Ireland, public social insurance has afforded proprietorial directors and their families only minimum benefits (Duggan, 1998). The availability and cost of family services – which may be amenable to policy at the local level – is likely to have an impact on the rate of female self-employment, although no studies were found on this subject.

Public programmes to support self-employment

Variation across countries in the economic and policy variables described above affects the inflow and stock of the self-employed. In addition, almost all OECD member countries have adopted a range of measures to encourage and support self-employment. In particular, most OECD governments have established schemes to assist the unemployed to enter self-employment. OECD (2000) provides an overview of the scope of these programmes. Spending on such programmes as a share of expenditures on all active labour market programmes is seen to range from almost zero (Belgium) to five per cent (Greece) for the years 1995 to 1998. Over the same period Sweden registered the highest share of the unemployed participating in these programmes (at six per cent), with Belgium the lowest (at merely a tenth of one per cent).

The content of support programmes varies across countries. Only a few countries – among them Italy, Belgium and Spain – include initiatives to allow the self-employed to exploit the scale economies in training that exist in larger firms (OECD, 2000). Only a minority of countries – among them France, Belgium, Finland and Ireland – provide the self-employed with the financial encouragement offered to small firms aimed at increasing hiring (by reducing social security contributions). Concerns have sometimes been voiced that the self-employed behave essentially as employees – often dependent on a single contractor – but without the social insurance and other benefits associated with employee status. Consequently, a number of countries have introduced measures to counter spurious forms of self-employment. Programmes of support typically focus on the provision of financial assistance – usually replacing unemployment benefit payments with enterprise-oriented grants and income support. Programmes differ along the following broad lines:

- *Eligibility in scheme participation.* Eligibility generally applies to all unemployed workers, though some schemes are not open to the recently unemployed. Programmes are sometimes restricted to target populations such as indigenous groups (Australia) or the long-term unemployed (Ireland, Portugal). In at least one national programme an age criterion has been applied. A programme in the Netherlands limited eligibility to applicants who had already unsuccessfully applied for a business loan (so as to maximise the likelihood that the use of programme resources represents an addition to those available from other sources).
- *Selection procedures and criteria.* The presentation of a business plan is a common entry requirement. In some cases entry criteria specify a minimum equity participation, but this may be waived through in-kind contributions. Access to the German Bridging Allowance has been contingent on applicants being able to demonstrate that the intended source of self-employment will provide an income at least equivalent to two-thirds of the gross monthly income of an employed person in similar work. Interviews are also widely used to identify promising participants. And some programmes have involved compulsory pre-entry training and self-assessment. This has a self-screening effect, possibly serving to deselect less viable ventures.
- *The type of support and its duration.* OECD (2000) notes that increasing importance is being given to training and counselling. These are provided in different ways, including the award of time-bound grants and lump-sum subsidies to cover the costs of training and counselling. Australia's NEIS programme provides business advice and mentor support during the first

year of business.[6] Evaluation suggests that such support has improved enterprise performance (Chapman *et al.*, 1998). The Australian State of New South Wales has a programme designed to assist the self-employed to expand by subsidising the cost of independent consultants to study the activities of a business and advise its management. In different programmes the methods used to monitor participants range from telephone consultations to personal visits and requirements for written progress reports.

- *Monetary assistance.* Financial assistance is provided in lieu of unemployment insurance benefit payments. The amounts available may equal or be greater than the unemployment insurance benefit. Monetary support is provided either as a lump sum (rolling up a stream of future benefits) or in the form of periodic payments. The Netherlands is the only country to offer participants a choice between the two modalities (OECD, 2000). Greater flexibility in this aspect of programme design might be beneficial. Some survey findings indicate that a significant number of entrepreneurs believe they would benefit from receiving start-up grant assistance as a lump sum (for example, Fielden *et al.*, 2000). In addition, there is evidence from the United States that lump-sum payments might improve survival rates (Meager, 1997). This reflects the increased likelihood that entry will occur in the form of larger and non-service-sector businesses. In principle, lump sum payments provide participants with more options on how to use resources, because a periodic allowance is generally too small to permit a significant investment. In addition, older participants with accumulated savings and other financial assets (such as redundancy payments) might have less need of lump sum disbursements, especially by comparison with younger participants. Lump sum payments might also help to offset constraints in access to seed capital. And by possibly attracting individuals who have fewer financial resources the lump-sum approach could lead to lower programme deadweight. However, lump-sum payments could also raise a programme's overall financial cost if participants whose businesses fail early then return to claiming unemployment insurance (Meager, 1997).

Programmes in some countries have placed particular emphasis on financial assistance. For example, national self-employment support in Italy (particularly Law 44) has focussed on credit issues.[7] In Ireland, County Enterprise Boards have offered financial incentives including grants for feasibility studies (Duggan, 1998). However, providing subsidised financial assistance and/or lump-sum payments might make programmes more attractive to the unemployed. This could necessitate the enhanced screening of candidates.

- *Additional programme benefits*. Self-employment support programmes have also included exemptions from social security contributions, financial assistance contingent on the creation of new jobs, loans and grants for further development of the enterprise, and day-care and travel allowances.

In some countries the forms of programme delivery have changed over time. Shifts in the modes of delivering programmes usually reflect a desire to achieve more cost-effective targeting of support. As such they have often entailed the devolution of programme design and administrative responsibilities to lower levels of government, or decentralised forms of implementing centrally conceived initiatives. In Australia, for example, programmes responsibilities have increasingly shifted to State governments. And Duggan (1998) describes the United Kingdom's step-by-step transition from a national and regional programme model – the Enterprise Allowance Scheme (EAS) – implemented during the 1980s and early 1990s, to discretionary programme delivery at local level and a system of networked one-stop shops.

Assessing the efficacy of self-employment support

Despite the fact that public schemes to encourage and support self-employment exist in most OECD member countries, there are relatively few high-quality programme evaluations. Sometimes even basic data on programme costs are hard to obtain. In the Australian case Chapman *et al.* (1998) observe that:

> *"The most important point is that there is a general scarcity of information on this topic. For example, it is very difficult to even get an idea of the rough orders of magnitude of public money being used to support the self-employed. Information on the cost of the different programmes is generally absent, with a couple of exceptions…"*

Programme evaluations focus on the effects on participants' employment and incomes record as well as impacts on net job creation. Central to policy evaluation is the degree to which schemes involve deadweight costs, and so-called displacement and substitution effects. The concepts of deadweight and displacement have been referred to in earlier chapters. The problem of substitution arises when an assisted applicant takes up an opportunity that would have been had by another person in the absence of the programme. Measuring deadweight, displacement, and substitution is notoriously difficult, even under relatively controlled circumstances. More generally, encouraging self-employment should not be viewed as an end in itself. It should be seen as a means to raising incomes, independence and well-being. Programmes should be judged against these broader goals, and not simply in terms of numbers entering and continuing in self-employment. In fact, most persons

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who exit self-employment do so to take up waged employment, often on better conditions. And many, if not a majority, of the participants in schemes to facilitate self-employment end up as employees (OECD, 1995).

A comprehensive cost-benefit assessment of self-employment assistance also needs to account for savings in unemployment and other benefits, the creation of additional tax revenue, income and employment multiplier effects, and the opportunity cost of labour. Such fully-elaborated evaluations are expensive and have seldom been undertaken. As will be seen later, they can also be methodologically hazardous. Evaluations often ignore medium and long-term effects (Chapman *et al.*, 1998). For instance, an employee or a business may be displaced in period one, but their employment status or business prospects might change over a longer period as a result of the programme.

Programme deadweight can be high

Survival rates among assisted firms directly reflect the stringency of the criteria used to appraise business plans. Evidence from Germany, the Netherlands, Sweden and France indicates that survival rates are comparable or superior to those among non-assisted firms started by both the unemployed and the employed. OECD (1996) found lower rates of survival in subsidised firms in Ireland, Norway and the United Kingdom. However, the more able entrepreneurs were more likely to have established a venture in the absence of the programme, adding to deadweight costs when these entrepreneurs participate in a scheme. This underscores the observation that because of deadweight costs, rates of enterprise survival and entry cannot be used as unqualified measures of programme success.

Estimates of programme deadweight vary considerably. Meager (1993) points to evidence from Denmark of deadweight as low as seventeen per cent. For programmes in five OECD member countries estimates of programme deadweight from the early 1990s ranged from twenty-seven per cent in the United States to sixty per cent in France (Wilson and Adams, 1994). Deadweight of up to seventy per cent has been calculated for the United Kingdom's Business Start-Up Scheme (Tremlett, 1993, 1995). And a figure as high as eighty per cent has been estimated for a programme in Northern Ireland (O'Reilly, 2000). Differences in methodological approach may explain some of the divergence in estimates of deadweight. For example, surveys appear to overestimate deadweight by comparison with experimental techniques. Deadweight is also likely to be greater in programmes that have more stringent selection criteria.

Enhanced employability is a frequent outcome

Evaluations consistently indicate enhanced employability among programme participants, even if the attempt at self-employment fails (Benus *et al*., 1996; Tremlett, 1993). Australia's NEIS scheme showed a higher rate of participants in employment after the programme than in many other labour market initiatives (Chapman *et al.*, 1998).

Other potentially important programme benefits are rarely measured

A number of potentially important benefits of self-employment support are rarely assessed. Especially for the unemployed, these potential benefits include changes in post-programme asset accumulation, psychological well-being and physical health. Reductions in crime – a possible effect of particular relevance to community development – are also largely unexplored. Evaluations of Canada's Self-Employment Incentive programme indicate improved self-sufficiency for participants and households, significant impacts on community economic development, and opportunities for socially excluded groups (Wong *et al.* 1994; Graves *et al.* 1996). Such benefits are clearly of interest to local policymakers and merit further attention in evaluations.

Programme assessments point to similar conclusions: schemes are worthwhile, but only for a small group of the unemployed

A small number of relatively recent programme evaluations are described here. These and other assessments tend to the general conclusion that schemes to support the unemployed to enter self-employment offer positive net benefits, but only when they cater to a narrow section of the unemployed.

Wong *et al*. (1998) examine measures introduced by the Canadian government in 1987 to encourage unemployed individuals to move into self-employment. The Self-Employment Incentive (SEI) programme was active from 1987 to 1991. And the Self-Employment Assistance (SEA) programme was introduced in 1992. The SEA increased participants' funding, extended eligibility to all recipients of unemployment insurance (though welfare recipients were excluded), put more emphasis on training and shifted programme delivery to the federal government. The analysis indicates large positive benefits from participation in terms of gross earnings and mild negative effects on net earnings. However, as the programmes expanded the positive impacts appear to have weakened. The evidence suggests that the SEA program of 1992 to 1995 led to relatively smaller gains in earnings than the SEI program. The authors conclude that this may reflect the attraction of marginal participants under the SEA scheme as funding was increased and eligibility extended.

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Vroman (1998) reports on seven States in the United States that adopted Self-Employment Assistance (SEA) programmes. The SEA schemes never reached more than half of one per cent of unemployment insurance recipients. Of those participants that did start their own business, gross sales were modest. The study points to the complexities in interpreting cost-benefit analyses of self-employment support programmes due to incomplete data, insufficient long-term follow-up information, and the difficulties of identifying proper comparison groups.

In Hungary and Poland formal efforts to promote self-employment among the unemployed began in the 1990s. O'Leary (1998) finds that self-employment programmes were effective in both countries in terms of reemployment and savings in unemployment insurance. In Poland there was also a large and positive earnings impact. In both countries there were significant secondary employment effects. In Germany, transitions from unemployment to self-employment have been supported through loans termed "bridging allowances". Research by Pfeiffer and Reize (1998) on the impact of bridging loans – in term of survival rates and employment growth – was inconclusive.

Only one systematic study was found that examined the local impact of self-employment support. Cowling and Hayward (2000) undertook a cost benefit analysis of a local self-employment support scheme taking into account displacement, benefits savings, training costs and income tax payments for those who found work or became self-employed. In line with other work already cited, these authors found that enhanced employability was a key programme outcome. The authors reported increases in tax revenues and reductions in benefit payments that significantly exceeded programme costs. The immediate locality saw a sizeable addition to disposable income and numbers in work.

Conclusion

A broad conclusion from the available evaluative material is that self-employment support programmes can reduce the duration of unemployment, raise incomes and provide a cost-effective alternative to paying unemployment insurance, but only for a small subsection of the unemployed (OECD, 2000; Martin, 2000). Those most likely to benefit from self-employment support include the more motivated and persons possessing work experience and accumulated human and financial assets. Schemes appear less helpful for those who have experienced relatively long periods of unemployment. Indeed, Cowling and Hayward (2000) found an unemployment threshold of around a year, after which the probability of operating a successful business declined significantly.

Programme costs are often low, especially when financial assistance replaces payments of unemployment insurance. Although net job creation is generally small, the net cost per job created can also be low by comparison with other labour market policies (Meager, 1993). Programmes only have a small impact on national unemployment figures. In this connection, OECD (2000) found no correlation between national trends in self-employment and expenditures on self-employment support programmes.

Notes

1. There is diversity among countries in the compilation of self-employment data. For instance, some OECD member countries restrict the definition of self-employment to the unincorporated sector. If owner/managers of incorporated enterprises were included in the definition of the self-employed in the United States the self-employed would increase by about a third (OECD, 2000).
2. Local and regional governments usually possess little scope for demand management as a means of stimulating economic activity in their jurisdictions. Concerns over the need for central government control of interest rates and the money supply mean that subnational authorities are permitted only limited debt-raising powers. Local government borrowing in capital markets requires central government approval in around half the member states of the Council of Europe (Bailey, 1999). Market mechanisms – in countries such as Canada and the United States – and various rules-based systems, have been employed to control borrowing by subnational governments and maintain central autonomy with respect to the key levers of macroeconomic management.
3. However, some analysts hold that new technologies will facilitate small-firms' ability to operate in manufacturing. For example, Bednarzik (2000) shows that in the United States, during the first half of the 1990s, small firms created employment in manufacturing at rates similar to their creation of jobs in the service sector.
4. However, research results are sensitive to whether average or marginal rates of income (or, in other studies, corporation) tax are used.
5. The manner in which tax is levied can also be important. Chapman *et al.* (1998) note that in Australia the timing of payments for sales tax can create working capital and cash flow difficulties for the self employed. This is because sales tax is levied at the time income is earned, rather than received. The self-employed may thus need to find other sources of cash flow in order to pay this fiscal obligation.
6. Mentoring is a process of tailored business advice and support provided by experienced individuals. Mentoring is sometimes offered on a semi-continuous and personalised basis for a considerable period of time. The use of mentors is common across a range of entrepreneurship programmes (and is not limited to self-employment support). In addition to transmitting technical knowledge, one-to-one mentoring can help entrepreneurs learn how to learn and how to use information provided by other sources. A generally positive assessment of the impact of business mentors on early-stage firms in Scotland is described in Deakins *et al.* (1998). Useful information on mentoring can be found at *www.mentorsforum.co.uk*
7. Law 44, of 1986, aimed to facilitate the creation of new firms in the Mezzogiorno by persons between eighteen and thirty-five years of age. This legislation provided

for: a non-reimbursable subsidy of sixty per cent of capital expenditures; a loan covering thirty per cent of outlays on plant and machinery; and a loan for three years for administrative and management expenditures (see Belussi [1998] for a discussion of the policy and institutional underpinnings of self-employment and micro-enterprise in Italy).

ISBN 92-64-19978-0
Entrepreneurship and Local Economic Development
Programme and Policy Recommendations

PART I

Chapter 4

Considering the Merits of Enterprise Promotion as a Local Development Strategy

Enterprise creation and development is clearly a critical component of local economic development, potentially contributing employment and increased incomes, fiscal resources, improved service availability and positive role models. However, it is important to review a number of the potential limits to entrepreneurship-oriented strategies.

The distribution of benefits: entrepreneurship strategies favour the least vulnerable

Development strategies centred on promoting entrepreneurship inevitably favour those who possess superior financial, human and social assets.[1] Consequently, many individuals are better served by forms of public policy which make fewer demands on these assets, such as workfare programmes.

Chapter 2 discussed the fundamental role of human capital and work experience in generating viable business ideas and in accounting for subsequent business performance. And Chapter 3 described evaluations that show that when self-employment support programmes expand and eligibility is extended positive impacts often weaken because more marginal participants are attracted. Other research has shown that many of those who become self-employed by force of circumstance (such as after a factory closure) either quickly drop out of self-employment or operate weakly performing businesses (Whyley, 1998).[2] In this connection, Gomez (1999) found that individuals who preferred a paid job to being self-employed – possibly as an effect of being pushed into self-employment – earned significantly less than those who had opted for self-employment voluntarily.

Research in the United States has concluded that the majority of those who *choose* to take part in micro-enterprise schemes are among the least disadvantaged of the poor (Schreiner, 1999). And Schreiner (1999a) showed that micro-enterprise programmes appear to increase the number of people who make the transition from welfare to self-employment by less than one in every hundred.

From a local development perspective it is also important to note that there can be considerable sensitivity in enterprise exit times to the local rate of unemployment (Cowling and Hayward, 2000). Exit times also appear to be affected by economic disadvantage more generally (HM Treasury, 1999). This further underlines how serious the challenge of enterprises survival is for

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firms faced with adverse local economic conditions. Entrepreneurs working in these poor trading environments might in fact require *greater* aptitude and resilience than in other contexts.

While entrepreneurship promotion offers the prospect of greatest advantage for the best-qualified, most asset-endowed and least vulnerable, all job growth in poorer localities is to be welcomed. Poorer groups will often be under-represented among the beneficiaries of entrepreneurship strategies. But those among the poor who do benefit experience significant gains. Drawing on a variety of research sources from across the United States Bartik (1994) concluded that:

> *"the percentage increase in incomes from local job growth is greater for disadvantaged groups. High school dropouts gain more than college graduates, African Americans gain more than whites, and the lowest-income quintile families gain more than the average family" (p. 854).*

Furthermore, earnings from self-employment can contribute to increased income security for some low-income households, especially when combined with other income sources. Entrepreneurship can also provide a route into employment for some individuals whose efforts have been frustrated in the mainstream labour market and who also possess suitable assets. For example, among Mexican women self-employment appears to offer more work opportunities than salaried employment, especially when women re-enter the labour force but are no longer married (Samaniego, 1998).

Entrepreneurship cannot address all the problems of disadvantaged areas

Poor localities are usually characterised by multiple and inter-related forms of distress (OECD, 1998a). They may combine low average levels of income, a high incidence of unemployment, poor quality housing, difficult physical access to services, limited skills and training amongst residents, high rates of crime, and poor health status. Enterprise creation and development can clearly operate on a number of these variables, but not on all of them. Other responses are also required, possibly in education, health, housing, physical infrastructure and policing. In distressed areas, entrepreneurship promotion should form one component in an array of developmental programmes and policies.

Extended time-horizons are required

The encouragement of entrepreneurship is unlikely to yield major benefits in the short-run. The decision to employ additional workers in a business usually follows a sustained increase in turnover (Smallbone and North, 1995). Across OECD member countries it is typical that around half of all new firms fail before the third year of operation. The surviving firms often only begin to break even after around three years. Similarly, the investment cycle for early stage venture capital is often from five to ten years. Before this, the retained earnings of investee firms are usually inadequate to finance growth and development. In a related manner, surveys of business incubation schemes have indicated that most jobs are created only *after* successful firms graduate from an incubator's premises. Assessments of incubation programmes also show that early rounds of job creation tend to be in fields that demand significant skills, while later rounds provide jobs for persons with medium skills.

Such considerations suggest that the employment and other benefits of facilitating entrepreneurial activity will take considerable time to mature. However, if programmes are successful, and because workforce skills are created by employment expansion, even a subsequent reduction in enterprise activity may leave local residents better off than before the jobs were created. The relatively long gestation periods involved in business creation and development suggest that entrepreneurship strategies should be policy constants, rather than responses to short-term employment crises.

The problem of displacement

Displacement occurs when competition from new firms causes a loss of output or employment in existing enterprises. Unfortunately, displacement is likely to be greatest among the types of firm that predominate in poor localities. These are firms in mature low-growth sectors in which skill and capital requirements are limited and in which barriers to entry are low.[3]

However, enterprise displacement is not uncomplicated. It is conceivable that displacement could be negative if some of the unemployed and those who are initially displaced receive jobs in the newly established firms. Economic gain can also result if a new enterprise is more efficient than the one it displaces. Displacement will also vary depending on whether the products of firms in the same sector are close substitutes or not. Furthermore, the state of local demand and supply is critical to the magnitude of displacement effects. In an expanding local economy opportunities can arise for new firms to meet growing local demand for goods and services. When this is the case displacement might be low. Conversely, during local economic contraction displacement is likely to be high as existing and new firms compete for fewer local market opportunities.

It is mistaken to assume that output sold in local markets has a displacement effect while exports are non-displacing. Local firms may be in competition with each other for out-of-area markets. And while displacement is likely to be most acute at the local level, it need not be limited to the

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confines of a particular locality: out-of-area firms can also be displaced. Also relevant to displacement is that there are considerable differences in the geography of markets served by firms in different sectors. For example, manufacturers usually sell across a wider area than retailers. And service sector firms are more likely to have a local orientation, especially those that provide personal services. Furthermore, most business start-ups initially supply local markets. New firms tend to diversify their customer base as they mature, gradually reaching out to wider regional, national and international markets (although start-ups in so-called "high-tech" sectors often sell to international markets early on). Compared with employees, the self-employed appear less willing to move neighbourhood, town or region (Blanchflower, 1998). This preference – which presumably reflects the personal services orientation of much self-employment – might exacerbate displacement.

In addition, the severity of displacement is likely to be a function of the size of new firms. Larger firms may operate in less contested markets. Consequently, it is conceivable that policies that serve to increase the average capitalisation of new enterprises – such as various forms of financial engineering – could attenuate displacement. Displacement can also be aggravated if, as studies suggest, entrepreneurs tend to create companies in the same sector in which they were previously employed. So new firms created following a period of layoffs in the same sector would tend to be characterised by similarities that could worsen displacement.

The above considerations suggest that public encouragement of entrepreneurship – and especially self-employment and micro-enterprise, which operate mainly in the service sector – is likely to involve significant displacement. This will be more severe during periods of slow growth or recession. Consequently, some public programmes have been (re)designed to counter the displacement effect. Retail services for example have been excluded from coverage under the United Kingdom's Small Firm Loan Guarantee Scheme. Policies to help firms to sell in out-of-area markets, and to raise the average size of investment in new businesses, may also reduce displacement. Policy recommendations along these lines are described in Part II of this publication.

To mitigate policy-induced displacement some local authorities have also commissioned studies to assess the composition, by sector, of local business activity. The aim is to gauge the extent of local market saturation. The conclusion to be drawn, it is assumed, is that assistance for enterprise creation in overcrowded markets should be restricted. This approach may be helpful, but has obvious limitations if firms sell to non-local markets. Furthermore, enhanced productivity and competitiveness can arise from the geographic concentration of enterprises.[4] The mapping of enterprise demographics could therefore lead to inappropriate policy recommendations if the premise is a simple balance between the size of the local market and the presence of an enterprise cluster.

Evaluation of the United Kingdom's Enterprise Allowance Scheme (EAS) – which provided individuals with a small fixed sum to create a business – suggested a displacement rate of around fifty per cent (Storey, 1994; Scott, 1995). However, displacement varied substantially by sector, being particularly high in retail and construction, and even rising to one hundred per cent in the case of hairdressing (Hasluck, 1999) (the EAS was abandoned in 1994 because of concerns over high displacement). However, the complexity of displacement effects suggests that estimates of displacement be treated with caution. A particular methodological complication is that the measurement of displacement usually depends on surveys of the firms that may have caused displacement in others. The displaced enterprises are sometimes no longer in business (Persky *et al.*, 1997). The views of the two groups could differ systematically. Clearly, estimates of displacement are likely to represent approximate orders of magnitude only.

Who is employed, locals or non-locals, and in what ways does it matter?

Drawing on evidence from across the United States Bartik (1994) concluded that one in every five new jobs in metropolitan areas typically goes to local residents (over a five-year period). This ratio will be sensitive to the occupational structure of employment growth and the specific characteristics of local labour supply. For example, if high-tech firms are established in an area where low levels of skills are prevalent, it is less likely that the new jobs will raise the local rate of employment. Indeed, in England, evidence from a recent survey of local authority districts indicated that rates of long-term unemployment tended to be *higher* in areas with high levels of job growth, as the employment created in these areas had not benefited the long-term unemployed (Smith, 1999). In this respect, an important consideration is that there is differential mobility among persons with higher and lower levels of skills. Vacancies for those with high levels of skills are more likely to be filled by labour in-migration. The impact on local employment will also reflect the existing condition of the local labour market. In tighter labour markets a larger part of the benefits from employment creation will leave the locality, as recruitment from outside the area will be greater. Community development projects that deliberately select for local residents usually involve higher shares of local employment.

Research from the United States on employment of the urban poor suggests that inner-city residents are not excluded from jobs located in their own neighbourhoods. This is in spite of the fact that employers frequently

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hold negative perceptions of inner-city residents as potential employees (Reingold, 1999). A possible explanation is that employers might face difficulties in finding workers for entry-level positions who are willing to commute from working- and middle-class neighbourhoods. Because local staff sometimes walk to work, the fact that they need not depend on unreliable transport can also be an advantage (Ramsden *et al.*, 2001). Furthermore, if current local employees play an important role in providing on-the-job training then the hiring of locals may persist even against the employer's preference for hirees from more affluent communities. This might happen if the existing workforce accepts recruits from non-poor localities less readily, providing them with a lower volume and/or quality of on-the-job training. Hirees from non-poor communities could then be less productive than local recruits. Indeed, the rate of local employment in poor urban areas appears to be no different than in wealthier communities. As Reingold concludes:

> "At *a practical level, these findings suggest that enrichment strategies, such as enterprise zones and business recruitment initiatives, designed to increase private sector activity in decaying urban communities, will modestly increase employment opportunities for residents of these neighbourhoods.*"

Chapter 8 discusses a number of ways in which local employment content might be increased.

Local welfare and local job creation

The welfare gain from the creation of a job is the difference between wages and benefits in the new job and wages and benefits in the next best alternative job. When an employee foregoes the next best alternative job, the lost wages and benefits are known as the opportunity cost of labour. In many programme evaluations the wages and benefits earned in newly created jobs are taken as the measure of the welfare improvement that new jobs have provided. This approach gives no consideration to opportunity costs.[5] Economists usually equate the opportunity cost of labour with the so-called "reservation wage": that is, the minimum wage needed to induce employment. However, the reservation wage may be close to the actual wage. When this is so, welfare gains from job creation represent only a small part of the wages offered by the new positions.

Felsenstein and Persky (1999) argue that a more realistic description of opportunity costs in the local labour market needs to take into account the ways in which new vacancies help to create jobs chains. That is, the creation of new jobs establishes a sequential reaction. Workers move to successively more attractive posts as these are vacated. In turn, they leave positions vacant for others in the chain. Movement along the chain can be initiated by the creation of new jobs. For each change in position there is likely to be a difference between the actual wage and the reservation wage. The sum of these differences along the entire length of the jobs chain represents a more accurate assessment of the welfare gains from job creation than either taking no account of opportunity costs or only considering opportunity costs in one round of job creation. Felsenstein and Persky (1999) calculate that for occupations in the middle of the earnings distribution the sum of opportunity costs along the jobs chain represents around fifty per cent of the wage.

Thinking in terms of jobs chains can bring into focus a number of issues relevant to local policy. In particular, it is often observed that owing to labour in-migration the creation of new jobs may have no impact on local rates of unemployment. A somewhat larger perspective emerges when it is recognised that labour in-migration might do more than create competition with local residents for immediate vacancies, and could in addition break jobs chains and curtail broader impacts on the local labour market. This consideration draws attention to the importance of differential mobility among workers who possess higher or lower levels of skills. As previously noted, the more highly skilled are generally more mobile than those with fewer skills (Mauro and Spilimbergo [1999] provide an illustration of this phenomenon in the Spanish labour market). This means that the probability that vacancies will be filled by in-migrants is greater when skill requirements are higher.

Furthermore, the welfare effects of job creation are unlikely to be the same for persons with different levels of skills. Demand for highly skilled workers is generally high in relation to their supply. The opportunity cost of skilled labour is also high. And owing to the greater mobility of skilled workers, local labour markets for skilled workers are expected to operate at wage levels similar to those in national markets. By contrast, for low-skilled workers relatively few alternatives exist and the opportunity cost of their labour is likely to be low. This means that for jobs at the lower end of the labour market a higher share of the wages paid represents a welfare gain. Therefore, because of relatively greater welfare effects for the low-skilled, and the lower likelihood that jobs chains will be truncated by labour in-migration, a jobs chain perspective favours projects that create jobs in the bottom half of the wage distribution. As Felsenstein and Persky (1999) observe, such projects might need no further justification than their redistributive impact. But consideration of job-chain effects also underlines that projects to assist the creation of work for the under- and unemployed can bring overall gains in economic efficiency too. Further research on jobs chains might improve understanding of the circumstances under which job creation will make the greatest contribution to local welfare.

The magnitude of employment effects is likely to be small, at least over the short-term

Especially over the short-run the promotion of entrepreneurship is likely to have a relatively small impact on the growth of employment. This reflects low enterprise survival and growth rates, displacement effects, and deadweight in programme outcomes.[6] Furthermore, in most countries enterprise start-ups are only forty to sixty per cent of the average size of existing firms (OECD, 2002).[7]

Especially in connection with initiatives to encourage self-employment and micro-enterprise, a range of studies supports the conclusion that employment effects will be limited. For instance, a 1992 evaluation of Australia's NEIS programme revealed that only twenty per cent of the scheme's survivors had recruited an employee (Chapman *et al.*, 1998). Assessing a programme in the United Kingdom, Cowling and Hayward (2000) observed that just over three per cent of self-employed businesses created additional jobs during a five-year period (1994-98). As discussed in previous chapters, evaluations of self-employment support suggest that employment effects will also be sensitive to the duration of prior unemployment experienced by programme participants. Job creators usually come from among the newly unemployed. Self-employment that is not the result of specific support programmes also involves limited recruitment. Bevan *et al.* (1988) showed that seventy per cent of businesses established by the self-employed over a preceding four-year period had no employees. And Hakim (1989) found that barely more than half of the enterprises operated by the self-employed sought to create additional jobs, and that it was the smallest firms that were least likely to do so. When broader labour market dynamics are considered the picture may be still less impressive. For instance, evaluations have shown that the self-employed most likely to create jobs for others are also more likely to have entered self-employment anyway in the absence of assistance. Factoring in deadweight and displacement effects, one estimate shows only forty-two new jobs per hundred self-employed businesses created (Rubery *et al.*, 1993).[8]

More generally, there is evidence that businesses created by the unemployed generate fewer jobs than those established by the employed (Hinz and Jungbauer-Gans, 1999). Differential employment-creation in firms established by employed and unemployed founders could reflect a number of factors. For instance, the two groups may have different motivations. Lower-opportunity costs faced by the unemployed might lead to their initiating ventures that have prospective returns unacceptable to the employed. And the employed and unemployed may differ with respect to levels of human and financial capital. Growth aspirations have been seen to vary dramatically between entrepreneurs driven by necessity (possibly resulting from extended unemployment) and those motivated by opportunity. Across the twenty-nine countries included in the *Global Entrepreneurship Monitor 2001*, some fourteen per cent of the "opportunity-driven" entrepreneurs surveyed expected their newly created firms to produce twenty or more jobs in five years. By contrast, ninety per cent of "necessity-driven" entrepreneurs expected their ventures to provide no more than five new jobs over the coming five years.

Furthermore, where job growth is associated with part-time employment, and work in more than one job is frequent – as might be expected in areas with high concentrations of poverty – the number of persons employed will be less than the job creation total.

It should also be recalled that entrepreneurship support programmes often serve to enhance enterprise productivity. In the face of static demand for output an increase in productivity will create pressure for firms to shed labour (productivity growth can of course benefit the local economy in a variety of other ways, both direct and indirect. For example, more productive firms could provide the local economy with employment over a longer period. They may also be in a better position to sell outside the local area). This raises the important general observation that enterprise creation is part of a broader process in which financial, human and other resources should be efficiently and quickly reallocated from declining firms and subsectors to uses that the market values more highly. Under this light, enterprise failure need not be synonymous with policy failure. Indeed, strategy must be premised on a realisation that entrepreneurship support has at least as much to do with changes in productivity and incomes as with direct employment creation.[9] Indeed, some of the local benefits of enterprise formation described at the start of this publication are not confined to employment creation, such as fiscal effects and increases in service provision. In addition, the heterogeneity of the self-employed is reflected in diverse motives for entering self-employment. Consequently, a fall or rise in national or local levels of self-employment, or of enterprise creation more broadly, is neither good nor bad *per se*.[10] Key issues are the ease of entry, a facilitatory business environment, access to services and the overall quality of enterprise.

The quality of employment

Concerns about the quality of employment in start-up firms usually focus on micro-enterprises and the businesses of the self-employed. Issues of employment quality are therefore not specific to the firms established in poorer communities. But entrepreneurship in poorer localities frequently takes the form of micro-enterprise and self-employment. Consequently, and given that business creation is commonly presented as an instrument for raising incomes and reducing precarity, the quality of employment is a relevant consideration.

Surveys show that a large fraction of all employees – in some cases a majority – wish to become self-employed as a route to greater self-reliance and self-realisation. And the self-employed often register higher levels of job satisfaction than employees (Blanchflower, 1998). However, the self-employed are a heterogeneous category. Self-employment encompasses occupations as diverse as highly remunerated corporate financial consulting and part-time provision of child-care. The self-employed are disproportionately represented among both the most and the least educated, and income distribution among the self-employed is more widely spread than among employees. For some, self-employment is a state analogous to disguised unemployment: an option adopted for lack of a better alternative. US data indicate that owners of small firms often belong to the working poor (Servon and Bates, 1998). The self-employed are also more likely to be among the poorest of the population (Metcalf *et al.*, 2000). And the probability of being included in lower income groups can be higher for the self-employed than for employees who share similar occupations and other key characteristics (Meager, 1997). Women, in particular, have lower self-employment incomes than men and may face a bigger reduction in wages should they try self-employment and then switch back to waged employment (Williams, 1998). Other common features of self-employment are also undesirable. These include low and volatile earnings, long working hours, a greater exposure to physical hazard, and fewer benefit entitlements. More broadly, smaller firms tend to employ fewer full-time staff. In addition, their employees are generally less well qualified than employees in larger firms.

Periods of rapidly expanding enterprise creation can be marked by a decline in the quality of entrepreneurship. Robson (1997) shows that capital investment per person self-employed fell during much of the growth in self-employment in the United Kingdom after 1980. Indeed, the author links the rise of self-employment with an overall decline in earnings in the United Kingdom during the same period.

Deadweight in programme support

Deadweight occurs when a programme has effects that would have occurred in the absence of the programme. Deadweight occurs in many aspects of economic and social policy and is not particular to initiatives aimed at fostering entrepreneurship or local development. As discussed earlier, deadweight in programme support will probably be highest among the

Box 4.1. **A local entrepreneurship case study**

One of the few empirical studies to consider in detail the impact of new-firm formation on a poor locality is Turok and Richardson (1991). This work examined some two hundred firms founded in central Scotland during the 1980s. The study confirms some of the drawbacks to locally-oriented entrepreneurship policies described in this chapter. In particular, the authors found that start-ups involved significant displacement, added little to local economic diversity, and mostly involved firms with low levels of dynamism. Nevertheless, enterprise creation did serve to create jobs for some among those who were most at risk in the labour market. The economic circumstances of the area concerned were not the most propitious, and included sizeable prior job losses, a traditional dependence on a small number of large employers and a degree of isolation. Nevertheless, in such circumstances, the question must be asked whether further policy support to enterprise creation, rather than enterprise development, is appropriate.

entrepreneurs who create the major part of new jobs. That is, these entrepreneurs are more likely to create a business in the absence of the programme than are less successful entrepreneurs. Programmes can be designed to reduce deadweight. For example, if micro-finance can target those who face the greatest obstacles in access to finance – that is, persons who are unlikely to obtain loans in the absence of programme support – then deadweight can be minimised.

Conclusion

This chapter has reviewed key limitations and other policy considerations associated with the encouragement of entrepreneurship as a strategy for local development. The issues raised are diverse. They range from differential impacts across groups possessing higher or lower levels of human capital, to the problem of enterprise displacement, through to concerns over the geographic origin of workers hired to fill newly created vacancies. Some of the topics raised – such as the considerable time period before the employment impacts of entrepreneurship materialise – are scarcely open to influence through policy. But problems such as enterprise displacement, deadweight in programme support and some employment quality issues can be addressed through proper policy design. The relevant questions in policy

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design are examined, and recommendations made, in Part II of this report. The discussion in this chapter makes clear the need for policymakers to adopt realistic expectations as to what the promotion of entrepreneurship is likely to achieve. The following chapter examines the arguments why policymakers might need to intervene at all to foster business creation in local economies.

Notes

1. The distribution of gains from pro-entrepreneurship strategies between persons possessing different initial assets has been noted outside of the OECD context. For instance, it has been observed that higher income groups among the poor often gain easier access to schemes such as the Grameen Bank in Bangladesh – internationally perhaps the most renowned of all attempts at financial inclusion. Hulme and Mosley (1996) find strong evidence that in micro-finance programmes the impact of loans on borrowers' income is sensitive to the initial level of income. World Bank (2001) reports research showing that public works programmes in India afford greatest benefit, at the margin, to the poorest quintile, with credit programmes providing greatest benefit to the second and third poorest quintile.
2. However, Dahlqvist and Davidsson (undated) found that start-up motives had no power in predicting enterprise survival.
3. Cowling and Hayward (2000) address the issue of entry barriers to self-employment. They use a concept of entry barrier familiar to the industrial economics literature, conceiving this as an obstacle to entry resulting from market structure. For instance, market structure might confer cost advantages to incumbent firms. A small number of firms might control essential inputs and distribution channels, there could be large capital requirements for entry, and consumer preferences for existing products might be significant. While such considerations are of greatest relevance to industrial production – and only a minority of the self-employed enter manufacturing – entry barriers can also have an impact on self-employment. The authors note that even a sole proprietor working, for example, as a plumber, must take into consideration the loyalty of customers to existing plumbers, the prices charged by those plumbers, the level of advertising needed and the initial investment requirement. These considerations parallel the calculations made by entrants in manufacturing.
4. Agglomeration economies take many forms and are the subject of a vast multidisciplinary literature dating as far back as Alfred Marshall's *Principles of Economics* (see Porter, 1998). Significant empirical evidence exists of the productivity- and competitiveness-enhancing potential of belonging to a cluster. However, it is not the case that agglomeration is automatically associated with competitive advantage (see Appalled, 1995). The co-location of firms can, for example, give rise to congestion effects, especially for firms located in clusters belonging to industries other than their own. Based on a firm-level analysis in the United Kingdom and Italy, Beaudry and Breschi (2000) report that location in a densely populated cluster of innovative firms positively affects the likelihood of innovation. However, strong disadvantages arise from the presence of non-innovative enterprises, in both own and other sectors.
5. This leads to the observation that while assessments of local development policy often focus on employment outcomes the claims arising from job-counting exercises are frequently misleading. For example, if a company has been created in or moves to a given location, and hires twenty employees, this is invariably publicised as the creation of twenty jobs. However, if the twenty recruits simply

moved from existing positions there may have been no net job creation at all. Such redeployment might occur if jobs have been displaced from existing firms following competition from the new enterprise. Recruits may also have left old jobs voluntarily on account of more attractive conditions in the new openings (as discussed in the main body of this section, the welfare effects of these two scenarios – movement to new posts from jobs that are destroyed and from jobs left vacant – will differ). Typically, only a part of new hirings involves net job creation. Local welfare could still rise even if all hirings involved redeployment. By comparison with the displaced positions the new posts might offer income or other gains to hirees. Conversely, recruitment could entail a decline in welfare if persons who are redeployed from displaced positions experience income or other losses. Welfare losses of this sort could even offset the gains from recruitment that has involved some genuine job creation.

6. Job creation programmes can also have the unintended effect of encouraging some unemployed individuals who no longer search for work to re-enter the labour force. This can add to the number of persons reported as unemployed. Such an effect is most likely if the new jobs are part-time positions, which might suit individuals with low activity rates.

7. The share of all private-sector employment creation accounted for by firm births might also be small. Bednarzik (2000) shows that in the mid-1990s, across the entire United States, entrepreneurial activity was less important to job growth than expansions in existing firms. Between 1995 and 1996 just over a third of private-sector job creation resulted from the birth of new establishments.

8. Because programmes for enterprise creation will only play a small part in expanding the demand for labour, their effects on average earnings are likely to be negligible. Bartik (1991) found that a ten per cent growth in employment in metropolitan areas in the United States was required to bring about an increase in average earnings of four per cent.

9. Indeed, an unqualified focus on employment outcomes might even have undesirable effects. For example, it is often the case that most of the jobs created by business incubation schemes arise after the graduation of tenant firms. This is in spite of the fact that job creation is an almost ubiquitous goal of incubation programmes. Enhancing enterprise development will increase the likelihood of job creation. Evaluations should therefore concentrate on how incubation has affected various dimensions of enterprise development. But if employment creation is the chosen evaluation yardstick, and if funding depends on evaluation results, potential job creation might not be realised.

10. Duggan (1998) develops the idea of a natural and to some extent self-regulating limit to the rate of self-employment. She notes that an upper boundary to self-employment might be controlled through a variety of mechanisms. These could include saturation in easy-entry markets, and the selection by public programmes of the most promising projects, resulting in an early success rate which cannot be sustained. A maximum rate of self-employment could also reflect the success of the self-employed in creating jobs. As the self-employed create new jobs – and thus more work opportunities for employees – the rate of self-employment may fall.

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ISBN 92-64-19978-0
Entrepreneurship and Local Economic Development
Programme and Policy Recommendations

PART I

Chapter 5

Rationales for Public Policy

Do markets fail entrepreneurs? And are markets enough for poor localities?

This chapter examines the economic bases for public policies that aim to encourage self-employment and entrepreneurship in local economies. Frequently, the rationale for policy is assumed and implicit, rather than being clearly stated. Two related questions need to be considered: *i)* what grounds exist for entrepreneurship policy *per se*?, and *ii)* are there reasons why policy should be designed, implemented or targeted at the local level?

In seeking to foster entrepreneurship government has an undisputed role in ensuring the presence of high-quality framework conditions. These conditions include: well-functioning institutions; competitive markets for goods, services and labour; a transparent, fair, non-punitive and predictable system of corporate taxation; a propitious macroeconomic environment; and bankruptcy legislation that facilitates resource reallocation while properly protecting creditors. Aside from providing good framework conditions, the standard premise for policy intervention refers to failures in the markets that support entrepreneurial activity.

Market failure arises from systematic divergences between the private and social costs and benefits associated with transactions in the market concerned. Such divergences can occur for a number of reasons. These include the public good characteristics of certain services, information problems of various sorts, and non-competitive market structures, perhaps being dominated by one or a small number of firms. Gaps in the provision of goods and services can also exist owing to economies of scale in their supply – a consideration discussed below in relation to the market for venture capital. Concerns that market failure restricts the level of entrepreneurship usually focus on alleged shortcomings in the supply of debt and equity to new and small firms. But difficulties are also reported in other important markets, such as for industrial real estate, business development services and training. The relevant empirical and theoretical debates are reviewed later in this chapter.

Public support is sometimes advocated for small and medium-sized enterprises as a group on the basis that these provide large numbers of jobs. Calls have also been made for the public sector to support the minority of small businesses that grow rapidly and account for a disproportionately large share of new private sector jobs. Similarly, arguments have been made for public intervention to help the growing numbers of entrepreneurs from

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particular groups in society (the young, women, etc). Arguments of this sort – which depend solely on the weight that some category of firm has in employment, incomes or growth – are extremely weak. To be valid they would need to provide reasons why markets systematically fail to properly allocate resources to such firms and entrepreneurs.

Various arguments for policy rest on external benefits from entrepreneurship

Another set of arguments exists for supporting entrepreneurship that does not depend on failures in the markets on which entrepreneurs depend. These arguments assume that the creation of new firms gives rise to *positive externalities*. An externality is an outcome of a market transaction that affects others who have not participated in the transaction. An externality can create benefits – a positive externality – or costs – a negative externality. In broad terms, society gains from increasing activities that produce positive externalities (possibly through subsidisation) and decreasing activities that have negative externalities (possibly through taxation). Within such a framework, attention has been drawn to the fact that when an entrepreneur creates a business, valuable information is provided to other actual and potential entrepreneurs. That is, the establishment of a firm generates a positive externality. Information is supplied, for instance, on what products sell and what business strategies work. Even business failure sends useful signals to others. However, entrepreneurs are not rewarded for producing this information. Therefore, it is claimed, the amount of entrepreneurial activity is below a level that economists would describe as socially optimal.[1] If imitation plays a significant role in diffusing entrepreneurship – as discussed in Chapter 2 – the plausibility of such an account is strengthened. However, this policy rationale is theoretical only, with as yet no substantiating empirical basis.

A related line of argument draws again on the idea that entrepreneurship spreads in part through the influence of imitation. If potential entrepreneurs are prone to imitate actual entrepreneurs, then places that have few entrepreneurs today – perhaps a locality with a history of dependence on large-scale industry – will be more likely to experience low rates of entrepreneurship tomorrow, other things unchanged. An implication of this form of path dependency is that public policy would be needed to impart a shift to a higher level of entrepreneurial activity. However, the possibility that rates of entrepreneurial activity might be partially determined by demonstration effects has not been analysed empirically. The path-dependency case may have a basis in fact – and feels true-to-life for many practitioners – but whether it is important relative to other influences is not known.

Other positive externalities might be traced to a set of area regeneration effects from entrepreneurship. For example, start-ups might attract other firms to a locality by increasing the availability of services or by enlarging the local pool of trained workers. New firms might also make a location more attractive to live in. In so doing, they could help to counter the downward economic spiral that results when the best-qualified and most employable individuals emigrate from localities in decline. Increased start-up activity might also lower the unit costs of providing public utilities. And the value of housing could rise as new firms are created – a phenomenon witnessed in the vicinity of some business incubation schemes. New companies in a poor locality could also help to retain incomes that would otherwise have been spent elsewhere. Indeed, the variety of interactions between firms and the places that host them is considerable. Anecdotal accounts suggest that such processes can also be important quantitatively. However, policy arguments based on regeneration externalities are undermined by a lack of empirical studies of enterprise demographics and local economic development.[2]

The costs and distribution of unemployment have also played a part in policy thinking

Another strand of policy thinking rests on consideration of the social costs of unemployment. Unemployment and underemployment have obvious direct and indirect economic and social costs for communities as well as individuals. For any population group – local, regional or national – there are benefits in having the unemployed move into employment. If measures are available to reduce joblessness that cost less than the full cost of unemployment their adoption merits consideration. Encouraging entrepreneurship is potentially one such measure. Indeed, Cowling and Hayward (2000) found significant overall public savings from a full cost-benefit assessment of a local self-employment scheme in the United Kingdom. However, the available evidence indicates that the cost-effectiveness of entrepreneurship support is limited to a small fraction of the unemployed, and that pro-entrepreneurship strategies deliver relatively small numbers of jobs over the short-run. Nevertheless, promoting entrepreneurship in order to reduce unemployment could entail an automatic area-based targeting of programmes if, as is frequently the case, unemployment is geographically concentrated (for example, a 1998 study in the United Kingdom found that half of the unemployed live in the sixty-five most deprived local authorities[3]).

A related argument for policy focuses on spreading the burden of unemployment. The difficulty of re-entering the labour force increases as the duration of unemployment lengthens. Therefore, reducing the prevalence of long-term unemployment could enhance welfare even if total unemployment is unchanged. However, as a rationale for policy this argument again turns on the cost-effectiveness of entrepreneurship promotion – relative to alternative policy measures – as a vehicle for employment creation and improved social cohesion. As previously described, cost-effectiveness generally exists for only a minority of the unemployed. Furthermore, this minority tends not to include persons with the weakest attachments to the labour market.

A policy of targeting business support to specific areas might be justified if it were shown that the social benefits of enterprise are particularly high in some types of locality. For instance, it is reasonable to expect that the social benefits of entrepreneurship in poor communities could be greater than in wealthier localities. But this will not be the case for all poor communities. For instance, the cost-effectiveness of pro-entrepreneurship programmes is likely to be low in circumstances of severe economic and social distress. Enterprise survival times, for example, will generally be shorter than in localities with more conducive trading environments. In fact, promoting entrepreneurship in low-unemployment localities might yield greater economic benefits on account of lower displacement effects (Metcalf *et al.*, 2000).

A further basis for intervention is where this can yield other forms of benefit – not related directly to employment or local regeneration – that would not have arisen in the absence of policy. For instance, efficiency gains can result from stimulating various forms of collaboration among firms. In this connection, a catalytic public sector role in developing business networks can be relatively inexpensive (see Chapter 10). In addition, many firms fail for reasons not directly related to the underlying viability of the business. For example, the inability to manage cash flow is responsible for a high share of new and small-firm mortality. Measures to help attenuate such "unnecessary" business failure – such as mentoring and training – could generate economic and social benefits. Economic benefits could arise because it is unlikely that the process of reallocating resources following company closures is cost-less.[4] Economic and social benefits could arise because of savings from lower unemployment (even if this is temporary) and a reduction in the distress that afflicts individuals and households when a business fails. In principle, all of the benefits described in this paragraph can be realised without distorting the essential process whereby markets allocate resources to highest-value uses.

Intervention at the local level has potential advantages

Once it is decided that there are economic grounds for public action, intervention by subnational governments may have particular advantages. The combination of major spatial variations in entrepreneurial activity and the scope for superior resource mobilisation and allocation through local programmes highlight the importance of local flexibility in the design and implementation of policy.[5] Local authorities have a role to play in matching programmes to varied local circumstances. Managerial training programmes, for example, are often best delivered through local bodies, or decentralised offices of national programmes. These local institutions can adapt schemes to an area's specific needs. They can also operate near to trainees, allowing these to undertake training without spending excessive time away from the workplace. Even the manner in which enterprise agencies present themselves may need to be tailored to the locality, as support agencies can be perceived as part of a social structure that is alien to some residents of deprived communities.

There are also occasions when enterprise creation might require strategic guidance from a local authority. This is particularly so when problems of co-ordination among numerous economic agents are serious. For instance, when localities are subject to acute economic shock – such as a major factory closure – local rates of self-employment usually rise sharply. However, many of the unemployed making a transition to self-employment choose easy-entry markets, especially if those who have lost jobs possess low or medium skills. This problem of "flocking" to sectors with low entry barriers will lead to further distress as firms in oversupplied markets earn small margins or cease to trade. Such distress can be prevented, or mitigated, if local enterprise support agencies promote diversification and discourage overcrowding in the relevant markets.

Governments, local and central, must also be concerned with policy failures. That is, they need to correct policies that impede the efficient functioning of markets or worsen existing market failures. For example, inappropriate spatial planning can exacerbate the difficulties of finding a place to work that many nascent businesses confront. Policy options are available that have few if any distortionary effects on the markets concerned. For instance, measures such as increasing the flow of information and advice for starting, financing and managing entrepreneurial ventures, encouraging public awareness of entrepreneurship, and promoting beneficial collaborative behaviour among entrepreneurs (such as in mutual credit guarantee schemes and inter-firm networks) are unlikely to involve policy failure.

Discrimination on grounds of race, gender, age or disability clearly calls for a public response, although this response need not be specific to any particular level of government. Discrimination has been claimed most often in connection with the treatment of loan applications by banks.

The following sections of this chapter discuss alleged market failures in connection with the supply to new and small firms of finance, business advisory services, physical workspace and training.

Finance

Various characteristics of small firms can create negative perceptions among banks considering loan applications (see Box 5.1). An extensive literature has examined purported market failure in the supply of debt and equity to small firms, as well as financial impediments to self-employment. The empirical evidence is somewhat inconclusive but increasingly errs to the view that market failure is less important than previously supposed. Many policy analyses insist on survey findings that a significant share of entrepreneurs report difficulties in gaining access to finance. However, such reports do not necessarily constitute evidence of market failure. For instance, in responding to surveys entrepreneurs may have a bias towards explaining poor enterprise performance in terms of developments external to the firm and its management. Access to finance is just such an external consideration.[6] Indeed, it has been shown that the views of entrepreneurs do not always accord with those of more "objective" observers such as credit rating agencies (Cressy and Olofsson, 1997).[7]

Credit markets do not function as a textbook market should

The market for credit for small firms does not function as a neo-classical market should. In a textbook market good projects should be funded regardless of the resources of the proprietor. In practice, collateral-based lending predominates, with the interest rate relatively unimportant as a means of discriminating between projects having different levels of perceived risk. For example, Astebro and Bernhardt (1999) show that while Canadian banks are increasingly interested in funding start-ups and small enterprises, loan applications are almost exclusively evaluated against the entrepreneur's personal creditworthiness rather than an assessment of project merits.[8] In the United States during the early 1990s some seventy per cent of all commercial loans were secured (Cowling, 1998). Such findings suggest particular problems for individuals with few financial assets or low personal creditworthiness and who wish to start a business.

In recent years banks in many countries have moved heavily into small-firm transactions. Indeed, banks have a growing commercial interest in cultivating a portfolio of small-firm clients.[9] Competition and rising costs in other markets – such as personal deposit taking – have reduced business for some banks. Banks can also benefit from lending to small firms as a way of marketing a range of banking services. Indeed, fee income from small-firm clients, for services other than lending, usually exceeds income from loans. There is evidence from the United States that competition in financial services has helped to supply the needs of lower-income groups. The demand for micro-loans for example is being met in part through credit cards which,

Box 5.1. **Bank lending and the financial structure of small and nascent firms**

The financing of new and small businesses typically differs from that of medium-sized and large firms. Small businesses usually depend for finance on the entrepreneur's own capital, retained profits, trade creditors, other creditors (such as fiscal authorities in the case of an allowance for deferred payments of corporation tax), and short-term credit in the form of hire-purchase, leasing and bank overdraft. The lack of equity and long-term debt capital, combined with a reliance on short-term credit, is reflected in a high debt to equity gearing ratio and low liquidity.

Characteristics of new and small firms that are likely to create negative perceptions among banks considering loan applications include the following:

- A high level of perceived risk owing to a high rate of enterprise failure and a general vulnerability to adverse market conditions. Amongst other causes this vulnerability can stem from reliance on a small number of products and/or a restricted market. Dependence on only a small number of products might also deter longer-term bank lending if product life cycles are short (bootstrap financing – financing out of cash flow – is irrelevant to many new-technology-based firms owing to very short product lifecycles).
- The lack of a track record, in the case of start-ups.
- The inability of some small-scale firms to provide collateral. Lenders may request personal guarantees as security for a loan. Such guarantees can be socially counterproductive if they deter Directors from taking the risks necessary to continue the expansion of their businesses. In addition, the intangible and highly specific nature of the assets of many new-technology-based firms can present obstacles in posting collateral.
- High bank transaction costs (for example in assessing and obtaining collateral) as a proportion of the amounts lent.
- Frequently, a relative lack of accounting expertise and of the skills required for proper presentation of business plans and loan applications. More generally, banks (and venture capital funds) may wish to see evidence of multidisciplinary business skills in a firm's management (including financial awareness, marketing skills, technical knowledge of the business, etc.) that may be unusual in small owner-managed companies.

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Box 5.1. **Bank lending and the financial structure of small and nascent firms** *(cont.)*

- Risk associated with cash flow deficiencies. Cash flow problems can arise from a lack of financial management expertise, rapid growth, and the fact of having a small number of products (with a larger number of products cash flow surpluses and deficits may cancel out). Innovative firms that supply new markets also face inherent difficulties in forecasting the scale and timing of capital requirements and may need substantial funds at short notice.

despite carrying high rates of interest on debt, can involve low introductory rates, low transaction costs and low total costs (by comparison with specialised providers of micro-finance) (Glackin, 2002). Increased attention by banks to the small firms sector may have served to narrow previously reported funding gaps. Public policy may also have had an impact. In the United Kingdom, for instance, a secondary effect of the Small Firm Loan Guarantee Scheme has been to raise awareness among some bankers of business opportunities in the small firms sector (although the primary impact of this policy in reducing funding gaps appears to have been small). Similarly, in the United States, the Community Reinvestment Act has made many banks more alert to the commercial opportunities available in low-income areas.

Evidence exists both for and against market failure

Attempts to demonstrate failures in the supply of debt have used a number of criteria. Some studies have sought to assess the effects of individual wealth on the likelihood of entry into self-employment. However, a positive association between wealth and entrepreneurship might simply reflect a greater propensity, or opportunity, for entrepreneurial activity among the affluent. It could also be a result of the tendency of children of wealthy parents to inherit family-owned businesses. To eliminate these possibilities research has examined whether windfall gains such as lottery wins, which bear no relation to the existing wealth of the recipients, increase the likelihood of entry to self-employment. This line of enquiry has revealed ample evidence that asset windfalls increase the probability that agents enter entrepreneurship, which is consistent with borrowing constraints (Blanchflower and Oswald, 1998; Taylor, 1998). Other research shows a positive relationship between the real value of housing equity and the rate of creation of unincorporated businesses, again indicating a collateral constraint on bank lending (Barlow and Robson, 1999). Similarly, house prices have been shown to be the single most important determinant of loan size under the United Kingdom's Small Firm Loan Guarantee Scheme (Cowling, 1998). And using data on one thousand six hundred companies, Carpenter and Petersen (1999) showed that the growth of small firms is constrained by the availability of internal finance, which supports an external constraints hypothesis.[10] As described earlier, there is also robust evidence, particularly from the United States, of discrimination in credit markets against certain ethnic minorities (Blanchflower *et al.*, 1998).

When firms increase in size they require a wider range of sources of finance. At the same time, greater size can bring efficiencies in obtaining financial resources. Various authors have found that liquidity constraints are more severe for smaller companies. For instance, Audretsch and Elston (1999) showed that small German firms are relatively disadvantaged in terms of access to finance.

However, there is also a considerable weight of evidence suggesting that market failure is not significant. Cressy and Toivanen (1999) found a regime of symmetric information between borrowers and banks in the United Kingdom, with "good" entrepreneurs receiving larger loans on better terms than "bad" entrepreneurs. Calcagnini *et al.* (1999) find empirical support for the proposition that small-firms in Italy are no more likely to be credit constrained than larger firms. A succession of recent Annual reports on small firm finance by the Bank of England tends to the view that credit constraints on small companies are not critical. And Hughes (1997) found little evidence for generic market failure in either the supply of debt or equity to small firms in the United Kingdom.

Ongoing contributions to the theory of credit markets also suggest that constraints are unlikely to be binding (see Box 5.2). Indeed, economists are increasingly coming to the view that while some investment projects with a positive net present value do go unfunded, market failure in the provision of debt is not widespread (Berger and Udell, 1992). If market failure does occur it appears to be more isolated than systemic and perhaps does not merit a major public policy response. As described by Cressy and Olofsson (1997), summarising a variety of empirical studies in Europe:

> *"There are* both *supply and demand constraints in* some *European countries. However, the evidence also suggests that in others the gaps are confined to specific financing modes (debt or equity), to specific sectors/types of firm (*e.g. *high-tech), and that they may also be a function of the state of the economy (recession or boom). The association of perceived funding gaps with other 'real' factors like management skills […] also weakens the argument for governments simply 'throwing money' at the problem."*

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Box 5.2. **Theory increasingly suggests that credit gaps are not decisive**

Stiglitz and Weiss (1981) provided the theoretical basis of much concern regarding constraints in lending to small firms. The analytical starting point is that banks do not possess the same information on investment proposals as entrepreneurs in new and small firms. The authors show that if banks and borrowers do not have the same information on a project's risk (expressed in terms of variation around a mean return) then the interest rate cannot be used to efficiently allocate loanable funds. This is because raising the interest rate will only attract more risky projects. Entrepreneurs who know their projects are less risky will hold them back when the interest rate rises. This happens because borrowers who know that their projects have a high risk also know that they will have a high return if the venture goes well. However, if the venture goes badly the downside is the same for two projects with identical expected mean returns. This is because protection against extreme downside losses is afforded by legislation on limited liability. So borrowers with risky projects can bear a higher interest rate than borrowers with less risky investment proposals.

However, the Stiglitz/Weis analysis depended on projects differing only with respect to their risk. Other models have been proposed. In particular, DeMeza and Webb (1987) considered what would happen if the key distinction that entrepreneurs make between investment projects is based on each proposal's expected mean return. In this case a higher interest rate would attract borrowers who believe their projects have a lower risk of failure. In practice, uncertainty exists with respect to both the risk of projects and their expected mean return. Consequently, there is also uncertainty as to the role of the interest rate in project selection (Cosh and Hughes, 1994).

In more recent work DeMeza (1999) has argued against Stiglitz and Weiss using a model in which *laissez faire* will result in *excessive* lending. Furthermore, over-lending is in this paper compatible with the presence of lending gaps. DeMeza also presents evidence suggesting that over-optimism among entrepreneurs merits caution in bank lending. He concludes that policies that make entry harder, such as strict bankruptcy laws or higher taxes on success, may lead to increased lending and higher quality entrepreneurship. In support of this contention evidence is cited from the United States where in States with generous bankruptcy laws it appears more difficult for low-income households to obtain loans (see Gropp *et al.*, 1997).

Box 5.2. **Theory increasingly suggests that credit gaps are not decisive** *(cont.)*

Parker (2000) takes the debate in a different direction by examining the decisions that entrepreneurs make over time – in the presence of credit constraints – regarding whether to enter and remain in entrepreneurship. He considers the fact that entrepreneurs can alter their decisions to save in order to overcome credit gaps and finance a business. Empirical evidence is presented from the United States showing that entrepreneurs do indeed have a greater incentive to save than employees. That is, the return from saving is higher for entrepreneurs. While welfare losses still occur in Parker's model as a consequence of constrained borrowing, this research casts further doubt on claims that credit gaps are a binding constraint.

One of the financing modes in which constraints may be serious is the supply of the smallest-sized loans. Collateral is not taken by banks for such loans because the costs of assessing the collateral's worth, and collecting it in the case of default, are too high relative to the size of the loan. In this connection, where banks rely on personal credit history, and there are persons who combine potentially viable projects with poor credit histories, public intervention can be valuable in principle. Schemes to facilitate access to loans in the smallest size class are detailed in Chapter 9.

The supply of equity may be more problematic than the supply of debt

The supply of small volumes of equity may be more problematic than the provision of debt, especially for start-ups and new-technology-based firms.[11] This is largely because venture capitalists face costs in assessing, monitoring and managing investments that vary little with the size of the investments they make. This makes smaller investments relatively unattractive. In addition, mobilising investment resources is a time-consuming process. This fact, combined with regulations that restrict the share of a venture fund that can be held by any individual partner, creates incentives to raise large-volume funds (Lerner, 1999). Consequently, selecting large average investments makes sense for fund managers who need to invest large-volume resources.

Analysts have drawn a distinction between so-called primary and secondary equity gaps. The primary gap represents the smallest size of investment required by most formal venture capital firms. The secondary gap is the minimum equity investment considered by privately operated business angel networks (the term "business angel" refers to an informal private equity investor). Mason and Harrison (1997) observed primary and secondary equity gaps in the United Kingdom of around 638 000 ECU and 128 000 ECU respectively (they also observed a trend towards growth in the average size of venture capital investments). In the United States, in the early 1990s, publicly supported early-stage venture capital companies reported minimum investment thresholds of around US$1 million. In 2000 the average size of early-stage equity investments in the United Kingdom was around £1.4 million (Mason and Harrison, 2002). Across Europe the average venture capital investment in 2001 exceeded 2.2 million Euro (data provided by the European Venture Capital Association). The size of equity gaps will vary somewhat from country to country, and possibly across regions within countries, in response to a variety of institutional, regulatory and market characteristics.

Scale issues are also important for other reasons. Smaller venture capital funds account for the bulk of formal equity investment in start-ups. For the reasons described above, large funds seek large investments in management buy-outs, mergers and acquisitions and business development. But because of their size the smaller funds are limited in the degree to which they can hold diversified investment portfolios. They thus incur relatively greater risk than larger funds (in addition to the greater risk inherent to early-stage investments). Small funds can also register higher operating costs on account of a greater need for assistance in early-stage firms. And small funds may find it difficult to finance additional rounds of investment in their investees, which is most likely to be needed by the companies that succeed and grow. This inability to provide later-stage financing can undermine a small fund's ability to fully profit from its investments (Murray, 1994). Equity guarantee and enhancement schemes can help to address these problems. Such schemes are considered in Chapter 9.

Inadequate demand could also constrain equity investment

Demand factors can also constrain firms in adopting optimal financial structures. Among many entrepreneurs knowledge of external equity investment processes appears to be limited. At an extreme, one Canadian survey showed that a high proportion of small-firm owners did not know that equity markets exist (Feeney *et al.*, 1999). Furthermore, venture capitalists often demand a significant equity stake in the firm as well as Board participation. But entrepreneurs frequently decline access to external equity, being averse to surrendering even a minimal degree of control over the enterprise. This is especially so in family-owned firms. Consequently, many businesses are undercapitalised. This adds to their risk, which in turn deters providers of debt. A policy implication is that programmes to expand the supply of debt might be counterproductive in some cases. A greater willingness to accept external equity would facilitate growth and survival in many small firms. Demand for external equity might be increased through tax policies and possibly education, training and information.

Furthermore, it is a frequent assertion that a lack of good projects is a prime constraint on the expansion of venture capital activity. For example, in Canada, some ninety per cent of investment applications are rejected by business angels because of quality concerns (Feeney *et al.*, 1999). A scarcity of high-quality investment proposals has also been reported in the United Kingdom (Mason and Harrison, 2002). Policies that help to improve the quality and presentation of investment projects might expand access to equity finance (see Chapter 9).

Business development services

Many persons starting a company have only a vague conception as to how they will undertake the formation of the enterprise and its management. Fielden *et al.* (2000) found that thirty-five per cent of potential new business owners believe they would benefit from ongoing practical advice from a mentor in a related line of business.

Whether the market works well in providing advisory and information services to new and small firms is a contested subject, but market failure may be less frequent than is claimed. The Internet is augmenting information supply to small firms, and many providers of technical and managerial information have a strong interest in demonstrating products, equipment and services to potential small-firm clients. Hundreds of "how-to" books and journals are available to new entrepreneurs. In addition, manufacturers associations, chambers of commerce, universities and other bodies often provide a broad range of technical and managerial services tailored to small-firm requirements. Nevertheless, survey work conducted by the North American Business Incubators Association has found a scarcity of private advisory services for the earliest stages of enterprise creation.

Feller (2001) notes that market failure arguments in this field take a variety of forms, but that the market failure rationale is attracting increasing reservations, at least as concerns services for manufacturing. The problem rests on alleged imperfections in the market for information, on the sides of both demand and supply, as outlined in the following paragraphs.

On the demand side, small firms are said to incur higher costs in information search and screening processes. However, a more widespread use of new information and communications technologies is likely to lower relative disadvantages for smaller companies in information search. Even so, screening costs may be high for small firms relative to their turnover. A further demand-side argument is that small and micro-enterprises do not know their real assistance needs, especially in a context of rapidly changing technologies, production methods and managerial practices. Exacerbating such a situation, small-scale entrepreneurs may limit external contacts on account of a self-help psychology (Curran and Blackburn, 1992). However, some observers would hold that over the long-term it is incumbent on entrepreneurs to be aware of the importance of continuous and autonomous skills and information acquisition. Some commentators take the above-mentioned arguments further and posit that for certain business services, and at certain times, small firms will fail to constitute a source of effective demand large enough for private supply to emerge.

On the supply side, the elevated costs of marketing services to large numbers of small enterprises – relative to expected revenues – is held to be a barrier to private sector outreach. For instance, it has been seen that some management consultancy companies have first designed and marketed major service packages – such as in technology management – for and to the large-firm market. Similar products tailored to the needs of smaller companies have been developed and marketed only later.

An argument that combines elements of demand- and supply-side constraints runs as follows: possessing a limited internal division of labour, small enterprises must contract in the skills that are scarce within the firm. However, if the volume of services demanded is small, and there is some indivisibility in their supply,[12] then markets can fail to provide the missing skills. Whether such purported market failures are constraints in practice, or whether these arguments are essentially theoretical, is under-researched. Nevertheless, there are some types of services that are unlikely to be established by private agents without public support and which can be important in promoting entrepreneurship and generating economic and social benefits. In particular, pre-start advisory and screening services for low-income or unemployed individuals need some public stimulus as, in addition to involving high transaction costs, these clients are easily discouraged by a requirement to pay. Temporary public support to expand the availability of some types of advisory service might also be justified where this aims to increase awareness (and absorptive capacity) among small firms regarding the commercial benefits of adopting particular business practices (such as ICT and its emerging applications).

As Storey (forthcoming, 2003) points out, the nature of the alleged market failure is directly relevant to the form that public intervention should take. If the assumption is that firms are unaware of the possible benefits from using external advice then the appropriate policy response should involve a one-time demonstration of these benefits. If the assumption (or evidence) is that markets systematically fail to supply the necessary services in the right amounts then a policy to rectify this situation should entail continuous measures. However, Feller (2001) observes that claims of market failure are highly generic. Their real-world significance depends on the particular – and in practice varied – structure of inter-firm relationships in given industries and regions. Inter-firm (and social) relationships often represent key sources of information and advice. So whether alleged market failures for business services necessitate a public response depends in particular cases on the extent of information supply from private and not-for-profit sources.

Finally, it needs to be borne in mind that even if market failure is confirmed, the policy response need not, and probably should not, involve direct public provision of business services. Appropriate regulation of private providers – and in some circumstances the subsidisation of their use – can have advantages. Regulation can, for instance, encourage competition among service providers. As previously noted, one argument that has been made for public intervention holds that this is justified in order to raise awareness among small firms of the benefits from using certain business services. If successful, this could increase effective demand and stimulate the private supply of services. In the framework of such an argument, the logical option would be to support the use of private service providers in the first place in order to bring about such demonstration effects.

Business accommodation

The supply of industrial real estate is often problematic. Westall *et al.* (2000) concluded that "One of the key barriers to enterprise in disadvantaged areas is appropriate premises; that is premises that offer affordable and flexible rents". The authors note little investment in workspace for disadvantaged communities in the United Kingdom. A lack of available premises was also observed to be a key reason why micro-enterprises choose to relocate. Survey data for western Germany from the early 1990s revealed that almost ninety per cent of firms in business incubators considered that the rented space that these programmes offer had played a significant role in the development of the company (OECD, 1999c).

Supplying industrial accommodation often holds little attraction for private investors without public support. In economically distressed areas there may be difficulties in securing tenants – especially if auxiliary infrastructure is poor – and long time periods in recovering investment outlays. Moreover, opportunities for higher returns often exist in other forms of real estate. There can also be serious problems in the supply of accommodation for new and small firms in dynamic property markets. These difficulties principally relate to the superior returns available from using real estate for office space and/or housing. Such uses do not involve the high transaction costs of invoicing and collecting payments from numerous small firms, tracking rent arrears, maintaining an optimum level of occupancy, and overseeing the movement of firms in and out of the property (OECD/LEED-SOFIREM, 2000).

Furthermore, corporate property investors are often averse to the risk entailed by unknown business propositions such as enterprise start-ups. They sometimes demand a quality of covenant from prospective tenants that many new ventures cannot meet, even if these have business plans accepted by external financiers. For the private property developer an adequate covenant might require the submission of audited accounts for a number of previous years showing profits in excess of the annual rental, or one year of rent paid in advance on a rolling basis.

Training

For a variety of reasons small firms may express insufficient demand for training. The opportunity cost of time spent away from the firm can be especially high in a small venture – even though the potential benefits from training are considerable in firms with a minimal internal division of labour. Training can be expensive, while small firms face high levels of uncertainty in their investment decisions, including investments in training (Kitching and Blackburn, 2002). Firms may be particularly concerned about their inability to appropriate the benefits of investments in training. This apprehension is likely to be acute in the smallest firms, which are generally unable to match the compensation packages offered by larger companies and which experience relatively high rates of turnover among managerial staff. Indeed, the share of managers that undertakes formal external training is a positive function of firm size (OECD, 2000a). Entrepreneurs in some small firms may also be unaware of what types of training have greatest potential impact on business performance.

On the supply side of the training market, the training provided may be inappropriate to the specific needs of the smallest category of firms. In part this is because providers of training face high costs in tailoring programmes to the diverse needs of many small firms. Supplying generic forms of training entails lower costs for trainers.

Concluding remarks on rationales for policy

The strongest grounds for policy intervention appear to be the correction of failures in a number of markets on which entrepreneurs depend. Policy justifications premised on employment effects appear weak. This is because there is only a limited population over which enterprise support is a cost-effective alternative to unemployment insurance, while employment creation from the birth of new firms tends to be small over the short-run. At present, there is insufficient empirical evidence to base policy solely on regeneration and other externalities from enterprise births. Nevertheless, the local economic impact of enterprise creation is likely to be multifaceted and possibly significant (and certainly merits further investigation, as described in Chapter 11). Where discrimination exists against minorities, women, the disabled or other groups, corrective and preventive policies are essential (indeed, preventive policies might be justified at all times).

Market failure justifies public action if failure is confirmed, and if policy is likely to produce a situation superior to the "do nothing" option. However, the identification of market imperfections does not imply that the public response should be a direct one. For example, commentators have noted that techniques used by banks to assess creditworthiness can operate to the disadvantage of poorer individuals – regardless of inherent creditworthiness. So, for some banks, making regular mortgage repayments is more likely to be taken as an indicator of good credit standing than is a history of regular rental payments. And making regular loan repayments appears to be considered as better evidence of creditworthiness than consistent payments into a savings account (Metcalf *et al.*, 2000). An appropriate response for public authorities wishing to change banking practice might be indirect, working with the banking industry, exercising moral suasion and encouraging the examination of alternative criteria in credit assessment. Part II of this book addresses possible policy responses to key issues of market failure discussed in this chapter.

Notes

1. Theory indicates that if an economic activity such as entrepreneurship produces positive externalities then it should be subsidised up to the point where the amount of the subsidy equals the value of the external benefit associated with the next unit of activity. In practice, however, policymakers will not know when this condition has been achieved. This is mainly because it is extremely difficult to assess the value of benefits (and costs) that occur outside a market. Precisely because these benefits are external to the market no monetary value is expressed for them. In the case in point, if a market existed in which actual and potential entrepreneurs could buy the information produced by enterprise creation then policymakers would have an indication of how much this information was worth. But such a market is absent. In some fields of economics a great deal of attention has been given to estimating the size of externalities using a range of innovative techniques. However, this report found no studies that attempt to assess information externalities associated with entrepreneurship.
2. By contrast, a large number of comprehensive quantitative studies have been undertaken of local and regional income and employment effects stemming from discrete and generally large commercial investments, investment subsidies and infrastructure projects. Examples are described in Foley (1992).
3. Department of the Environment, Transport and Regions, index of local deprivation, 1998.

4. This is especially so when the value of assets is specific to a particular use (see Williamson, 1985). However, asset specificity is most common in manufacturing. It is less relevant to the micro-enterprises, often in the service sector, that are frequent in poorer localities.

5. However, centralised co-ordination and/or implementation of programmes will also be necessary. In the most general terms, if local policies have important effects on the welfare of other localities then inefficient resource allocation (from a national standpoint) could occur in the absence of central control. If policies entail economies of scale then they might best be implemented centrally. Central co-ordination can also provide a degree of economic insurance because inter-regional recessions and growth are often not perfectly correlated. And centralised policy is required on equity grounds. This is because policies that have redistributive effects at the local level may become financially unsustainable owing to the movement of wealthier individuals out of redistributing areas and the movement of poorer individuals towards such localities.

6. More telling perhaps are responses from employees maintaining that a lack of capital is a key reason for not becoming self-employed (see Banchflower and Oswald, 1998).

7. However, Egeln *et al.* (1997) compare firms' subjective assessments of financial restrictions with credit-rating data. The authors find a relatively high correlation between self-classification and the "objective" data.

8. At the same time, the creditworthiness of owners was not seen to correlate strongly with business success. The banks considered by Astebro and Bernhardt were thus found to be doing a relatively poor job in allocating loanable funds. While the receipt of a bank loan was seen to be a significant positive predictor of a firm's survival, other sources of debt were more than twice as effective in increasing business survival. Indeed, higher-quality projects tended to select non-bank sources of debt, where terms were better (it was also found that the number of sources of finance appeared to be a good predictor of project quality). The authors show how the use of additional variables to predict business survival could significantly reduce bank loan losses. The variables used include the number of owners of the firm, the human capital of the entrepreneur(s), the availability of equity, whether the company was new or bought from a previous owner, and whether the firm was a franchise. The authors note that the failure to properly evaluate start-ups affects bank profitability. It may also limit potentially able firms by sending incorrect signals to other actors. It is not clear, however, that these important findings lead to a public policy conclusion. Successful banks will presumably be alert to such research – which was in fact sponsored by a bank – and modify lending practice accordingly. Other banks will be forced to follow suit or risk losing market share.

9. See for example "Small business offers bankers rich pickings", *Financial Times,* 11/08/2000.

10. Other studies use a related but different approach, examining the existence of a relationship between cash flow and investment. In an efficient capital market there should be no systematic relationship between the two. Firms would be indifferent whether funds came from internal or external sources. Using such an approach, Audretsch and Elston (1994) find evidence for liquidity constraints on a sample of German small firms from 1977 to 1985. However, Kaplan and Zingales (1987; 2000) have called into question the theoretical and empirical suitability of investment-cash flow sensitivities as an indicator of financial constraints. The authors note, *inter alia*, that such sensitivities can also be seen in large firms – such

as Hewlett-Packard – that are hard to classify as financially constrained. Why these sensitivities exist is still unclear.

11. Nevertheless, debt and equity gaps should not be treated as unrelated because banks may be more willing to lend to a company they had previously refused a loan to if the firm can obtain additional equity (Cressy and Olofsson, 1997).
12. For example, entrepreneurs sometimes attest that engineering firms are unwilling to service frequent small job requirements.

ISBN 92-64-19978-0
Entrepreneurship and Local Economic Development
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PART I

Chapter 6

Entrepreneurship Support for Target Groups

Most countries operate specialised schemes to assist target firms and population groups. These include programmes designed for women, ethnic minorities, youth and social enterprises. Entrepreneurial activity in a number of these target groups has grown significantly in recent years and is often closely linked to local communities. This chapter briefly reviews what is known about entrepreneurship in these target populations. It then considers how local authorities should design and implement the relevant specialised programmes.

Women

While increasing numbers of women are active in the OECD labour force, significantly fewer women than men engage in entrepreneurship. Women participate in entrepreneurship at about one-half the rate of men across the twenty-nine countries surveyed by the 2001 Global Entrepreneurship Monitor.[1] However, change is apparent. In most countries the number of women entering self-employment has increased significantly in recent years (OECD, 2000). And in some countries change has been striking. Since the 1970s, for instance, women have experienced a six-fold increase in their share of business ownership in the United States (Renzulli *et al.*, 2000). And according to Industry Canada, between 1991 and 1996 the number of self-employed women grew twice as fast as for men.

While research is sparse, studies suggest that female entrepreneurship has a number of stylized characteristics. For example, women often express lower preferences for self-employment than men and frequently elect different types of self-employment. Business opportunities are frequently sought that can be combined with family responsibilities (Brush, 1992), although the desire for autonomy, independence and satisfaction from work are important for both male and female entrepreneurs. Women are less likely than men to have multiple firm ownership (Rosa and Scott, 1999). And for a number of reasons women tend to initiate smaller projects than men and to commence with lower growth expectations. In the United Kingdom, between 1991 and 1995, proportionately three times as many male self-employed created jobs as women (Cowling and Taylor, 2001). The smaller size of female-owned businesses may also explain higher recorded rates of enterprise failure in these firms (European Observatory for SMEs, 1996). However, not all studies find lower rates of survival in women-owned firms.

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Entrepreneurship among women has been concentrated in service sector businesses, often reflecting broader sectoral patterns of women's labour market participation. Female entrepreneurship in technology-intensive sectors also appears less frequent than for males. Other research suggests that women are more likely to create and work in (mixed gender) start-up teams rather than sole proprietorships (Carter, 1997).

A range of personal characteristics relating to marital status and the number and ages of children affect women's decision to enter self-employment (Williams 1998). Women entering self-employment can also face particular obstacles. These have been seen to include a relative lack of business experience, limited business networks, the tendency to make small investments, and mobility constraints on account of child-care commitments. In addition, various studies suggest that women encounter difficulties in obtaining bank loans. Indeed, there is evidence that women's reliance on formal sources of business finance is less than for men (Carter, 1997). Metcalf *et al.* (2000) review a number of reports that indicate that women are more likely to be asked for (co)-guarantors, are more frequently requested to provide collateral, and have the perception of not being taken seriously by bank staff. The fact that women-owned businesses are disproportionately present in the service sector can also raise financial hurdles if the assets of these firms are less tangible and more difficult to value as collateral.

There is a need to selectively adapt some aspects of entrepreneurship development programmes

Programmes specifically designed to facilitate female entrepreneurship often focus on measures to remedy perceived difficulties in accessing business lending. Another common feature of women-oriented business assistance is the stress on developing support networks. Network programmes might be particularly beneficial for women who have interrupted or failed to develop careers, owing perhaps to child rearing and other responsibilities. Some evidence suggests that women have less diverse and useful networks than men and that their business discussion networks include more kin and fewer co-workers (Renzulli *et al.*, 2000; Cooper *et al.*, 1994). While such traits might affect the type of business information available to women it is not clear that this will have important consequences. Indeed, some research has found women to be just as active and successful as men in seeking and obtaining advice and assistance.

In some respects there is little justification for establishing business support programmes exclusive to women. The basic skills and knowledge required to operate most businesses – preparing business plans, keeping company accounts, managing cash flow, marketing goods and services, etc. – are not gender specific. In addition, the concept of separate programmes for women might be considered as running counter to the goal of "mainstreaming" women's role in economic and social life. And for development agencies with limited budgets separate programmes can involve wasteful duplication of overhead costs.

However, there are reasons for selectively adapting programmes in a variety of ways. This is especially so with respect to peer-group support and networking. Women often have experience of shared challenges and difficulties in establishing and managing firms. Practitioners note that important benefits – such as increased confidence and improvements in the quality of projects – can stem from discussion and analysis among women engaged in enterprise creation. Information, training, and consultation material might also be adapted to the needs of female entrepreneurs. For example, as women tend to establish smaller ventures advice might examine how the disadvantages of small scale could be compensated for by the adoption of niche business strategies. Female staff might also be included among the providers of business advisory services, as some women feel more comfortable in seeking information from other women. And advisory and mentoring programmes might even include home visits in order to help break down communication barriers with other family members. Enterprise development organisations can also play a role in changing attitudes in the business community. The economic importance and achievements of women's entrepreneurship need to be underlined so as to counter sexism and unfounded discouragement. More broadly, local governments can be critical in providing high-standard, reliable and affordable childcare services, without which entrepreneurship is an excessively demanding challenge for many women.

Ethnic minorities

For a variety of reasons, many ethnic minority populations reside in geographically concentrated communities. Some of these communities are affluent. Others have an enclave character and register severe economic and social distress. In some countries various forms of real and perceived discrimination against minority groups have been reported. For instance, as described earlier, robust evidence exists of discrimination against African Americans in the market for credit in the United States. And Metcalf *et al.* (2000) report a number of studies that indicate difficulties in accessing bank lending for some members of ethnic minorities in the United Kingdom. Improving the welfare of minority communities, and facilitating their integration into the economic and social mainstream, is an evident concern for many local authorities.

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The share of minority populations that engage in entrepreneurship is often high relative to the national average (Borjas, 1986). Two competing theories have sought to explain this. On the one hand, it is held that minorities face obstacles in obtaining waged and salaried employment. This might be due to employer discrimination, causing individuals to turn to self-employment. It might also reflect difficulties in finding employment for persons with relatively low levels of education and skills, particularly language skills. On the other hand, a set of broadly positive influences might "pull" ethnic minorities into entrepreneurship. These could include supportive ethnic business networks, access to informal sources of labour obtained through family ties, advantages in the design of business strategies that target niche ethnic markets, a propensity towards entrepreneurship among individuals who have migrated, and traditions of entrepreneurship in originating countries (Hammarstedt, 2001).

Studies provide evidence both for and against the above hypotheses. For example, Ram and Jones (1998) showed that poor employment prospects facing ethnic minorities do affect self-employment entry in the United Kingdom. However, research in the United States has also shown self-employment to be more common in more advantaged immigrant communities (Fairlie and Meyer, 1996). And there is even some indication that banks can prefer individuals from certain immigrant communities by comparison with host-country loan applicants (Hughes and Storey, 1994). Given the enormous variation that exists in the circumstances of migrant groups and host countries, it is unsurprising that the rival hypotheses elicit both confirmatory and contradictory evidence. Even in the same city, different minority groups can face different constraints on business start-up and make use of community resources in different ways (Teixeira, 2001). And further differentiation is evident between recently landed migrants and those with more years in the host country (Gomez, 1999). Furthermore, a combination of push *and* pull factors are likely to operate simultaneously. For instance, Clark and Drinkwater (1998) examined why the share of ethnic minorities that are self-employed in England and Wales is high relative to their share of the population. The authors estimated the relative importance of various push and pull factors using a data set covering over five thousand individuals of Asian and Caribbean origin and almost three thousand whites. Discrimination in the labour market was found to contribute to the over-representation of ethnic minorities in self-employment. However, push factors failed to fully explain differences in self-employment propensities. Pull factors also appeared to play a role.

Programmes could be selectively adapted when targeting ethnic minority groups, while policy should tackle discrimination and other barriers.

For reasons similar to those described above in connection with policy towards women entrepreneurs, there are potential drawbacks to developing separate programmes for ethnic minority entrepreneurs. However, appropriate adaptation and specialisation within mainstream support programmes could be helpful. Policy needs to pay attention to any lack of knowledge among immigrants as regards the practical steps to take in setting up a business. In this regard, a frequently encountered problem is the low usage of mainstream advisory and support services among minority groups. This suggests that proactive outreach to these communities may be necessary, along with monitoring of whether service use is evenly distributed among minority and non-minority entrepreneurs. Hiring business advisors from ethnic minorities might serve to lower communication barriers where these occur.

Local authorities have a role to play in countering prejudice through their own discrimination-free practices in enterprise development, and possibly by acting as a channel for reports of discriminatory behaviour. Local authorities can also act to raise awareness of the problem of discrimination while seeking to highlight the opportunities for entrepreneurship among minority groups (indeed, it should be recalled that ethnic minority entrepreneurs can represent a particular asset for the locality. For instance, among other positive contributions, their international contacts might be of use in facilitating marketing abroad). National authorities might monitor bank lending in under-invested communities, and consideration can be given to statutory bank disclosure of lending activities (as in the United States). Policy should also minimise the influence of factors that inhibit ethnic entrepreneurship. Training, particularly in language skills, can be especially important. However, not all the inhibiting factors are easily amenable to policy. For example, business migrants can face problems if information on their creditworthiness and business history exists in the originating country and is otherwise hard to ascertain. This is a constraint that local bodies can do little to resolve.

Youth

High rates of unemployment among young people in deprived communities – combined with such problems as delinquency and drug-abuse – have spurred some development agencies to consider ways of encouraging youth entrepreneurship. In a number of more affluent areas an interest in youth entrepreneurship has also been motivated by the fact that significant numbers of successful family-owned businesses fail to find a successor once

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the owner retires. Some schemes for youth, such as the Prince's Youth Business Trust in the United Kingdom, have established a considerable record of success. A survey and assessment of youth-oriented schemes is provided in OECD (2001).

While design modalities vary, programmes of self-employment support for the young give particular emphasis to training (OECD, 2000). For example, the self-employment option of the United Kingdom's New Deal allows young people to study for an approved qualification. The Italian programme of youth entrepreneurship support (Law 44/86) – one of the most developed in any OECD member country – stresses comprehensive business mentoring, business plan development and financial assistance to viable ventures.

Young entrepreneurs generally face a number of obstacles that are more severe than for other groups. For example, working from home, the start-up site of choice for many entrepreneurs, is often problematic for young people. Social skills needed for business may be lacking. For instance, younger people can feel uneasy attempting to sell to older people. Less experienced young people may lack awareness of the support programmes available, with graduates often better at accessing assistance. And among young people from some disadvantaged groups there is occasionally a distrust of government agencies. But the key constraints reflect inadequate human and financial assets, and limited work and business experience. The human capital constraint is evidenced in many studies showing that the age of the entrepreneur is an important determinant of enterprise survival. For instance, Scott (1995) found that persons over thirty-five years of age entering self-employment usually have greater survival probabilities. And in France, INSEE (2000) showed that if a new entrepreneur is fifty years of age or older there is a sixty-six per cent probability of the venture surviving for three years. By contrast, this probability falls to fifty per cent if the entrepreneur is younger than twenty-five.

Large numbers of the young express a preference for self-employment (Blanchflower, 1998). However, the lack of human capital and relevant experience makes entrepreneurship a viable option for few young people. More particularly, as a remedy for unemployment amongst disadvantaged youth the promotion of entrepreneurship will have little effect. As in the case of programmes for women and ethnic minorities, establishing separate public schemes for youth could be inefficient. Rather, existing programmes might be adapted and advertised in a variety of specific ways. Training and mentoring networks will be critical in helping to compensate for inadequate prior experience in business. As young people generally have limited financial resources of their own, assistance in the preparation of business plans and loan applications is particularly important. Business advisors might need to possess, or be able to call on, specialised sectoral knowledge, as young people sometimes develop business ideas in fields such as the music industry and aspects of information technology that may be less common among older entrepreneurs.

Social enterprise

While there is no generally accepted definition of a social enterprise, the term usually applies to firms that aim to achieve social objectives using resources from a variety of sources. These sources include government, supplier discounts, philanthropic donations, volunteer work and income from sales of goods and services on commercial markets. The combination of public and other funding with income earned from market transactions is the key trait distinguishing social enterprises from traditional non-profit organisations. In Europe social enterprises first appeared in significant numbers in the late 1970s. Their emergence occurred in parallel with the growth of interest in local development as a sphere of public policy, and was in some respects caused by the same structural economic transformations. Social enterprises are essentially local. They often work closely with public authorities, local volunteers, community-oriented grant-awarding bodies and the beneficiaries themselves in order to address specific local needs. Many social enterprises have inspired new ideas for social and economic development programmes and complemented public initiatives. They have become increasingly prevalent in disadvantaged communities and now attract growing policy attention among local authorities. The key characteristics of the sector, the legal forms and regulations that encompass it, and the reasons for its expansion (particularly in higher-income countries) are reviewed in OECD (1999b) and Borzaga and Defourney (2001).

The most frequent objectives of social enterprises are to upgrade the skills of the unemployed and underemployed and facilitate labour market integration. These aims are usually approached by providing training-oriented work experience of a given duration and/or by offering longer-term employment. Social enterprises thus afford work experience that is intermediate between unemployment and the open labour market. Another common objective is the supply of social and economic services that are otherwise under-supplied. That there might be systematic under-supply of certain services has been explained in terms of public under-funding and/or the newness of the services in question and/or the limited profitability of fully commercial service provision. Social enterprises that focus on the supply of selected services can also fulfil a work-integration function in that the enterprise's workforce often includes individuals who qualify for employment subsidies.

Policy support for existing social enterprise should essentially be the same as for profit-oriented firms

In discussing the role for government it is necessary to distinguish between policy towards the social enterprise sector *per se* – such as developing a specific regulatory framework – and policy to upgrade the capabilities of existing social enterprises. In a given country, the importance of the social enterprise sector and the desirability of its further development reflect a variety of policy objectives and institutional conditions that bear little relationship to entrepreneurship. These conditions can include the level of development of other third-sector organisations, the role of the public sector in providing community and social services (as contrasted with the roles assigned, whether by default or custom, to family and informal networks), and trends in decentralised contracting of public services.[2]

Abstracting from the merits of policy towards the sector as a whole, once social enterprises operate they will require access to some of the same services needed by for-profit companies. Entrepreneurs in social enterprises can face particular challenges. These can include managing a financial structure that might be based on a number of uncertain and activity-specific revenue streams, determining the appropriateness and level of charging for selected services, deciding the degree of cross-subsidisation between different beneficiaries and income sources, negotiating contracts with third-party payers, and overcoming aversion among banks to working with an unfamiliar form of enterprise. However, management methods characteristic of for-profit ventures must also be adopted by social enterprises. In this regard, training services might be particularly valuable, especially because externally recruited commercial managerial expertise can be excessively expensive. Tax advice will be helpful in some jurisdictions. And services to foster business networks – including with for-profit companies – might help compensate for the small size of social enterprises, for instance in making joint approaches to banks. In some countries, including France and Italy, national financial bodies have established investment and loan funds as well as guarantee programmes and other measures to facilitate the financing of social enterprises. However, there may be too little demand at the local level for local governments to justify specialised financial programmes for social enterprises.

Conclusion

This chapter has described key features of entrepreneurship among women, ethnic minorities, youth and in social enterprises. The growth of some of these categories of entrepreneurship was noted. Linkages to various local development concerns were also described. Broadly stated, the policy emphasis was placed on adapting and adding emphases to mainstream support structures rather than creating separate services. In some cases, a major element of outreach and programme monitoring is required, combined with measures to facilitate interaction with, and service use among, the target groups. Also important is that local authorities highlight the opportunities for entrepreneurship in the groups in question. In parallel, broader steps are needed to counter problems of sexism and racism, and to foster an overall environment that supports entrepreneurial initiative among the groups concerned (such as through the provision of appropriate childcare services).

Notes

1. Problems exist in accurately determining the dimensions and specific characteristics of women's entrepreneurship. These largely stem from the fact that women are disproportionately represented in small service-sector firms for which statistics are often incomplete.
2. Broader policy concerns also exist. For example, while there are a number of positive assessments, more evaluation is required of the extent to which trainee-recruits integrate into the mainstream labour market after graduating from social enterprises. Attention also needs to be paid to the costs incurred by the public sector relative to other job creation and training programmes, as well as the terms on which publicly assisted social enterprises compete with for-profit firms.

PART II

POLICY RECOMMENDATIONS ON ENTREPRENEURSHIP, SELF-EMPLOYMENT AND LOCAL ECONOMIC DEVELOPMENT

Abstract. *Part II presents a detailed discussion of policy recommendations on supporting entrepreneurship as a means to facilitate local economic and employment development. The recommendations are organised around three themes: strategy, finance and programme design. Each recommendation is addressed to the level of government that possesses the relevant policy competence: national, national and local, and local. The overarching challenge that the guidelines seek to meet is to maximise the advantages of increased entrepreneurship while minimising the drawbacks (such as enterprise displacement effects). Part II addresses a number of important strategy choices that policymakers face. For instance, consideration is given to trade-offs between programme deadweight and enterprise success. Attention is also given to the widely debated policy choice of whether to direct support to established firms, or whether to prioritise support for the creation of new enterprises. Part II closes with a review of the types of research that are needed in order to improve understanding of the key policy issues.*

ISBN 92-64-19978-0
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PART II

Chapter 7

Overview of Policy and Strategy Considerations

There is much that local governments and locally devolved offices of central authorities can do to encourage entrepreneurship. The range of available measures includes initiatives to: increase the flow of information and advice for starting, financing and managing entrepreneurial ventures; encourage awareness of entrepreneurship; facilitate access to accommodation; improve skills; modify incentives for the private supply of key business development services; and promote beneficial collaborative behaviour among firms (such as in mutual credit guarantee schemes and inter-firm networks). Indeed, some countries, such as Italy, have an important history of policy development at the subnational level, for example through regional credit consortia such as Ervet in Emilia Romagna (Belussi, 1998).

Policy choices involve unavoidable trade-offs

A number of the policy choices that decision-makers face involve important trade-offs. For instance, the greatest contribution to employment creation will come from the entrepreneurs who establish firms that survive and grow. However, a policy of targeting this group – which has been widely advocated – would entail greatest programme deadweight. This is because those with the highest probability of success in business are also the most likely to enter entrepreneurship of their own accord. Attempting to address issues of poverty and social equity by promoting enterprise among the unemployed or low-income groups could involve lower deadweight, if individuals less likely or able to become entrepreneurs enter into business. But such an approach is also likely to bring higher rates of enterprise displacement and more limited employment creation.

An evident dilemma is that there is a trade-off between programme deadweight and enterprise success. One way of attenuating this trade-off is to focus support on lowering the barriers to entrepreneurship that either do not – or need not always – bear a systematic relationship to enterprise viability (Metcalf *et al*., 2000). Such barriers include the lack of an adequate credit history, and discrimination against individuals on account of gender, race, disability and the possession of a criminal record.[1] An approach along these lines could facilitate entry among persons from disadvantaged groups who have viable projects. It might thus reduce the size of programme deadweight without raising rates of failure. Nevertheless, this approach will not eliminate the trade-off entirely. As discussed in Chapter 10, to attenuate some of the policy trade-

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offs described in this publication, well designed performance monitoring is essential for selecting the right candidates and projects to work with.

Should policy concentrate on existing firms or the creation of new enterprises?

Another policy choice concerns whether to target support on established firms or enterprise creation, or both. A policy of targeting the creation of new businesses might get less than full support from incumbent firms facing increased competition. Incumbents can also be relatively effective at influencing policy in as much as they are better organised than start-ups and their preferences are better known.

More specifically, Storey (1993; 1994) and others have argued strongly for support to be directed to established and/or fast-growth firms. The reasons usually given for this prioritisation are that failure rates are lower in established enterprises, and that only a small number of fast-growth firms account for a disproportionately large share of private-sector job creation.[2] Public resources deployed during enterprise start-up will be lost at a high rate because early-stage firms experience high mortality. The impact on employment generation, it is held, will also be small relative to what could be achieved by a focus on established firms.

Evidence suggests that some types of programme, particularly those that concentrate on the smallest size class of firms, will be more effective if focused on incumbent firms. Assessing a scheme of micro-enterprise support in Washington DC, Schreiner (1991) found that the impact on the length of time worked per year was greatest for those who were already owners of a business. He concluded that the most significant effects of micro-enterprise programmes are likely to occur when they assist existing ventures. Indeed, more generally, practitioners often observe that while policy has done much to encourage persons into business, less attention has been given to improving the chances that these businesses survive.

However, there are at least three counter-arguments to a policy of prioritising incumbents. Firstly, if programmes are successful in expanding the pool of entrepreneurs – without diminishing average enterprise quality – then the number of fast-growth firms is also likely to rise. Second, some of the alleged market failures that bear on enterprise activity may be more serious for start-ups and early-stage ventures. A related observation is that constraints might operate on the process of start-up itself. For example, surveys undertaken as part of Scotland's Business Birth Rate Strategy found that low rates of enterprise creation were a reflection of widespread uncertainty concerning the initial steps required to implement business ideas. This was the case even for individuals who expressed a general interest in entrepreneurship. A third argument is specific to local development and hinges on the observation that firms that grow tend to become less embedded in the local economy. Enterprises that are expanding often sell and source a larger part of production and inputs in out-of-area markets. Therefore, a local economy might benefit from new rounds of enterprise creation (Gorton, 1999). And, as discussed in detail in Chapter 10, proposals to target advice and support on fast-growth companies have some important drawbacks.

In conclusion, there are reasons why policy should in principle facilitate both high-quality start-up *and* support existing firms. The appropriateness of a balance between the two must depend on specific local circumstances. For instance, some local areas might have little alternative to prioritising increased rates of company start-up. In localities undergoing major industrial restructuring there may be few private sector employers – and these could be large and not in need of public assistance – while any long-term development prospect for the locality might require a new generation of firms. Nevertheless, the arguments against supporting the creation of new firms must be taken seriously. It is clearly wasteful to invest public resources in efforts that only serve to raise the number of new firms regardless of their prospects for survival or growth.

The success of programmes in affecting area development depends greatly on initial conditions, as well as factors outside of local control

Many critical variables that affect business viability – such as the interest rate and the level of aggregate demand – are either entirely or partially outside the influence of local policymakers. While some research has concluded that the business cycle plays a limited role in overall small-firm mortality, there is a considerable weight of evidence that macroeconomic factors can be of major importance. For instance, using Australian data, Everett and Watson (1998) found that from thirty to fifty per cent of small business failures were caused by macroeconomic conditions.

The success of programmes will also be sensitive to initial conditions. For example, Cowling and Hayward (2000) encountered a strong negative correlation between the local rate of unemployment and enterprise survival. And the earnings of the self-employed have even been seen to vary with the average educational attainment of a locality's inhabitants (Gomez, 1999). Programme outcomes will also be influenced by whether an area is experiencing entrenched long-term unemployment or short-term employment fluctuation. This is because candidates coming from an extended period of unemployment are less likely to operate successful businesses. In addition, if the self-employed compete for market share then benefits from self-employment might be higher in areas with low levels of pre-existing self-employment (Robson, 1998) (see the discussion of enterprise displacement in Chapter 2).

Policy recommendations are summarised in Box 7.1. The subsequent chapters present detailed discussion of the reasoning for each recommendation. The recommendations have been endorsed by the Directing Committee of the OECD's Local Economic and Employment Development (LEED) Programme. The recommendations reflect the findings of an ongoing series of LEED studies and seminars on entrepreneurship and local development. This range of entrepreneurship-related activities spans issues as diverse as business incubation (OECD/LEED-SOFIREM, 2000; OECD, 1999c), youth entrepreneurship (OECD, 2001b), social enterprises (OECD, 1999b), micro-finance (OECD/IFDEC, 1998), and *in situ* local entrepreneurship reviews. The policy conclusions have also been drawn from an assessment of the literature cited in this publication, as well as from consultation with leading enterprise development agencies across the OECD.

Partly for ease of exposition, the recommendations are organised around three themes: strategy, finance and programme design (the same recommendations could also have been presented in terms of their relevance to the gestation, start-up and development stages of business creation). The recommendations are also addressed to the different levels of government that possess the relevant policy competence: national, national and local, and local.

The recommendations do not address framework conditions such as regulatory, fiscal and competition policies. Public policy in these domains essentially pertains to central governments. It is not usually formulated with sub-national jurisdictions in mind, and is the subject of a comprehensive literature elsewhere. The recommendations also ignore the much broader set of policies that impact on the quality of life in any locality – such as transportation, health care, criminal justice, etc. – and which make some places more attractive than others for starting and running a business. A number of the recommendations primarily serve to map the limits of policy. This is necessary, as erroneous expectations can lead to resources being used in unproductive ways. Indeed, the overarching challenge that these recommendations seek to meet is to maximise the advantages of increased entrepreneurship while minimising the drawbacks. Other recommendations are more prescriptive as regards the specifics of programme design and operation.

Because the recommendations stem from an assessment of the functioning of the markets that are key to entrepreneurship, they are applicable to both poor and wealthy localities. However, there is variation in

Box 7.1. **Summary of policy recommendations**

Strategy *(For both national and local levels of government)*

- Make the strategic and policy goals of enterprise support explicit.
- Do not view the promotion of micro-enterprise as a solution to social exclusion for large numbers of individuals.
- Adopt a commercial approach to service provision.
- Promote public awareness of entrepreneurship using a variety of media.
- Ensure that micro-enterprises are given proper attention in the system of enterprise support.
- Identify and redress benefit traps that can discourage enterprise.
- Facilitate access to training as a means of enhancing enterprise performance, job creation and survival.
- Encourage small-firm usage of the Internet by taking government on-line and promoting ICT awareness.
- Expect limited short-term employment creation from entrepreneurship promotion, but examine measures to enhance local employment impacts.

Strategy *(For the local level of government)*

- Seek to ensure the availability of business premises offering affordable and flexible rents.
- Make local regulations current and minimise their burden on enterprise.

Finance *(For the national level of government)*

- Consider introducing regional flexibility in the terms of national loan guarantee schemes, reflecting regional differences in the real value of the housing stock.
- Consider the creation of incentives for bank support to micro-finance initiatives.
- Pay careful attention to the design and operational characteristics of micro-finance programmes.
  - ❖ Consider using income-contingent loans.
- Ensure effective enforcement of anti-discrimination laws in bank lending.
- Address the broad issue of a lack of banking facilities in deprived localities.

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Box 7.1. **Summary of policy recommendations** *(cont.)*

Finance *(For the local level of government)*

- Work with local banks and other financial intermediaries to facilitate access to finance for entrepreneurs.
- Consider the promotion of mutual credit guarantee associations.
- Encourage equity investment through education and information, and support networks of business angels.

Programme Design *(For both national and local levels of government)*

- Consider incorporating new objectives into existing institutions, rather than creating new organisations.
- Ensure flexibility in the operation of self-employment support programmes.
- Design self-employment and micro-enterprise support programmes such that budgets and capacities can be expanded during economic downturns.
- Aim for visible points of referral to professional advisors, as comprehensive programme outreach by public bodies is costly and unnecessary.
- Ensure access to high-quality pre-start advisory services.
- Carefully select monitoring and performance measures as these shape programme outcomes in diverse and important ways.
- Systematically evaluate programmes and policies and ensure that evaluation findings inform policy.

Programme Design *(For the local level of government)*

- To help counter displacement effects ensure a strong marketing component in assistance programmes and consider restricting the terms of business support.
- Encourage the creation of team-based firms.
- Examine where the public sector can play a catalytic role in establishing private-sector-led networks.
  - ❖ Implement broad campaigns to introduce the networking concept to businesses.
  - ❖ Expect to provide some financial support in feasibility work, start-up activities and the costs of network brokerage.
  - ❖ Work with realistic time-frames.
  - ❖ Ensure the presence of experienced network brokers.

local economic and social circumstances that may call for some prioritisation or sequencing among these recommendations. For instance, an episode of recent high unemployment might require that resources be concentrated for some time on providing pre-start advice. And many localities may already be implementing most or all of the recommendations described, but perhaps need to give further attention to the ways in which existing programmes are designed and implemented. If the sequencing or prioritisation of actions is needed, this will usually be evident to local development practitioners operating close to the issues in question.

Notes

1. Ex-offenders might be numerous. In England, around thirty per cent of males under thirty years of age have committed an offence dealt with by criminal courts (excluding minor driving offences). *The Observer,* 14th April, 2002, page 18, "Criminal records haunt a third of Britain's men".
2. Indeed, Storey (1993) found that over a ten year period in the United Kingdom around half of total private sector employment creation was attributable to just four per cent of firms.

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Chapter 8

Recommendations on Strategy

Recommendations on Strategy for National Government

Make the strategic and policy goals of enterprise support explicit

In many countries a plethora of enterprise support programmes has become established over time. For instance, a survey in 1992 in the US State of Wisconsin revealed over four hundred business assistance programmes providing seven hundred services, but with only limited knowledge of the programmes among entrepreneurs (Reynolds and White, 1997). Often, an ensemble of programmes and institutions aims to meet diverse and changing objectives that need not be mutually coherent. Different goals are frequently pursued simultaneously with little strategic specification. As described in the opening chapters of this book, programmes to increase entrepreneurship have variously been justified as a means of lowering unemployment, raising competitiveness, promoting an enterprise culture, and developing disadvantaged localities. This proliferation of objectives is to some degree inevitable, given that entrepreneurship has diverse social and economic causes and impacts. Nevertheless, clarifying policy and strategic goals can help to inform decisions on how enterprise support should be designed, targeted and evaluated. For example, if area-based regeneration is the strategic goal then making services equally available to all might be unnecessary. And because in the short-run the promotion of entrepreneurship is unlikely to yield major benefits in terms of employment, entrepreneurship strategies should be developmental constants rather than responses to short-term changes in labour markets. Making strategies explicit will also help the assessment of their feasibility prior to implementation.

Making policy choices clear and transparent may also be important if divergent strategic interests exist between central and subnational authorities. This could be the case if, for example, the targeting of programmes results in coverage being unequal across low- and high-income localities. In a related way, the principles of local innovation and flexibility can sometimes be at odds with the desire of central authorities to standardise certain types of intervention. Indeed, devolved approaches to government support have in some cases lead to variation across localities in the quality of provision (Metcalf *et al.*, 2000).

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Ultimately, policy choices are shaped by the magnitude of available resources relative to the size and nature of employment and area-development goals. With sufficient resources policy trade-offs cease to be binding. However, resources are almost everywhere scarce. Transparent formulation of policy is therefore a necessary part of effective policy.

Do not view the promotion of self-employment and micro-enterprise as a solution to social exclusion for large numbers of individuals

For some individuals self-employment and micro-enterprise can provide a route out of joblessness and poverty. Those most likely to benefit from self-employment and micro-enterprise programmes include the more motivated, persons possessing work experience and accumulated human and financial assets, and those with an employed spouse or partner. Businesses that employ others also tend to be run by entrepreneurs with greater skills and experience. However, as expected returns in the wage labour market fall in line with the duration of unemployment, the long-term unemployed have greater incentives to enter self-employment. Cowling and Hayward (2000) reported that "those recently unemployed are significantly less likely to complete the [self-employment] programme. Yet those who were out of work for one or two years were four times more likely to stay the course". But the ability of the unemployed to operate a successful business can decline as skills erode with time spent unemployed. For these reasons the promotion of entrepreneurship is unlikely to have a sizeable direct effect on large numbers of the poor and marginalised. In areas of concentrated poverty, local regeneration usually requires a range of other actions besides business support – such as in housing, education, health and policing.

Adopt a commercial approach to service provision

There should be a positive bias towards the adoption of commercial approaches to expanding entrepreneurship. This means, for instance, that the private provision of services should be favoured over public supply. Regulation to expand the supply of services should be sought before subsidisation. Loans should be considered over grants. Lending should have a last-resort function. And loan guarantees should be examined before loans. The creativity, resources and know-how of markets can provide powerful support to policy. However, local and regional policymakers often overlook the role of markets.[1] For example, reviewing a range of European micro-finance initiatives Evers *et al.* (2001) observe that:

> *"Without a doubt, the biggest challenge for public authorities is to move beyond the presumption that providing grants and subsidies is the most effective*

financial instrument in any circumstance for supporting enterprise and other economic activity in the local area."

Working with markets is important for at least five reasons:

- A commercial orientation will help to avoid displacing private suppliers and crowding out private-sector jobs. A market-oriented approach can in fact contribute to creating private-sector employment. For example, the United States has a large and dynamic sector of small specialised private providers of training services.
- Adopting a market logic can help to avoid unfair competition between programme beneficiaries and non-beneficiaries.
- Attending to market signals is likely to increase the relevance and quality of programmes. The need for policy initiatives is often assumed rather than tested. Community programmes for enterprise development usually focus on the supply of support services, but their establishment rarely follows any form of prior demand assessment (Lichtenstein and Lyons, 2001). Kitching and Blackburn (2002) surveyed over one thousand firms in the United Kingdom to examine why companies fail to participate in government training initiatives. More than a quarter of firms responded that initiatives were irrelevant to their needs. By contrast, firms are normally willing to express a market demand for services they consider meet a genuine need.
- Working through markets can mobilise resources additional to those of the public sector. Consequently, programmes that leverage private resources can reap economies of scale and be more cost-effective than those that rely exclusively on public funds.
- A market orientation has the potential for greater sustainability and therefore larger overall impact. For instance, programmes that provide grants and soft loans are inherently unsustainable. Grants preclude the recycling of scarce financial resources for future use (while soft loans involve commercial discipline they also contain a grant element). Grants can also create a level of demand that is too high to permit affordable screening and monitoring. Consequently, grants are more likely to be given to persons who either do not need them or do not have good uses for the granted resources. Grants will also be regressive to the extent that they subsidise firms that succeed. And if programmes do not generate income from customers they are unlikely to be in a position to provide the specialist management and technical support essential for programme sustainability. Evers *et al.* (2001) found that over a third of soft-loan funds in the United Kingdom survive for less then two years (see *www.localdeveurope.org*). The ARP-Loan programme in Berlin exemplifies some of the preceding observations. This programme offered interest-free loans of up to fifteen thousand EURO for unemployed persons wishing to become self-employed.

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The Investitionsbank Berlin – a public bank charged with administering the scheme – became involved in drawn-out selection procedures to sift the large number of applicants. Market distortions were reportedly widespread, and in August 1999 the budget had been exhausted after the awarding of two hundred and seventy-four loans. In a similar fashion, an early assessment of the European Seed Capital Fund Scheme showed that commercially-oriented venture funds created more employment per investee and per fund – and registered higher survival rates among investee firms – than developmentally-oriented regional funds. This occurred in spite of the fact that the regional funds had an explicit job creation goal (Murray, 1998).

Evidently, the public sector must perform critical functions that markets cannot. Planning and strategy setting, ensuring effective institutions, providing public goods, redistributing resources and correcting market failures are all obvious public sector roles. As described in other parts of this book, in some circumstances the public sector also has a role to play in inducing private supply (such as certain niche business advisory services) and expanding private-sector demand (for example for network services, the benefits of which often need to be demonstrated to entrepreneurs). And by lowering firms' transaction costs, and sometimes by sharing risks, the public sector can induce private agents to supply otherwise unavailable goods and services. Indeed, in general terms, and whatever its particular cause(s), local economic distress represents a market judgement. That is, markets have judged that a given location is not an attractive place to invest in or recruit from. The public sector is therefore essential if this judgement is to be modified. But if properly channelled, markets can be brought to bear on issues long considered exclusive to the public domain, such as infrastructure supply.

The above remarks do not imply that grants have no place in economic development.[2] Rather, they highlight the need for policymakers to identify specific developmental objectives for granted funds. Grants should only be considered as a tool for achieving outcomes that the market will not. For example, grants might be used to make it profitable for private agents to undertake activities from which they do not derive all of the benefits. Cases in point could include the upgrading of an environmental amenity (a public good), or the renovation of a derelict area to make this fit for private investment. Grants might also be used strategically to bring about synergies among programmes. For example, in France, AIDE is a national micro-credit organisation that targets the long-term unemployed. AIDE has agreements with many local authorities that they will only authorise grants to recipients of AIDE loans. This adds to the entrepreneur's equity, while lowering risk to the business and the lending bank. In summary, uses for grants should be sought that complement the market rather than replacing it.

Box 8.1. **A commercial approach to providing business services: the cases of Greater London Enterprise Ltd. and Shorebank**

Greater London Enterprise Ltd.

Greater London Enterprise Ltd. (GLE) is London's city-wide economic development company. A commercial company, it is owned by all thirty-three of the London boroughs. With the exception of an early inheritance of assets from public stakeholders it is not subsidised. Each year around a hundred million pounds are deployed in running the business. GLE uses its financial resources and commercial skills to facilitate economic regeneration. It does this by tailoring services to meet otherwise under-exploited commercial opportunities. GLE's main activities involve:

- Purchasing, developing and managing commercial properties tailored to the needs of small and medium-sized enterprises (SMEs).
- Investing in smaller growing firms. In this, GLE works with a range of partners to establish and manage funds for investment in the small business sector. Money has been raised from high street banks, institutional investors and the public. GLE also operates a business angels network.
- Assisting the growth of SMEs by facilitating their financing and cash flow management. In this connection GLE lends against invoices and provides a professional debt collection service.
- Providing a full range of support services to SMEs and start-ups, especially in deprived localities. Companies are also assisted in accessing opportunities in overseas markets through partnerships and joint ventures.
- Providing access to information, funding and strategic advice on regeneration and economic development to the public, private and voluntary sectors.

GLE works in partnership to support the economic development objectives of all London's local authorities. This includes providing investment opportunities for the pension funds of London boroughs, delivering contracted-out economic development services, and developing derelict sites. The value of GLE's assets in 1993 was £8 million. This had risen to £26 million in 2002.

Box 8.1. **A commercial approach to providing business services: the cases of Greater London Enterprise Ltd. and Shorebank** *(cont.)*

How can GLE operate in a commercial way in market niches that are often unattractive for wholly commercial players? The answer relates to GLE's required rates of return, extended time horizons and scale of operation. Being publicly owned GLE can target and remain in markets that offer lower profit margins. In other words, GLE is commercially driven – to achieve public purpose goals – but is not profit-maximising. On account of its being publicly owned, GLE is also able to take a patient approach to unlocking assets. For instance, the time required to negotiate the purchase of under-utilised real estate can be considerable, representing a disincentive to entirely commercial firms. GLE is able to stay the course of such delays. Being owned by all the London boroughs GLE is also able to exploit various economies of scale and scope. In particular, within a single region it can build and manage a portfolio of accommodation of a size that would be difficult for a commercial player to match. Greater scale allows low unit overhead costs and economies of scope (for instance, in dealing with the same business more than once as it relocates from one GLE property to another).

Shorebank

Shorebank corporation was founded in the South Shore district of Chicago after all local commercial banks in the vicinity had closed. It is now the oldest and largest community development bank in the United States. With the exception of an international consulting arm, Shorebank's companies and affiliates seek to increase assets and opportunity in under-invested communities in the United States while at the same time addressing the individual financial concerns of consumers, businesses and religious and community organisations.

The then management assembled the capital to acquire the South Shore Bank of Chicago in 1973. The next fifteen years were spent focusing on investment in the South Shore neighbourhood. Two main tools were used, loans and real estate development. Over time the bank was successful in stabilizing and improving the neighbourhood, despite continuing decline in adjacent areas. In the early 1990's Shorebank began a decade of expansion by establishing operations in rural Michigan, Cleveland, Detroit and the State of Washington.

Box 8.1. **A commercial approach to providing business services: the cases of Greater London Enterprise Ltd. and Shorebank** *(cont.)*

A major element in Shorebank's activities has been lending and investing in SMEs. In its early days Shorebank recognized that supporting entrepreneurs created wealth, employment and broadened opportunity in its target markets. In 2001 Shorebank and its partners provided over US$237 million in financing to SMEs.

Since the late 1980's Shorebank has been active internationally in helping local financial institutions apply in their own countries some of the techniques that it has developed for running profitable lending operations in distressed localities. In particular, Shorebank has accumulated significant expertise in how to underwrite and manage loan portfolios when there are no credit histories, little or no collateral, and a large informal sector with weak links to the mainstream economy.

At the time of its purchase the assets of the South Shore Bank of Chicago had declined to US$40 million. Today, Shorebank, as a bank holding company, has close to US$1.3 billion in assets and US$80 million of capital. There are fifteen operating subsidiaries and affiliates and five hundred employees.

Shorebank's shareholders include a diverse array of institutions, from major commercial banks to charitable foundations and church groups. Rather than maximising return on capital, the primary motivation of the shareholders is to positively affect the prospects and quality of life of the targeted communities. At the same time the shareholders and bank regulators (such as the Federal Reserve Board) expect Shorebank to operate in a profitable and disciplined fashion. Like GLE, Shorebank is driven by public purpose goals and operates on a for-profit basis but is not profit-maximising. The organisation's focussed and longstanding experience in particular communities and markets – such as the rehabilitation of rental housing – has created an almost unique body of expertise. This expertise allows Shorebank to operate with extremely low loss rates.

Promote public awareness of entrepreneurship using a variety of media

A favourable public perception of entrepreneurship will help to underpin entrepreneurial activity. Attitudes to entrepreneurship vary across places and cultures. For instance, Gavron *et al.* (1998) report survey results showing that sixty per cent of Germans consider entrepreneurs important to the functioning of the economy. At the time of the survey only thirty per cent of the British shared the same view.

Public authorities in many countries have sought to influence attitudes towards entrepreneurship. A large number of schemes have been implemented in educational institutions ranging from primary schools to universities. For example, Denmark has created the "Action plan for promoting a culture of entrepreneurship in Denmark: Entrepreneurship and Innovation". This scheme aims to give thirty to forty per cent of young people exposure to training in entrepreneurship, with coverage spanning primary to tertiary and vocational education (Lundstrom and Stevenson, undated). Iceland has instituted a New Business Venture Fund that sponsors a yearly nation-wide business plan competition involving numerous public and private organisations. And in Atlantic Canada in the early 1990s widespread awareness-raising programmes were delivered through mass media and the education system. Among other benefits partly attributed to this initiative, the share of the general population intending to start a business doubled between 1991 and 1995 (although from a low base).

Local authorities can take practical and relatively inexpensive steps to influence attitudes. Straightforward measures might include the creation of public award schemes for successful entrepreneurship. To increase interest, these schemes can be divided into various subcategories. For instance, prizes might be offered for firms engaged in exporting, for businesses headed by young or female entrepreneurs, or for companies operating in particular subsectors. Business idea competitions can create interest and develop skills at the same time. Local authorities can also publicise entrepreneurial success stories, sponsor various forms of interaction between local businesses and schools, and encourage the creation of entrepreneurship clubs in educational institutions. Where local bodies play a role in the design of educational curricula, steps might be taken to ensure that all students have access to entrepreneurship courses.

Among other benefits, simply drawing attention to potential business opportunities might support start-up activity. Reynolds *et al.* (2000) found that "those who believe there are good opportunities to start a business in their community are three times more likely to be involved in entrepreneurship than those who do not...". Awareness-raising exercises might also be important in shaping attitudes towards entrepreneurship among those working in public services. For instance, Metcalf *et al.* (2000) found that the unemployed are not always referred to self-employment support, even when they possess suitable aptitudes.

Scottish Enterprise, Scotland's principal development agency, has implemented one of the most comprehensive entrepreneurship promotion programmes in the OECD. Its Business Birth Rate Strategy grew out of research showing that the Scottish public had low levels of interest in starting a business and limited appreciation of the economic function of entrepreneurs.

Low rates of start-up were also found among those predisposed to create a firm. In response, more than a hundred initiatives were instituted to modify attitudes and encourage the creation of new firms. These included sponsorship of a television series, the designation of 1995 as Scotland's Year of the Entrepreneur, the creation of six Centres of Entrepreneurship in Scottish universities, the preparation of entrepreneurship materials for secondary and primary schools, and eight mobile exhibitions addressing all facets of enterprise creation. The period 1992-1997 witnessed a sizeable increase in the number of people who categorised themselves as enthusiastic about starting a business. And there is evidence that significant numbers of referrals to some enterprise development centres were triggered by the campaign (Deakins *et al.*, 1998). The number of persons who could but didn't want to start a company also fell. Between 1995 and 1997 annual growth in business start-ups exceeded seven per cent. The extent to which these changes are directly attributable to the Business Birth Rate Strategy is relevant to policymaking in a number of countries and merits further examination.

However, it is unclear to what extent the inclination to start a business is open to influence

As with many of the initiatives discussed in this book, evidence on the effectiveness of awareness raising schemes is scarce. Results may be modest. For instance, many practitioners attest that entrepreneurship courses do not significantly raise the percentage of the student body starting a business.[3] The Graduate Enterprise Programme, for example, was a University-targeted initiative in the United Kingdom that involved awareness seminars, business workshops and training. An assessment found that the scheme's principal effect was to bring forward the ventures of students who would have considered entrepreneurship anyway, rather than changing the percentage of students that opted to create a business (Gavron *et al.*, 1998). Cox and Moss (1997) found that one effect of university level entrepreneurship courses was to reduce unrealistic expectations. Intentions to initiate a venture decreased towards the conclusion of a course. Such an outcome appears most likely when students have had limited prior exposure to the realities of business creation and management.

Achieving attitudinal change is also likely to be a medium- to long-term undertaking. And even a comprehensive promotional campaign will only be one among a host of influences. Economic and policy framework conditions are also likely to shape attitudes over time. Indeed, there is little to be said for investment in programmes to affect popular perceptions of entrepreneurship if broader framework conditions militate against business creation and development.

A complication in seeking attitudinal and behavioural change is that little is known about the social and cognitive skills that typify entrepreneurs. Attempts to identify distinctive psychological traits appear largely inconclusive. For example, Blanchflower and Oswald (1998) ran a battery of tests on the role of childhood psychological characteristics in determining the probability of becoming self-employed as an adult. No strong results were evident. Some studies point to qualities that are either difficult to teach or desirable irrespective of their relationship to entrepreneurship, such as intelligence, creativity, an ability to think critically, and self-reliance (Hornaday and Bunker, 1970). Commonly held views on the psychological attributes of entrepreneurs may also be erroneous. For instance, the conventional notion that entrepreneurs seek risk is placed in doubt by evidence that they may just have greater confidence in their own assessments of risk, but be no more risk-seeking than employed managers (Gavron *et al.*, 1998). In this connection, it is relevant to note that research in the United States has shown that entrepreneurs are often able to have others bear an important part of start-up risk. The highest levels of professional and financial risk to founders of fast-growth firms arise after the firms become established (NCOE, 2001). If there are distinctive features in the psychological make-up of entrepreneurs they are likely to exist as combinations of characteristics, rather than singular attributes. Furthermore, some characteristics might be conducive to some aspects of business development but antagonistic to others (Ray, 1993). For instance the highly autonomous risk seeker might not be a good team builder. Furthermore, studies that seek to trace psychological characteristics face complex and perhaps intractable methodological problems. In the final analysis, the sheer diversity of entrepreneurs suggests that a common and distinctive psychological profile is unlikely.

Attitudes to careers in small firms are also relevant

A broader attitudinal issue relates to the growing numbers of graduates who face the prospect of work in small firms. Many graduates consider this possibility with reluctance. This is unsurprising given that employment in large firms is usually associated with superior remuneration, conditions of work and prestige. At the same time, a bias exists in many small firms against the recruitment of graduates, who are sometimes wrongly judged to possess inappropriate experience. This labour market mismatch has a bearing on the development of small firms – given that graduates can be a source of new ideas and skills. It also has a bearing on entrepreneurship more generally – given that employees in small firms frequently aspire to become owners of small firms themselves.

Attempts have been made to narrow this mismatch through policy. Westhead (1998) analyses an employee placement scheme for graduates targeted at small firms – the Shell Technology Enterprise Programme – which sought to reduce recruitment and job-search biases. This research found that participating graduates came to look more favourably on a career in a small business – although this effect was not strong and many participants took advantage of their increased employability by joining large firms (after graduation, participants were significantly more likely to be offered full-time jobs than similar non-participating students). However, while three-quarters of host firms indicated benefits for their businesses from the programme, there was no statistically significant difference in graduate hiring practice after twelve months. This work concluded that to bring about the greatest attitudinal change schemes should target firms that do not already employ a graduate. Incentives are also needed to expand the supply and small-firm take-up of such programmes, especially as the provision of training may not be in the short-term interest of the companies involved.

Ensure that micro-enterprises are given proper attention in the system of enterprise support

While micro-enterprises are the target of many dedicated programmes they can also be effectively omitted from some mainstream support measures. For example, credit guarantee schemes sometimes only apply to loan sizes that are too large for the requirements of many micro-firms. And surveys conducted by the North American Business Incubators Association suggest that public sources of business advice involve too little specialist support for early-stage firms, given that programmes sometimes operate under an obligation to offer advice to all-comers. Micro-enterprises can also fall below the notice of statistical agencies. For instance, data on VAT registrations often exclude smaller companies (see Johnson and Conway, 1997).[4] And other information sources, such as the databases of Chambers of Commerce, may be unrepresentative or incomplete.

Accordingly, across a range of institutions that support entrepreneurship, attention may need to be drawn to the particular needs and opportunities facing the smallest size class of firms.

Identify and redress benefit traps that can discourage enterprise

Chapter 2 described some of the ways in which inappropriately designed, inflexible and/or inefficient benefits systems might deter some individuals from entrepreneurial activity. The incentives created by benefits arrangements may need to be reviewed. For the unemployed or those on low incomes contemplating a transition to self-employment one approach could be to introduce a transitional subsidy. Some percentage of previous benefits could be offered during the initial period of self-employment. In the United Kingdom, for example, under the current self-employment option of the New Deal, applicants receive training and counselling, plus a period of up to six months of test trading in which they are still eligible for unemployment benefits but cannot draw profits from the enterprise. Enterprise counseling and advice might also be designed to include guidance on debt management and planning for the transition from benefits to independence.

The problems stemming from benefits dependence are likely to be particularly significant in areas of concentrated poverty where a large proportion of residents receives social or unemployment insurance benefits. However, the extent to which the design and operation of the relevant benefits are the responsibility of local authorities varies from country to country. Central authorities usually play the principal role.

Facilitate access to training as a means of enhancing enterprise performance, job creation and survival

Many firms fail for reasons unrelated to the underlying viability of the business idea. The lack of basic managerial skills accounts for a high share of new and small firm mortality. While a degree of enterprise failure is inherent to an efficient process of resource allocation, the reduction of unnecessary business failure should be a policy aim. From a local development perspective, increased enterprise survival times can afford greater opportunity for the development of work-related skills, increased tax revenues and a larger local economic impact. Training has a role to play both in reducing enterprise failure and in improving a range of outcomes relating to enterprise performance.

Studies suggest that some owners of micro-enterprises do not enlarge their firms owing to problems associated with employee management and recruitment. In part this reflects insufficient time to train new recruits. But it can also be a symptom of the cost and difficulty of identifying suitable external training. For instance, Fielden *et al.* (2000) found that around forty per cent of micro-business owners would not seek to enlarge their firms because of difficulties related to recruitment. In general, the share of own-account workers who become employers is low, suggesting that insufficient skills in the management and hiring of staff might pose obstacles to job creation (OECD, 2000). Possible failures in the market for training services for small firms were discussed in Chapter 5.

There are a number of dimensions to the relationship between enterprise development and the human capital of business owners and employees. Cowling and Hayward (2000) found that business longevity is increased if the entrepreneur has a vocational qualification. Cressy's (1999) research on the primacy of human capital in business longevity has been cited in earlier chapters. And Cressy (1996) contended that workers with higher levels of human capital will earn higher wages and thus have greater assets to invest in business formation (in this connection, Egeln *et al.* [1997] found that regional wage levels in Germany – which in part reflect the supply of human capital – are positively associated with the rate of enterprise creation). Cowling *et al.* (1997) showed that the self-employed who were most likely to create jobs were those with a high level of work-related vocational skill (rather than academic qualifications).

A number of studies have observed a positive association between human capital in the workforce and enterprise-level productivity (Lynch and Black, 1995; Bartel, 1989). The use of new technologies has also been positively correlated with the presence of skilled workers – although the specific link between training and technology use is unclear (Doms *et al.*, 1997). Black and Lynch (1996) found that computer training increased productivity in non-manufacturing firms. Workers with higher skills are also more likely to receive opportunities for further skills upgrading. And Canadian data show that new firms that invest in training have higher probabilities of growth, regardless of the innovation-related strategies they adopt (Baldwin, 1998).

But the impacts of different forms of managerial training are varied and sometimes unclear

However, research on the impacts of different forms of training on enterprise performance has also produced some surprising and conflicting results. Investments in management training have been found to improve survival rates significantly (Storey, 1994; Cosh *et al.*, 1998). Other studies have witnessed significant improvements in sales growth and other dimensions of business development. And management training may be more closely associated with enhanced performance in the smallest firms (Cosh *et al.*, 1998). However, the link between training and enterprise performance is probably not as strong as conventional wisdom suggests. OECD (2000a) notes that many analyses of managerial training suffer from methodological weaknesses (such as failing to properly account for external and other internal influences on firm performance). So studies often show weaker results when other non-managerial practices are also considered. And there may be biases in the selection of firms, given that the attributes that lead a firm to invest in training could also be associated with other performance-enhancing traits. Furthermore, it is not always clear where the direction of causality lies: is it that successful firms decide to train, or that training causes success?[5]

Examining a sample of over three hundred firms, Amos (1998) found only a weak link between education, training and company performance. Part of the explanation could be that, especially for larger firms, education and training are sometimes treated in a modular fashion, divorced from overall business strategy and sometimes enjoyed by employees as a fringe benefit. In addition, the finding by some researchers of a tenuous relationship between corporate performance and spending on training points to the role that might be played by the quality of training. Spending might have little effect if training is inappropriate or of substandard quality. The link between training quality and outcomes merits further research.

Training can be provided through a variety of mechanisms

There are varied institutional modalities for providing training to small firms. In some countries, such as the United States, private sector provision is common. In others, such as Germany, industry chambers and associations play a lead role. Colleges, universities and public organisations are all important providers in many jurisdictions.

For established firms, general training has been found to have a greater impact on productivity than specific training (Barret and O'Connell, 1999). OECD (2000a) observes that training is probably of greater relevance for start-ups than for established enterprises, owing to the fact that entrepreneurs in new firms face a more or less common set of managerial challenges. As the report notes:

> *"When an entrepreneur starts a business there are a number of 'generic' issues which have to be addressed, many of which are encompassed within the formulation of a business plan. These include market assessment, pricing and costing, financing and cash flow. It may also include aspects such as employing workers, health and safety, intellectual property rights, etc. Awareness of these issues can be enhanced by training which can be provided to similar groups of beginning entrepreneurs."* (Page 20).

Counselling is preferable for established firms as these usually face a more differentiated set of challenges. OECD (2000a) identifies a number of critical training areas. They include: formulating business plans; the recruitment of skilled employees; market research; and compliance with government regulations. Good practice also appears to indicate that training should be targeted to *groups* of entrepreneurs that share similar problems and challenges (OECD, 2000a). Therefore, training might be arranged so as to cater to group needs (women, youth, exporters, IT-based firms and others). Training should also be offered in a flexible manner – for instance through modules of varying duration at times convenient for employers and employees – and be delivered through local bodies able to adapt schemes to local needs.

There are often major spatial differences in labour force skills and the supply of training. For example, it has been estimated that by 2003 there will be an e-business skills shortfall of over one and a half million people in the European Union. The European Commission recently canvassed all European Union member countries on whether their IT-related training and educational facilities are physically oversubscribed. Only two countries replied that they were: Portugal and Ireland. However, significant infra-national deficiencies were seen, with the supply of training often greatest in more attractive localities. This phenomenon could well exacerbate aspects of the digital divide – a digital divide that exists between places and localities as well as across income groups. So the issue of access to training is clearly of concern for local policymakers.

Encourage small-firm usage of the Internet by taking government on-line and promoting ICT awareness

Large numbers of new and small firms have inadequate understanding of the business opportunities provided by the Internet and electronic commerce. Indeed, the greater becomes the use of ICT in everyday and business life, the more excluded will be those persons and firms with limited or no access to ICT systems. Using some of the earliest plant-level data to become available, Atrostic and Nguyen (2001) find strong positive links between labour productivity and the presence of computer networks. OECD (2000b) cites research by France's National Institute for Statistics and Economic Studies (INSEE) showing that Internet usage is associated with superior performance in small firms. Small industrial firms using the Internet grew twice as fast and exported twice as much of their output as non-users. Internet-using firms also reported higher revenue per salaried person, higher added value, superior job creation, and a proportionately greater number of registered patents (however, it is unclear whether Internet adoption caused superior performance or *vice versa*). Anecdotal evidence from the United States also suggests that small firms that use the Internet have higher revenues than non-users (Phillips, 2002).

Public authorities across the OECD have implemented varied measures to encourage the take-up of ICT among new and small firms. Initiatives have included schemes to raise awareness of the benefits of electronic commerce, awards programmes, training and a range of specialised advisory and support services (OECD, 2001c). Many of the policies that could enable greater up-take of ICT are in the remit of central governments (such as measures to ensure transaction security and low-cost network infrastructures). However, local and regional governments concerned with the competitiveness of resident firms must be alert to the importance of ICT competencies and access.[6] Also relevant to local policy concerns is the fact that new technologies can permit certain forms of employment to develop more easily in locations that are distant from customers. For instance, many forms of advisory services in which the self-employed are prevalent lend themselves to provision through new telecommunications technologies. Indeed, in the United States, over half of all business tax returns filed in 1999 were from home-based activities (Phillips, 2002). Many of these enterprises rely on electronic media. There has also been significant growth in the number of firms that specialise in the remote processing of business information.

In addition to affording potential efficiency gains for (local) public authorities, the progressive shift to on-line government services can encourage small firms to explore Internet-based business opportunities. Many public services could be efficiently provided using electronic media, from the provision of administrative information to the collection of tax returns. Small firms that engage with (local) public authorities via the Internet experience a demonstration of this medium's utility. At the same time, they gain familiarity with certification, authentication and security systems (OECD, 2001c). Government on-line procurement also holds potential for reducing biases against small firms in public purchasing. However, it appears that the public sector is not fully exploiting new applications and services. Use of the Internet in public procurement seems quite limited for example, although goals in this connection were set at the 1999 Lisbon summit of the European Union.

More broadly, many public authorities have initiated programmes to improve general familiarisation with ICT. For example, the Irish town of Ennis (*www.ennis.ie*) is home to the world's largest community technology project. Ennis gave a subsidised personal computer to every household in order to link the locality to wider markets and improve overall ICT literacy. Indeed, much can be done to encourage the take-up of information technologies across entire communities. For example, OECD (2000b) describes an initiative in the small French town of Moussac. In 1995 the local authorities were instrumental in creating a network of rural schools called "Réseau Vienne-Gartempe". The network aimed to equip the schools with a multimedia computer and provide training for teachers. As a secondary effect the project helped to raise computer awareness in the areas concerned, as the adult population could access the facilities after classes had finished. Schemes also operate in which enterprises have given computers (or instituted cheap hire-purchase systems) to a large part of the workforce so as to improve understanding of ICT. For instance, Denmark's Danska Bank gave a personal computer to its entire staff (and the Danish fiscal authorities were asked to consider this as a direct receipt rather than a taxable benefit-in-kind). Local authorities could seek to work with corporate partners to encourage programmes of this sort.

As regards the regulatory framework, most advanced economies have universal service obligations without price discrimination for conventional telephone services. However, statutory comprehensive service is not the case for new ICT services. OECD (2000b) observes:

> *"This legal obligation concerns telephone service and, by tariff and technical extension, basic Internet access time, priced at the rate of local calls. It does not apply to digital data transmission or to the range of new wide band services aimed at business but that the general public is also concerned by, if only to benefit from high speed access to the Internet."*

National ICT policies often have no territorial dimension. Municipalities generally lack regulatory powers over ICT industries. As the provision of ICT infrastructure reflects the level of demand for ICT services, the lack of universal service requirements will particularly affect areas of low-demand density and high initial investment cost such as remote rural sites. OECD (2000b) reports that regulations in a number of countries are beginning to allow local authorities to take action on the supply of ICT-related infrastructure if the private sector fails to make the necessary investments. In France, for example, a law passed in June 1999 authorises local public investment in the case of inadequate private supply of wide-band services or infrastructure. Local authorities must then lease the infrastructure to an operator on a competitive basis.

Expect limited short-term employment creation from entrepreneurship promotion, but examine measures to enhance employment impacts

As described in Chapter 2, the promotion of business creation usually has a relatively small impact on employment growth, particularly over the short-run. Especially with the smallest ventures, this reflects low survival rates, displacement of existing firms, deadweight effects, small size and low rates of growth. Nevertheless, there is some room for improving employment outcomes. For instance, it should be ensured that entrepreneurs are informed of wage subsidy schemes that some governments provide for employing additional workers. Scope may also exist for improving the effectiveness of local labour market intermediaries engaged in job training and placement, including decentralised public employment services, local partnerships and community organisations. For example, in the United States, Theodore and Carlson (1998) describe how industrial restructuring has fragmented relationships between firms and some job training and placement agencies. A reliance on regional data on job openings has further hindered the effectiveness of some agencies. The authors describe cases in which organisations have gone beyond the gathering of information from state and local employment databases and employer contacts. Instead, they have made use of techniques more common to the economic development community, preparing detailed local industry and occupation profiles from a range of non-traditional data sources in order to target jobs and training in smaller areas.

Westall *et al.* (2000) describe the Interview Guarantee Scheme run by the city of Durham, England, which aims to raise awareness among local firms of the advantages of employing local staff. Among other effects, employers subscribing to the scheme report increased local sales stemming from greater involvement with the community. Advertising the commercial benefits of employing locally may be a useful step for local development agencies,

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especially if this is complemented by effective job training and placement activities.

Westall *et al*. (2000) also describe Purchase Local First, an initiative of the Chester West and City of Durham Enterprise Agency that aims to increase the sourcing of inputs from local suppliers. The encouragement of local purchasing could undoubtedly help retain employment in local firms. Such schemes could also enhance efficiency if they increase the availability of information on supply and purchasing opportunities in local markets. However, their net employment effects taken over many localities would likely cancel out, as imports that are substituted by local production in one location also represent exports lost in another.

Recommendations on Strategy for Local Government

Seek to ensure the availability of business premises offering affordable and flexible rents

The lack of suitable premises is an often-cited reason why micro-enterprises migrate from under-supplied localities. Microenterprises and small firms require "easy-in, easy-out" forms of tenure. They also need to be able to graduate into different sizes of accommodation. For prospective tenants, it is access to flexible accommodation, rather than price, that appears to be the greater constraint.

The imperfect functioning of markets for business accommodation was described in Chapter 3. The public policy response need not involve government investment in incubator-type buildings. This is a capital-intensive use of public funds, with limited prospects of cost recovery through onward sale of the property (because of the investment behaviour of private property developers described in Chapter 3). A preferred alternative may be for public authorities to guarantee the rent of a privately funded building. Practice shows that this can be a low-risk undertaking if tenant firms are well selected (and well managed). This policy option, with the public sector acting as head tenant, avoids tying up large amounts of public money in incubator buildings, while gearing in private finance.[7]

Another way to address the problems associated with small-firm property management is to adopt a portfolio management approach.[8] By offering more units of different sizes in different sites a provider of small-firm accommodation can better diversify risk. It can also achieve important economies of scale as well as economies of scope (for example by re-housing the same tenant firms a number of times). And it will be better positioned to raise investment because of its larger asset base and turnover. An approach based on providing incentives for the scaling up of commercial activities may be superior to local public subsidy of private small-firm accommodation (aimed at compensating for high transaction costs). Local subsidy may appear to be a reasonable response when the problem is viewed from a local perspective only.

In recent years the OECD's LEED Programme has undertaken a number of studies of business incubation initiatives. A summary of the policy recommendations emerging from this work is presented in Box 8.2.

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Box 8.2. **Summary of OECD policy recommendations on business incubation**

- Public intervention should be justified by explicit reference to market failures and/or the provision of public goods. Market-enhancement, rather than displacement, should be aimed for.
- Sound feasibility work should be a pre-requisite for the receipt of public support. In each case, options other than incubation – but which might achieve similar effects – should also be considered.
- A clear mission statement for each programme is essential. An explicit recognition of exactly what public funds are being employed for can help avoid displacement of private suppliers. It can also facilitate policy choices, programme management and the evaluation of public support. Realistic objectives and a sufficiently long implementation period are critical.
- Business development should take primacy over job creation. In the context of incubation, job creation is best attained through successful business outcomes. Broader initiatives to raise interest in entrepreneurship should complement incubation.
- When it is given, public support should come at the initial stages, not through the subsidy of operational costs. Without exposure to commercial disciplines the incubator is unlikely to provide competitive services.
- Local authorities and incubator sponsors should encourage local business and community support. They should also seek to link incubator initiatives with wider business networks.
- Aim to achieve scale. Greater scale opens possibilities for cost and risk reduction, as well as the leveraging of private finance.
- For small communities incubators should probably be treated with caution. If attempted, it may be advisable to embed the incubator in a larger umbrella organisation or network. So-called “virtual” incubators can be a cost-effective means of providing non-property-based services in areas with small numbers of potential tenants.
- Avoid the public purchase of incubator buildings. Rather, empower public authorities to guarantee the rents of privately funded buildings, the public sector effectively granting sub-tenancies to incubated enterprises. Regional and local authorities should assess whether public incentives might encourage the scaling-up of commercial industrial real estate activities, so that these can benefit from economies of scale and scope as well as reduced risk.

Box 8.2. **Summary of OECD policy recommendations on business incubation** *(cont.)*

- As the success of incubation programmes often turns on the quality of management, encourage the development of professional training courses.
- Local and regional bodies that sponsor incubation programmes should ensure the establishment of a Board of directors embodying a spectrum of skills and experience.
- Aim for high-quality accommodation to attract high-quality entrants.
- Ensure that rigorous procedures for benchmarking and evaluation are integral to all publicly supported incubator schemes.
- The development of professional incubator associations should be encouraged in order to disseminate best-practice, create benchmarks, and implement training. Associations can likewise be encouraged to create an accreditation programme.
- Commission longitudinal studies to assess: the additionality achieved by business incubators; the cost-effectiveness of incubation as compared with measures that aim to achieve similar goals; and the broader economic impacts of incubation schemes.

Source: OECD/LEED-SOFIREM (2000).

Make local regulations current and minimise their burden on enterprise

Bearse (1989) put forward a number of recommendations for reducing the burden of local and regional regulations that affect small businesses. These suggestions are not equally applicable to all countries given that local regulatory responsibilities vary from one national jurisdiction to another. However, the recommendations are generic in character and their relevance is widespread. The proposals include: attempting to ensure that regulatory officials are sensitised to the problems of small business owners; introducing mandatory regulatory impact analysis; revising existing regulations so as to facilitate compliance; providing more and better regulatory information; affording technical assistance to firms in order to aid compliance; bringing about uniform enforcement of regulation across jurisdictions; making regulations more specific; raising performance standards for staff of regulatory agencies; affording one-stop permitting; incorporating sunset provisions in regulations; and taking the views of small firms into account in the process of formulating regulation.

Phillips (2002) points to ways in which regulations that apply to home-based businesses might be made less rigid, and more appropriate to an era in which the use of electronic media in business is widespread. For example, regulations that stipulate work hours in home-based firms – if enforceable – may be largely irrelevant to the realities of many e-commerce and professional-services-based businesses. Regulation of the number of persons allowed to work in the home might need to take into consideration the type of business and the size of the home.

Notes

1. Local policymakers are often in frequent contact with potential programme beneficiaries in a way that national-level policymakers are not. They may be directly acquainted with companies and individuals facing hardship and can come under considerable pressure to respond to the needs of local constituents. Furthermore, without the aggregate view inherent to policy-making at the national level, markets may appear abstract from a local perspective. Indeed, the practice of subnational economic development is replete with examples of policies that appear rational from a local viewpoint but which are not efficient nationally.
2. Wren (1998) has shown that the direct employment effect of grants is likely to be greater in small rather than large firms, despite higher rates of failure in the former. This result only holds for firms that are new or relatively young and which have a higher cost of funding than larger enterprises. Without financial assistance such firms implement smaller projects. Assistance allows a proportionately larger increase in the scale of projects undertaken. However, as the author acknowledges, this study ignores possible indirect effects of assistance such as enterprise displacement. And it is probable that the average employment effects of projects would decline if policymakers sought to expand the number of small firm projects through subsidy (even aside from the other drawbacks of grants cited in this chapter). Another drawback to subsidisation is its possible deleterious effect on the subsidised firm. Bergström (2000) shows that capital subsidies provided in Sweden appear to be linked to poor productivity performance, especially over time and as subsidies increase.
3. Various appraisals of entrepreneurship education have found that a high share of graduates do establish firms. But many of these assessments fail to control for the fact that those who are most likely to become an entrepreneur have chosen the course.
4. Conversely, some companies appear to be micro-firms but in reality they are not, as part of their payroll is in the informal sector.
5. OECD (2000a) observes that research in the United Kingdom has revealed a positive correlation between training and past performance but no clear association between training and subsequent performance.
6. The many ways in which new information and communications technologies will impact on local and regional economies are far from fully understood. With technological, economic and social forecasting notoriously prone to error, many prognoses have been mistaken. For instance, a frequently predicted decline in the dominance of a small number of international financial services centres, such as London and New York, has so far failed to materialise. The spatial impact of ICT

may only become clear some time in the future. In Europe, at least, it is evident that a significant fraction of small- and medium-sized firms that access the Internet do so to gather information, rather than for purposes of distribution and supply chain management. Once these deeper forms of Internet use become common spatial impacts are likely to be more marked.

7. See *When Does Public Support for Business Incubators Make Economic Sense*, by Mr. Ian George Dalton, in OECD/LEED-SOFIREM (2000).
8. See the comments of Mr. Greg Clark on a portfolio approach to property management, in OECD/LEED-SOFIREM (2000).

ISBN 92-64-19978-0
Entrepreneurship and Local Economic Development
Programme and Policy Recommendations

PART II

Chapter 9

Recommendations on Finance

Recommendations on Finance for National Government

Consider introducing regional flexibility in the terms of national loan guarantee schemes

Within the same country – and because housing can be an important source of collateral for business finance – persons with equally feasible projects may face differential constraints on business start-up and development owing to house price fluctuations outside their control. To help counter this effect, Robson (1998) has suggested that a degree of regional variability could be introduced into the terms of national loan guarantee schemes. This would reflect regional differences in the real value of the housing stock. In this connection, Cowling (1998) also demonstrated significant regional variations in the coverage of small firms under the United Kingdom's Small Firm Loan Guarantee Scheme. Use of the Scheme was seen to be greatest in regions with better-developed financial markets. Guarantee programmes might be designed to vary across regions in terms of the premium and the guaranteed share of each loan. Indeed, Cowling found that firms and banks are highly sensitive to changes in these parameters. Issues in the design and operation of credit guarantee schemes are set out in Box 9.1.

Due to minimum loan-size requirements, the relevance of loan guarantee schemes to micro-enterprise may need to be examined. Guarantee schemes might also be opened to micro-credit intermediaries and community finance institutions. For instance, the United Kingdom's Phoenix Fund offers guarantees on investments in local and micro-finance institutions.

Consider the creation of incentives for bank support to micro-finance initiatives

Some commercial banks provide support to micro-finance initiatives for a variety of business and philanthropic reasons. A case in point is the NatWest Community Bond established in 1999 in the United Kingdom. Incentives might be used to increase bank support – and possibly support from individuals – for institutions that provide micro-finance. Incentives could include tax credits on investments in these organisations, and/or tax deductions from the revenues associated with these investments, as well as public awards.

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Box 9.1. **Credit guarantee schemes: purposes, design and impacts**

Credit guarantee schemes aim to facilitate the access of firms with viable projects to bank lending from which they would otherwise be excluded. Schemes are designed to do this by guaranteeing repayment of a part of loan losses incurred by banks (and in some cases by non-bank institutions). An advantage of guarantee schemes is low deadweight among borrowers: because of their higher cost, there is little incentive to access a programme unless as a last resort.

Almost all European countries have a national credit guarantee fund. Examples include the Finnvera scheme in Finland, the CERSA programme in Spain, and the Almi initiative in Sweden. Credit guarantee *associations* are more widespread in France and Italy than in other countries, where guarantee *funds* are predominant.

In the design of guarantee funds the critical operational issues are:

- the apportionment of risk between the actors involved such that bank participation occurs and defaults from borrowers are of a reasonable and manageable magnitude;
- that staff have sufficient managerial know-how (paying claims promptly, using transparent claims criteria, keeping administrative costs low, etc.) and technical skill (appraising loans effectively, establishing appropriate fee schedules and total loan volumes, etc.) in order to convince participating banks that they are reliable partners;
- that schemes should not be remote from borrowers as they appear to be more successful when staff have a sound knowledge of the borrowing firm and its operating environment and when technical support services for borrowers are also available (whether provided by the scheme or by third parties).

Borrowing firms usually pay a guarantee fee. This helps offset the fund's investment appraisal and other operational costs. Under most schemes fees are insufficient to provide for claims against defaults, unless loan appraisal is stringent and the default rate correspondingly low. When fee income is inadequate, public authorities often issue counter-guarantees. For instance, in Germany, the central government provides a counter-guarantee of sixty per cent for every guarantee made by the sixteen regional guarantee banks (Evers *et al*., 2001). Determining an appropriate fee schedule can be problematic if statistical projections of loss rates are unreliable. A degree of trial and error may be unavoidable, with fee schedules being adjusted over time through a series of iterations.

Box 9.1. **Credit guarantee schemes: purposes, design and impacts** *(cont.)*

Under some schemes lending banks assess the loans and the scheme provides automatic approval. Where this practice prevails the sustainability of the fund can be jeopardised. This is because banks may be tempted to use the scheme to guarantee their risky loans, including loans for which adequate collateral is available. In this connection, it has been suggested that where banks are under a legal obligation to lend in disadvantaged communities, guarantee schemes might be used simply to cover this fraction of the loan portfolio. Furthermore, if lending banks have to appraise loans then the programme is not helping to reduce bank transaction costs, which for banks should be a benefit of participation. Schemes thus require a degree of autonomy from the banks involved. This necessitates a body of well-trained staff, especially in the area of loan appraisal. The manner in which claims are treated by the guarantee scheme, for example, is a key factor in whether banks take part or not.

In different countries financial contributions to credit guarantee schemes have come from banks, trade associations, chambers of commerce, and local, regional and national authorities. In some cases, as in the Netherlands, a fund is not established, but an undertaking is given by government to reimburse bank losses. A scheme run by the United States Small Business Administration has allowed banks to sell the loans covered by the scheme on money markets as government-guaranteed securities. The size of the guarantees offered is in some cases established by legislation, and in others is set as a multiple of the guarantee funds. Schemes with low average claims have provided guarantees equivalent to twenty to twenty-five times the amount of the fund (Levitsky and Prasad, 1987).

The most important operational parameter affecting guarantee schemes concerns the degree of risk to be borne by the lending bank, the guarantee scheme and the borrower. If bank loans are fully guaranteed then there may be little incentive to properly appraise loan requests and banks may use the scheme to lend to risky borrowers or to reward good clients by allowing them to substitute the loan guarantee for part of the usually required collateral. If banks face too high a risk they may not participate at all, considering that loan appraisal by their own staff is indispensable. According to Levitsky and Prasad (1987), experience suggests that lending banks should be required to assume between twenty and thirty per cent of the risk. The authors propose that the risk borne by banks might vary in line with the frequency and magnitude of their claims. This could serve to deter abuses of the scheme.

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Box 9.1. **Credit guarantee schemes: purposes, design and impacts** *(cont.)*

There is also unwillingness in public authorities to capitalise guarantee schemes if banks themselves share no risk. However, research suggests that schemes in which banks assume no risk need not incur prohibitive losses, once certain basic conditions prevail. These conditions are that loans be properly appraised, that loan default should severely reduce the likelihood that a borrower gains access to future loans, and that banks attempt to preserve a reputation for good judgement in lending regardless of whether loans are guaranteed or not (Levitsky and Prasad, 1987). Conversely, the level of collateral required of borrowers should give an incentive for loan repayment without deterring participation. Without some of their own assets at risk borrowers may see default as an easy option.

Loss rates in different schemes will in part reflect whether the intended constituency includes mainly low or high-risk borrowers. A scheme experiencing no losses is unlikely to be performing its intended function, as loans would probably be going to only the safest borrowers. Indeed, there has been little evaluation of schemes on the additionality criterion. Exceptions include evaluations of Canada's Small Business Loan Act (Riding and Haines, 2001) and the United Kingdom's Small Firms Loan Guarantee Scheme (KPMG Management Consulting, 1999). *Inter alia*, the latter study estimated growth of 0.3 to 0.6 jobs in each beneficiary firm, after accounting for displacement effects. Employment additionality was found to decline with firm size and rise with the age of the enterprise. Innovative and new activities were also positively correlated with increased additionality. Larger loan size was likewise associated with high levels of financial and employment additionality. Overall, about sixty per cent of lending under this Scheme was found to be additional (around a fifth of the Scheme's guaranteed loans have been for enterprise creation).

Additional Source: Levitsky (1993).

Pay careful attention to the design and operational characteristics of micro-finance initiatives

Micro-loans can be valuable to the smallest enterprises, especially during early phases of start-up before banks offer term loans or a business overdraft facility. Programmes to provide small volumes of credit to those intending to start or expand a business are now widespread in OECD member countries.

Examples include, to name just a few, the *Goldrausch Frauennetzwerk* scheme in Berlin, the *RACINES* network in France, and *Generation Banlieu*, an investment co-operative supporting the micro-businesses of young people in disadvantaged suburbs of Paris. In the United States, in the mid-1990s, the Treasury allocated the Small Business Administration one hundred and twenty-five million dollars a year to support innovative micro-lending initiatives. The multiplication of programmes and the growth of policy interest have been inspired in part by examples of successful schemes in the developing world. Globally, the micro-credit movement has reached significant scale. Towards the end of the 1990s the largest two hundred micro-lending organisations held over seven billion dollars in outstanding loans (Conaty and Fisher, 1999). Furthermore, the apparent promise of reducing poverty through profit-making activity has won approval for micro-lending from across the political spectrum.

Micro-lending programmes have diverse objectives and operational arrangements. Some schemes focus on social goals, targeting minority and socially disadvantaged groups. Others are more explicitly economic, aiming to enhance business creation and development *per se*. Clients include persons on low to moderate incomes, the working poor, the unemployed, and welfare recipients (Bhatt and Tang, 2001). In other words, borrowers in such programmes are among the groups most likely to face difficulties in gaining access to a formal source of credit, owing to high risks, high costs and limited collateral. They are also among those who are likely to have the greatest need for formal credit, owing to their low average net financial assets.

Some micro-credit schemes fund enterprise creation, while others specialise in working capital. Programmes frequently lend at commercial or even higher rates of interest (although interest rate caps have affected programmes in some countries, such as the United States). Commercial-rate lending reflects pressures to achieve financial sustainability as well as the view of many practitioners that access to credit for business development is a greater obstacle than the financial cost of borrowing (however, more research is needed on the responsiveness of credit demand to the interest rate among low-income borrowers). By contrast with commercial bank practice, programmes often lend on an unsecured basis. Schemes also vary in the extent to which they provide training, develop business networks and assist with other services such as childcare and legal advice.

Micro-credit represents a distinct, specialised and innovative financial service

Micro-credit programmes represent a specialised financial product, with schemes exhibiting considerable innovation in the techniques they employ. These innovations focus on reducing the high transaction costs of repeated small-volume lending as well as discouraging payment default. For instance, micro-credit initiatives have used various forms of peer-based lending. Under one system of peer-based lending borrowers form small groups in order to provide a collective guarantee of loan repayment.[1] In variants of the peer-based approach loans are made directly to the group itself. This allows the lender to deal with a single entity rather than many. The group is then responsible for on-lending borrowed funds to one or more group members. Another advantage of such arrangements for the lender is that the group also assumes functions (and costs) associated with project and borrower screening, monitoring, and enforcement of loan contracts. In some schemes members of the group become eligible for loans on a rotating basis after each borrower has demonstrated his or her creditworthiness. Theory also suggests that group-based loan contracts can help lenders to distinguish among borrowers with similar levels of risk. This is because there are disincentives for borrowers to group with other borrowers of dissimilar risk (Ghatak, 1999).

In addition, many programmes operate systems of stepped lending. These provide borrowers with access to progressively larger loans contingent on repayment of previous credits. This practice can reduce programme risks by screening out less viable borrowers (but with the possible drawback of constraining ventures that grow rapidly [Servon and Bates, 1998]). Furthermore, regular repayment schedules are typical of micro-credit loan contracts, with initial repayments often required shortly after receipt of a loan. These conditions can serve to alert schemes early on if a repayment problem is emerging, as well as providing an indication of the reliability of borrowers (Morduch, 1999).

Important benefits have been associated with micro-credit initiatives

Important benefits have been reported from micro-credit schemes. For example, among clients of a number of major micro-credit programmes in the United States reliance on public assistance has fallen significantly, while enterprise profitability, equity growth and take-home pay have risen markedly (Bhatt and Tang, 2001). In transition economies micro-credit has helped bring small firms into the formal economy. Some programmes have reported increased employability among borrowers, especially when borrowing occurs in conjunction with training and mentoring. The costs of job creation via micro-credit are also held to be relatively low. Reviewing a number of initiatives, Evers *et al.* (2001) maintain that a new job created through micro-lending often costs less than five thousand EURO. In Poland, around four short-term loans from the *Fundusz Mikro* programme were reported to generate one new job on average. And around the globe default rates in micro-credit schemes are frequently stated to be lower than for commercial bank lending to small firms.

Among less tangible benefits, positive psychological impacts from being entrusted with a loan have also been described among borrowers. Improved self-discipline may likewise result from the demands and trust placed on participants. And schemes frequently create beneficial business and support networks among clients. For example, a valuable consequence of peer group lending has often been to allow women to share experiences of dealing with the challenges of running a business. Programmes in the United States have created important support networks both among borrowers and between the programmes and other institutions (Servon, 1998) (in this connection, examining a Toronto-based initiative, Gomez [1999] found that individual borrowers who graduated from a peer group slightly outperformed other loan clients). More broadly, successful programmes can also serve to illustrate that it is possible for the poor and unemployed to establish and operate creditworthy businesses.

It should also be noted, however, that evaluations of micro-credit programmes have rarely used control groups or sophisticated statistical forms of assessment. And many of the claimed successes of micro-credit schemes must be treated with caution. High rates of loan repayment, for example, have rarely been associated with programme profitability (Morduch, 1999). And serious overestimation of programme impacts can result from not accounting for the fact that the selection of participants may be biased towards high-quality borrowers.

But micro-lending entails complex institutional and policy challenges

Micro-lending is a specialised and skill-intensive undertaking that involves complex institutional and policy challenges. Few banks specialise in this area (indeed, the key role of banks is likely to be as wholesalers of funding for specialist micro-finance institutions). And programmes typically require extended periods of planning and experimentation. However, micro-credit initiatives have sometimes been established without proper feasibility assessment, and many eventually serve only small numbers of clients and make few loans per year (Evers *et al.*, 2001). In the United States, programmes have often experienced high loan losses, excessive overhead costs and limited outreach (Bhatt and Tang, 2001). Chapman *et al.* (1998) cite research in Australia attesting to the absence of common approaches to micro-lending and the low sustainability of numerous micro-credit funds.

Sustainability has two components, financial and operational. Financial sustainability is achieved when earned income at least matches operational costs *and* the commercial cost of capital. Operational sustainability exists when earned income at least matches operational expenditure. Low sustainability has a variety of causes. For example, economies of scale that are possible in developing countries, where there are often large numbers of potential borrowers, are generally unavailable to initiatives in OECD member countries. In the United States, most micro-loan schemes sponsored by the Treasury have not achieved efficient scale (Conaty and Fisher, 1999). Problems of inadequate scale are an even more acute limitation for schemes that target local areas. Achieving sustainability will be still more challenging if programmes focus on the most disadvantaged borrowers, concentrate on the start-up phase of business development or have an experimental component. It is therefore unsurprising that in the United States well over half of all the clients of some of the longest-standing programmes are not low-income individuals (Bhatt and Tang, 2001). Governments sometimes exacerbate the problems of small scale by choosing excessively restrictive and inflexible terms for providing funding. Resources are often tied to client target groups, to partnership-based schemes, to loan capital uses, to funding for new business creation, etc.. Restricting the terms of sponsorship can limit the opportunities for achieving scale efficiencies. It can also diminish investment in some critical functions that are sometimes given low priority by public sponsors, such as market research.

In practice, many micro-credit schemes are not operationally sustainable. Fewer still are financially self-sustaining, even in the developing world. This is not a cause to disregard micro-credit initiatives, because the social benefits from such programmes might exceed financial returns. However, there is at present too little evaluative research to allow a quantitative assessment of the full range of benefits that programme subsidies create. The policy community has little idea of what might constitute an optimal level of subsidy to ensure access to business loans for low-income borrowers and to bring about significant impacts on incomes and other desiderata.[2]

A number of common problems affect programme design and operation

What are the most frequently encountered design and operational pitfalls in micro-lending and how might they be avoided? Many authors have described a variety of problems that affect micro-lending. Bhatt and Tang (2001) provide a particularly clear and synoptic assessment. They describe three issues that regularly undermine programmes operating in the United States. The three problem areas are: a deficient process of engaging and preparing prospective borrowers; problems of risk management and transaction costs minimisation; and faults in programme administration. Bhatt and Tang's account of the difficulties experienced in these three areas is summarised below:

- A deficient process of engaging and preparing prospective borrowers

  There is inadequate awareness of programmes among potential clients. Indeed, a lack of demand for programme services, rather than the underfunding of schemes, has been described as the main challenge facing the sector in the United States (Glackin, 2002; Burrus, 2002). Contributing factors include insufficient and/or inappropriate investment in outreach, the isolation of borrowers – especially in rural areas – and cultural and language barriers. In preparing borrowers, the training provided by micro-credit initiatives is often too generic.

- Risk management and transaction costs minimisation

  Some programme sponsors misunderstand the role of collateral. Accounts of well-known developing-country micro-finance schemes have sometimes placed excessive emphasis on the absence of collateral requirements. This has overlooked the use of a variety of collateral substitutes in many successful programmes. Furthermore, the social ties that underpin group-lending in many developing countries can be exceedingly weak in low-income inner-city communities in the United States and other OECD member countries. The concept of joint-liability may be alien to local experience and history. Indeed, even in developing countries, as Woolcock (1999) has shown, weak social relations among programme staff and potential and actual borrowers have seriously undermined sustainability in group-based programmes. Consequently, the weakness of group borrowing arrangements has hindered cost minimisation, because transaction costs – in screening, monitoring, and loan enforcement – have had to be borne by the programme. In this connection, Box 9.2 presents research on the ways in which neighbourhood characteristics have influenced the success of a micro-lending programme for the self-employed in Toronto. More generally, when compared with developing country micro-finance schemes, developed-country programmes have high non-financial costs, particularly for staff.

- Deficient programme practices and administration

  A lack of commercial discipline is a frequent problem. When micro-credit funds are capitalised from concessional sources there is a risk that resources will be treated as cost-less and lent without due diligence. European analysts also see this as a major constraint on the development of micro-lending (Evers *et al.*, 2001).

  When borrowers default but continue to receive loans – possibly because managers and programme sponsors view the scheme as having a redistributive rather than commercial function – current and prospective borrowers have an incentive to follow suite. Different programme stakeholders can also have diverging and even conflicting objectives. For example, a public sector sponsor may wish to see the disbursement of large volumes of credit. Achieving this could require relaxed screening procedures. At the same time, the performance of programme managers might be assessed against their record in minimising loan defaults, even though the rate of default is likely to rise if screening is made less stringent.

Box 9.2. **Neighbourhood effects, social capital and peer-group lending: links to self-employment success**

Gomez (1999) undertook research on social capital, neighbourhood characteristics, peer-group lending and their roles in the success of the small-scale self-employed. His study used a self-designed cross-sectional survey conducted in 1998 in combination with client files for nearly six hundred and fifty small-scale self-employed living and/or working in Metropolitan Toronto. The respondents were all clients of Calmeadow Metrofund, a non-profit provider of micro-finance. Calmeadow lent to self-employed persons traditionally neglected by mainstream financial institutions. Thirty per cent of Calmeadow's client base comprises businesses with less than one year of operation. This group is not usually served by banks, which often ask to see one to three years of personal and business financial statements.

The study used three main indicators of neighbourhood quality: the share of residential/commercial accommodation built before 1960; the proportion of individuals with less than thirteen to fifteen years of education, which was used to capture local human capital; and the share of home ownership. The links between social capital and business success were estimated using the following measures: the strength of social ties, as reflected in whether respondents felt they could always depend on friends or relatives for help; a dummy variable indicating whether the respondent was an active member of any group, organisation, club or team; the role of contacts in creating business opportunities; and the importance of social norms, as reflected in a person's belief that living in a neighbourhood in which one knows most of one's neighbours is a key factor in business success.

Self-employed individuals who received an individual loan were found to earn more on average than those in a peer group. However, individual loan candidates who went through a peer group process earned more than both individual and peer group loan candidates. While the co-efficient was not significant, peer group graduates were seen to earn twenty-one per cent more than comparable individual borrowers.

Individuals who reported strong connections with family and friends earned significantly more than otherwise similar individuals (revenues were thirteen per cent higher). However, the direction of causality is unclear: by earning higher revenues a self-employed person may be in an easier position to establish social relationships. Unobserved traits may also predispose individuals to do well in the labour market while also forming stronger and more numerous social relationships.

Box 9.2. Neighbourhood effects, social capital and peer-group lending: links to self-employment success *(cont.)*

Being a member of an active club, team, association or organisation was positively associated with business success. On average, active members earned forty per cent more than non-members. Those who reported that contacts were not useful to their business earned one hundred per cent less than persons who described benefits from contacts. Owing to sample size, the study results were inconclusive as regards the influence of neighbourhood characteristics on self-employment success.

However, home based enterprises were seen to earn thirty-seven per cent less on average than those operating from a store, market or industrial park. Also of interest was the finding that individuals who reside and/or work in neighbourhoods that have more people with higher levels of education earned significantly more than otherwise similar individuals.

In summary, borrowers with otherwise similar characteristics appeared not to benefit equally from participation in this micro-credit initiative. Factors that are less easily observed by lenders, such as social connectedness, access to information, attachment to community, and whether self-employment is entered into voluntarily, were all seen to influence self-employment success.

Source: Gomez (1999).

Factors in the design of sustainable and effective micro-credit schemes

To achieve programme sustainability policymakers need to allow considerable time. *Fundusz Mikro* – the previously mentioned Polish programme – received generous assistance from the Polish-American Enterprise Fund and USAID and required around five years to reach operational sustainability. And the recently established *Street UK* plans to achieve sustainability after approximately fifteen years of operation (with some forty offices in different parts of the United Kingdom serving around twenty thousand clients).

Policymakers must also allocate – and/or encourage others to contribute to – significant start-up capital. This initial outlay will usually provide little or no return. Reserves will also be needed to deal with expected losses. And business counselling, especially for start-ups, might require significant funding. Evers *et al.* (2001) suggest that using a range of private and public sources of funding is advisable. Dealing with diverse sponsors can add discipline to the lending process and increase a programme's financial stability. Indeed, some micro-credit schemes involve partnerships between the public, private and non-profit sectors. For instance, in Ireland, the *First Step* programme has received corporate support. And in Canada, the *Fonds de Développement Local et Régional au Québec* have been capitalised by federal and local government, trade unions, co-operatives, commercial banks and private firms as well as citizens groups and religious organisations.

Bhatt and Tang (2001) propose that capacity building and improved practice in micro-credit programmes concentrate on four broad areas. These are: the selection of lending techniques; the choice of financial products offered; the mechanisms used to provide non-financial services; and programme management. These recommendations are briefly described here:

- Lending techniques

  As discussed earlier, specialised micro-credit methods are essential for lowering transaction costs and encouraging repayment. They are critical for schemes with a local orientation that involve small numbers of loans. If opportunities for group lending are limited in some inner-city communities then alternative techniques might be employed for assessment of credit risk. These could include landlord references, savings records and utility bill and other payment histories. Consideration might also be given to using non-traditional forms of collateral such as furniture, cars or television sets.

- Financial products

  The financial services provided should match market demands as closely as possible. For example, the working poor may require a larger average size of loan than other borrowers. Similarly, financial products should be appropriate to the requirements of clients working in specific business niches. For instance, entrepreneurs in service-sector businesses might have greatest need for working capital loans. Those in manufacturing may require loans for investment in equipment.

- Non-financial services

  Training and technical assistance might be provided by specialist institutions – such as community colleges in the United States and Chambers of Commerce in Germany. The high cost of coaching has threatened the sustainability of a number of schemes (Evers *et al.*, 2001). Micro-credit programmes can seek to partner with specialised service providers. Doing so could help to lower overhead costs and raise effectiveness.

- Management procedures

  As important as providing funding, sponsors must ensure that programme managers possess the necessary competencies. Specialised skills and experience are required in such areas as establishing internal control and governance structures, negotiating with and maintaining the confidence of a variety of funding bodies, managing programme finances and planning for the long-term. Creating a programme using in-house staff is unlikely to be successful if these persons are not specialists. Nor will the required skills necessarily be found in local banks, as few banks engage in specialised micro-lending. Managers may also need diplomatic skills if the way a programme operates is threatened by political interference. In many OECD member countries training for micro-finance managers is now becoming available.

Even adopting these practices, the challenges of developing sustainable and effective micro-lending are significant. For instance, while having implemented many of the above recommendations, and with a highly professional organisation, ACCION USA, perhaps the leading micro-credit programme in the United States, has experienced difficulties in achieving scale (Burrus, 2002). Additional work is still needed in OECD member countries to identify, disseminate and implement best practice and policy in micro-lending.

Consider using income-contingent loans

Chapman *et al.* (1998) describe an innovative approach to the financing of prospective self-employment. The authors begin by noting that grants can be regressive to the extent that they subsidise the businesses that succeed. However, business loans to be repaid in predetermined instalments involve default risk, discouraging the risk-averse. A scheme is proposed in which loans are repaid according to future income or profits. Income contingent loans (ICLs) of this sort have provided a practical solution to problems of higher education financing in Australia, through the Higher Education Contribution Scheme introduced in 1989 and the 1993 AUSTUDY Loans Supplement (analyses of these programmes are contained in Chapman, 1992; 1997). Providing financial assistance for firms based on income or profit repayment contingencies could have a number of advantages. First, ICLs offer recipients default protection. Because repayment depends on achieving a specified level of income or profit there is little chance of individuals not being able to repay. Consequently, borrowers need not be concerned about the loss of creditworthiness associated with default, which could mean their losing access to other sources of lending. Second, the distributive consequences of ICLs are likely to be progressive. Schemes could be designed so that entrepreneurs who create successful businesses pay the most and those whose ventures fail pay the least.

Credit unions can also be valuable

Credit unions function by building a common fund from the regular savings of members. Loans are made to members only. The funds are owned and managed by the members on a not-for-profit basis. There is considerable variation across countries in the breadth of credit union membership. In the United States some thirty per cent of the population belong to a credit union. This compares with around one per cent in the United Kingdom (HM Treasury 1999). However, the extent to which credit unions finance micro-enterprise also varies greatly. In the United States Community Development Credit Unions (CDCUs) aim to fund a range of activities that contribute to local development, particularly in communities with reduced access to conventional financial institutions. In many countries credit unions primarily finance consumer loans. But for some of the self-employed, household and enterprise budgets may appear indistinguishable. Therefore, enhancing the availability of personal financial services – through credit unions and other financial intermediaries – might help to support local micro-business activity (indeed, theoretical work cited in Chapter 5 [Parker, 2000] has highlighted the role of saving as a possible means of releasing financial constraints on entrepreneurship). Appropriate regulation, and its enforcement, are required both to enable the development of credit unions and to protect the rights of depositors. For instance, in the United States, credit unions are insured by the National Credit Union Administration, allowing members to place their savings with a credit union without risk of loss.

Ensure effective enforcement of anti-discrimination laws in bank lending

There is econometric and anecdotal evidence of discrimination in credit markets against some ethnic minorities and women. Entrepreneurship among the former is often geographically concentrated, not infrequently in areas with poor business environments. Bank lending to minority groups, women, the disabled and others should be monitored to ensure the absence of discrimination, and where necessary consideration could be given to statutory bank disclosure of lending activities (as in the United States). Anti-discrimination legislation should be enforced.

Address the broad issue of a lack of banking facilities in deprived localities

Banks have particular advantages in lending to small firms. Banks can acquire important information on borrowers through deposit accounts and the provision of other information-intensive financial services (Petersen and Rajan, 2001). For the potential entrepreneur, a lack of previous contact with the banking sector – for example not having held a personal current account – will make access to credit more difficult. In some countries and localities this can be a serious problem. For example, in the United Kingdom, around ten per cent of households do not have a bank account (HM Treasury, 1999a), while the self-employed who live in distressed areas are less likely to have a personal current account than those who live elsewhere (Bank of England, 2002). At the same time, financial liberalisation has placed banks under acute competitive pressure. One result of such pressure is that some banks are closing branches in local communities, although branch closures are likely to be less frequent in areas that have higher levels of business activity.

However, the scope for local policies to retain bank branches seems narrow. One option might be for public authorities to commit to bank with a particular institution in exchange for an undertaking of a continued presence in the locality. But most of the relevant policy measures belong to national authorities. For example, the United States Treasury implemented the Bank Enterprise Award programme which offered financial incentives for lending in distressed communities. Some countries have also sought to provide banking facilities through post offices and public banks. And public authorities might encourage agreements among commercial banks to ensure at least one common banking outlet in small communities. Legislation equivalent to the Community Reinvestment Act (see below) in the United States, which does not have a European equivalent, would encourage bank lending in poorer communities and could alter incentives affecting branch closures. Community bank schemes have also been run on non-profit and for-profit grounds by specialised institutions. For example, Bendigo Bank in Australia operates a regional and community banking scheme in conjunction with the communities concerned on a profit sharing basis (*www.bendigobank.com.au*).

The Community Reinvestment Act is a far-reaching programme that appears to have had positive effects

The Community Reinvestment Act (CRA) came into force in 1977 in response to banks' under-provision of mortgage and other financial services in poor communities. The legislation initially focused on mortgage lending. The CRA gives standing for ordinary citizens to review the performance of banks in providing loans and other banking services to poorer communities and demographic groups. If a bank's record is found wanting, the legislation enables citizens to lodge protests with financial regulatory agencies. An institution's CRA rating is considered when actions require regulatory approval (such as mergers and acquisitions, applications for bank branches, federal charters and deposit insurance). Four levels of CRA performance rating are applied: "outstanding"; "satisfactory"; "needs-to-improve" and "substantial non-compliance". These ratings are based on consideration of a variety of weighted quantitative and qualitative performance indicators, including the loan portfolio, the geography of branch openings and closures, service provision in poor communities, support for not-for-profit organisations, and the record of partnership with government agencies.

In its early years the CRA appears to have had little effect on lending institutions, although some banks did begin to develop new products for low-income markets. A significant change in lending patterns occurred in the late 1980s. This change had a number of causes. These included the rejection of a merger request by the Continental Bank of Chicago because of poor CRA performance, as well as the suit for unfair lending of a major Savings and Loans Association (Belsky *et al.*, 2000). In 1995 legislative change created incentives for lending to small firms in low and medium income localities (a loan to a small firm is defined by the CRA as a business loan of less then US$1 million and/or a loan to a firm with revenues of less than US$1 million). Zinman (2002) estimates that the CRA has increased access to credit for around five per cent of firms in the areas concerned. Affected banks have augmented small business lending by from twelve to fifteen per cent. This appears to have occurred without evidence of deteriorating loan quality or bank profits. There is also evidence of positive real impacts on firms. In counties (a geographic subdivision of US States) where banks operate under binding CRA incentives business payrolls have increased by around one per cent and bankruptcies have decreased by four to five per cent. Among other outcomes, the CRA has also served to raise awareness among banks of the commercial opportunities for banking in disadvantaged communities and with persons on low-incomes. And some larger banks have begun lending for community development, sometimes using community development financial intermediaries.

The adoption of CRA-like legislation in other countries would need careful consideration

The creation of the CRA reflects the particular institutional, economic and social history of the United States. The circumstances from which this legislation emerged have included: significant *de facto* segregation in housing markets; a number of major inequalities across racial and income groups as well as geographic areas; and the failure of some banks to properly serve particular neighbourhoods on account of the racial composition of the inhabitants and/or the age of the housing stock. The extent and severity of these problems in the United States suggest that careful consideration is required in deciding whether to replicate CRA-type legislation in other contexts. Some of the CRA's reported success is also likely to have been influenced by other policy developments in the United States that have affected the mortgage industry, as well as the robust macro-economic conditions experienced during much of the 1990s (Belsky *et al.*, 2000). If enacted elsewhere, CRA-type legislation would involve non-negligible implementation costs for the public sector. And the burden of regulation could be significant for banks (see Zinman, 2002). But the CRA experience holds valuable lessons that might be adapted in different ways. For instance Belsky *et al.* (2000) indicate that public disclosure of bank lending, along with the desire to avoid negative impacts on reputation, were enough to cause the Board members of many institutions to reconsider lending practices.

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Recommendations on Finance for Local Government

Work with local banks and other financial intermediaries to facilitate access to finance for entrepreneurs

In most countries banks are by far the largest source of institutional finance for local businesses. Local authorities should seek to work with local banks. Collaborative arrangements between banks and local development agencies offer potential benefits for both parties. Overhead and operational costs can be shared, as well as risk. Both types of organisation can provide specialised services and expertise. In the appraisal of loans, for example, a local business support scheme might bring technical knowledge of sectors and projects unavailable to banks. Indeed, soft loan funds with greater community participation appear to have superior performance (Evers *et al.*, 2001). Training schemes run by local development agencies can help improve the quality of loan applications to banks. And training can ease anxieties among some potential borrowers over the approachability of banks. Programmes might also provide the financial security that banks seek to (co)-lend, allowing a start-up agency easier access to funding for viable projects.

Conversely, banks can be requested to refer failed loan applicants to advisory schemes. In so doing, the discouragement of potential entrepreneurs might be avoided if near-viable projects can be reformulated and made more feasible. Banks can also act as partners in organisations that provide micro-finance, offering staff to serve as advisors and mentors as well as giving guidance on issues of programme governance. Some banks have offered discounts on service charges on business accounts held by customers of local micro-finance organisations. The presence of a bank can by itself add credibility to a lending initiative. And banks often have a detailed knowledge of local markets valuable to enterprise agencies. Furthermore, banks already possess loanable funds, while putting together a loan fund on a greenfield basis can be a protracted and costly undertaking for a support programme. Indeed, in some European countries there are legal prohibitions on lending by local and micro-finance organisations in the absence of a partnership with a bank (Evers *et al.*, 2001).

A greater awareness of factoring services could be helpful

Few public programmes assist with finance for working capital. Factoring and invoice discounting houses can help small firms to manage working capital constraints. Factoring and invoice discounting services can also be helpful in addressing the serious problem of cash-flow management in small firms caused by late payments from large companies (and public authorities). Specialised factoring houses – or factors – operate by paying and assuming responsibility for the collection and administration of a firm's unpaid invoices. Factors thus provide a form of short-term finance against the security of a client's receivable accounts. So factoring does not depend on a bank's assessment of the firm's growth prospects. Banks and independent specialists offer factoring services.

However, factoring can be expensive. And research from the United Kingdom undertaken in the late 1990s suggests that factoring services are not equally available to all firms. The youngest and smallest companies tend to be excluded, some sectors are prioritised, and larger firms generally have less need of factoring services (Soufani, 2001). Independent factors are more likely to cater to the needs of smaller and younger firms, although the rates they charge are higher than those of bank-owned factors. The key public sector role is likely to be in raising awareness among entrepreneurs of when factoring and invoice discounting should best be used.

Consider the promotion of mutual credit guarantee associations

Mutual credit guarantee associations aim to facilitate the access of firms with viable projects to bank lending from which they would otherwise be precluded. This they aim to do by guaranteeing repayment of a part of any losses incurred by banks on such loans. They have a similar purpose to guarantee funds (described in Box 8) but a different method of operation. Here a common guarantee for a loan to a single borrower is provided by members of the association. Risk is thus spread over the association members. Credit guarantee associations originated in Europe and operate widely today in France, Italy, Japan and other countries. An advantage of guarantee associations is that evaluation of the loan risks may be done more effectively by association members working in the same industry, while peer pressure can help effect repayment. Co-guarantors will presumably have information about project characteristics not always available to banks. They will also have incentives to provide information to the scheme that they might not wish to give to a bank (Hughes, 1997). By using the information available to firms operating in similar lines of business, mutual schemes target the problem of information asymmetry between banks and borrowers described in Chapter 5. Associations can also negotiate with banks for favourable loan rates. In

France, Japan and elsewhere such associations also re-insure the loans, and publicly subsidised reinsurance programmes exist in a number of countries. There are many possible institutional arrangements with credit guarantee associations, although a key issue is the size of the group. Peer pressure and the ability to screen proposals thoroughly may be greatest with a small group, although the scope for risk sharing is also reduced. Consequently, the magnitude of the guarantees offered by small associations tends to be small.

There are striking differences between northern and southern Europe in the prevalence of such schemes. Hundreds of thousands of Italian small firms receive funds backed by mutual guarantee associations. By contrast, mutual guarantee schemes are almost non-existent in the United Kingdom. For policy, the key issue revolves around whether there is some obstacle to the establishment of such schemes by private agents. In a number of countries the private sector has created and run mutual guarantee associations by itself. It has been claimed, however, that there are public good aspects to the establishment of such arrangements, although this is debatable. In areas with little or no previous experience of such schemes a seedcorn role for the public sector might be appropriate, disseminating information and possibly funding feasibility work. This is broadly in line with the recent aims of the European Commission in sponsoring pilot projects in this field.

A vivid description of the operation of a successful credit association in Italy is given by Brusco and Righi (1989). When this paper was written Modena's Loan Guarantee Consortium (LGC) had well over three thousand members. If a member is unable to repay a loan the LGC makes repayment and seeks to recover these monies from the member concerned. The LGC negotiates interest rates on behalf of members, usually obtaining a rate below that for similar loans elsewhere. Only working capital loans are guaranteed, and the LGC charges a one per cent underwriting fee. An interesting feature of the LGC has been the overlap in membership between the National Confederation of Artisans (CNA) and two national political parties. Applications for a loan guarantee are appraised as much on the basis of the applicant's trustworthiness and professional reputation as on financial standing. These qualities are judged from the applicant's past dealings with the CNA, as local CNA staff will have known the applicant's business and helped to keep its accounts. LGC staff will also usually have detailed knowledge of the applicant's firm and the prospects of the subsector. Intimate knowledge of the applicant and common membership in political parties and the CNA appear to lead to well-targeted guarantees and considerable pressure from peers for repayment. From 1976 to 1989 the LGC had guaranteed ten billion lire in loans, with only seventy million lire unrecovered.

Mutual guarantee schemes may not be suitable for all contexts however. Where mutual undertakings are unfamiliar to the local or national business culture their establishment might be time consuming, with few participants. Countries with more developed banking systems may also deem such arrangements unnecessary.

Encourage equity investments through education and information, and support networks of business angels

Access to institutional equity investment is essential for many growing companies. Chapter 3 described reported gaps in the supply of formal venture capital to new and small firms. Many studies also show that the supply of, and demand for, formal venture capital is highly geographically concentrated. Companies that provide venture capital are scarce in less dynamic regions and areas without substantial activity in financial services (Mason and Harrison, 1991). Governments have created a wide range of schemes to expand equity investment in small firms and poorer communities (see Box 9.3). In some countries, publicly supported equity investment in small firms has been quantitatively significant. For instance, in 1995, in the United States, publicly provided and/or guaranteed equity financing amounted to more than sixty per cent of that provided by traditional venture capital funds (although much of this was for technological rather than area-development purposes) (Lerner, 1999).

However, it is not evident that measures to increase levels of venture capital investment will have a large impact in disadvantaged locations. First, formal venture capital activity is relevant to only a small minority of firms. Barely two in each thousand European start-ups receive institutional venture capital – despite the proliferation of public support programmes. In the United States only a little over a half of one per cent of new companies were funded with formal venture capital in 1999 (NCOE, 2001). And in the twenty-nine countries covered by the *Global Entrepreneurship Monitor 2001* fewer than twenty thousand businesses received formal venture capital in 2000. Second, firms with high growth potential that are most likely to attract venture funding are less prevalent in poorer communities.

Nevertheless, surveys show that venture-funded companies play a disproportionate role in job creation, and all venture-funded investment in poorer communities will clearly be welcome. However, as discussed in the next section, scale is critically important in the operation of venture funds. This fact, combined with the small volume of potentially viable deals at the local level – especially in poorer communities – means that the most appropriate level of intervention is generally not local, but regional and national. Experience also shows that it is critical that venture capital funds that have a public purpose be run on explicitly commercial grounds. A dilution of commercial objectives will limit the ability to attract private investments

Box 9.3. **Expanding venture capital investment in poor communities**

Small Business Investment Corporations – The United States

In 1958 the United States Congress created the Small Business Investment Corporation (SBIC) programme. SBICs are privately owned and managed investment firms licensed by the Small Business Administration (SBA). The two primary criteria for receipt of a license are qualified management and sufficient private capital. SBICs are profit-driven businesses that provide venture capital, long-term loans and managerial assistance to small independent businesses, both new and established. SBICs only invest in qualifying small businesses, as defined by the SBA. Some of the best-known companies in the United States have at some stage benefited from SBIC investment, including Federal Express and Intel.

SBICs provide diverse forms of finance (equity, invoice, mezzanine, etc.) tailored to the needs of small firm clients in a variety of sectors. Most SBICs are owned by small groups of local investors. Others are owned by commercial banks, and some are publicly traded corporations. A minimum private capital investment is required of between US$5 to 10 million. SBICs invest their own funds as well as funds borrowed through the Federal Government. Government leverage is available through the issuance of debentures guaranteed by the SBA. However, the appropriateness of this source of funding has been questioned on account of possible mismatches between debt repayment schedules and the maturity structure of venture capital investments. Carefully structured tax incentives may be superior (Bates, 2002) (SBICs do already enjoy a number of tax advantages, such as complete exemption from dividend tax). According to the SBA, the overall cost of the SBIC programme is lower than the yearly tax revenues from successful SBIC investments.

Specialised SBICs, known as SSBICs, target entrepreneurs from socially and economically disadvantaged backgrounds. However, large numbers of SSBICs have either gone out of business or shifted to serving more commercially attractive markets. SSBICs enjoyed limited success, and in 1995 legislators decided to cease granting licences to new SSBICs. This disappointing experience highlights the dangers of operating small-volume – and therefore high-risk and high-cost – venture-capital funds that pursue non-commercial objectives, often involving the targeting of high-risk, low-potential-return and long-maturing investment opportunities (Bates, 2002). This experience also accords with an early assessment of the European Seed Capital Fund Scheme (Murray, 1998).

Box 9.3. **Expanding venture capital investment in poor communities** *(cont.)*

Under this programme commercially-oriented venture funds recorded significantly lower failure rates among investees by comparison with developmentally-oriented regional funds. Employment growth per investee and per fund were both superior in the commercial funds.

Recent proposals in the United Kingdom

In October 2000 the United Kingdom's Social Investment Task Force recommended to the Chancellor of the Exchequer a broad set of measures to raise levels of investment in poor localities. The suggestions included new tax credits for investment in community development financial institutions (which invest in both non-profit and for-profit enterprises). Also recommended was a Community Development Venture Fund to provide venture capital in areas of disadvantage. A range of private, professional and charitable investors would be supported with public matching funds and tax credits.

At the same time it was proposed that voluntary – and if necessary compulsory – disclosure of bank-lending in under-invested communities be encouraged. Other measures involve grants, guarantees for community development venture funds and encouragement to charitable foundations to provide equity finance. A final proposal involves the scaling up of community development finance institutions by collecting investable funds on a wholesale basis and strengthening networks among, and representation of, community development finance organisations. The idea of an investment intermediary to screen, provide information on, standardise and channel resources into investments in community development financial institutions has also been proposed by Bates (2002) after examining related programmes in the United States.

Proposals formulated by the Department of Trade and Industry to establish early-stage venture capital funds in all the English regions have drawn critical reaction. Mason and Harrison (2002) express doubts about the likely success of the funds. Their reservations focus on: the ability of regional funds to attract investors; the scarcity of early stage venture capital skills; the low probability of financial viability; and the need to address demand-side constraints, inattention to which could lead to the displacement of private sector funds (as these would compete with

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Box 9.3. Expanding venture capital investment in poor communities *(cont.)*

subsidised public funds for the relatively small flow of potential deals). These substantiated concerns also hold lessons for other countries. If a shortage of relevant early-stage skills threatens the success of regional venture funds in the United Kingdom – which possesses the largest venture capital industry in Europe – countries in which the venture capital industry is less developed might face serious constraints in pursuing similar policies.

and professional fund managers. As described below and in Chapter 5, the essential rationale for public intervention to support commercially oriented venture funds is the existence of equity investment thresholds. As discussed below, at a local level, important benefits could come from supporting business angel networks. Appropriate education, training and information might help to reduce equity aversion among entrepreneurs.

Scale is critical for formal venture funds

As discussed in detail in Chapter 5, there are a number of economic and institutional reasons why most formal equity investment is made by large venture funds in the form of large investments in later-stage deals. By contrast, most formal investment in start-ups is undertaken by small-volume funds that face high unit costs and high levels of risk. The establishment of various equity guarantee/enhancement schemes may be a reason why in some countries – such as the Netherlands – higher levels of venture capital activity have been seen in early stage investments. In this connection, Murray (1999) sets out the key issues in the design of equity guarantee/enhancement schemes. The three generic options available are: insurance against the venture fund's losses; the provision of upside leverage; and subsidisation of part of a fund's operating costs. Putting a financial safety net under a small fund can be important, but may weaken the venture capitalist's incentives to ensure good investment decisions. Instruments to provide upside leverage multiply the financial benefits of success to the disproportionate advantage of venture capital firms and their investors. Murray's simulations show that, for a variety of reasons, a leverage programme has a superior impact on the returns of the partners in a venture capital fund when compared with a guarantee scheme. Moreover, the leverage exclusively rewards successful investment activity and does not insulate management from the consequences of unsound decision making. Aernoudt (1999) is also supportive of the role of public guarantees in promoting the development of early-stage private risk capital.

Policymakers can also address demand-side constraints

Chapter 5 discussed the role of demand-side considerations in determining the level of institutional equity investment. It was shown that some entrepreneurs decline access to external equity, possibly because of aversion to surrendering control over the enterprise. Consequently, many firms are undercapitalised, adding to the firms' risk. A greater willingness to accept external equity would facilitate growth and survival in many small companies. Demand for external equity might be increased through tax policies and possibly education, training and information. Another feature of demand-side constraints is that many proposals for venture capital investment are either incomplete or inappropriately developed. Mason and Harrison (2001) outline a structured programme of workshops, seminars and advice that could address key aspects of demand-side constraints.

Supporting business angel networks is likely to have the greatest payoff for local policymakers

Networks of so-called "business angels" aim to match informal investors with ventures seeking small amounts of equity finance. Owing to its informal nature the volume of equity provided by business angels is uncertain. However, in the United States informal equity investment is thought to be at least twice the size of the formal venture capital pool, with some estimates ranging significantly higher (Lange *et al.*, 2002). Reynolds *et al.* (2001) calculate that informal equity investment may reach one to two per cent of GDP in the twenty-nine countries covered by the *Global Entrepreneurship Monitor*.

Business angels generally invest in the early stages of enterprise start-up, often in firms that are not yet ready for formal venture capital.[3] Informal equity investors are often successful entrepreneurs themselves. For example, in the United Kingdom, previous business ventures represent the main source of wealth for around two-thirds of business angels (Lange *et al.*, 2002). Such investors therefore bring significant knowledge and experience to the investee firm. The non-financial resources provided by angel investors typically include assistance in such areas as business strategy, the search for additional finance, recruitment of key staff, and enterprise governance (Ardichvili, 2001). The level of control of the enterprise is frequently lower than that demanded by formal venture capitalists (Lange *et al.*, 2002). And the time horizons over which informal investments are allowed to mature are often greater than in the formal industry. Business angels are also not averse to investing in technology-based firms (Mason and Harrison, 1997). Furthermore, and important for territorial development, business angels are geographically dispersed and invest locally (Mason and Harrison, 1994). Informal equity investors can also play a role in raising the quality of investment proposals put to early-stage venture capital funds. This is because business angels screen projects and, through intensive interaction with entrepreneurs, help to resolve design and presentational shortcomings that might deter formal investors. In this way business angels help to address the demand side constraints in the formal venture capital market noted earlier (Mason and Harrison, 2002).

Public policy towards business angel networks is justified, in principle, by obstacles to the efficient functioning of the informal equity market. An information barrier may exist in this market if business angels are reluctant to publicise their willingness to invest and entrepreneurs are disinclined to reveal innovative ideas. Furthermore, informal investors tend not to be organised as a group. They often rely on friends and business acquaintances for referrals of investment opportunities. This reliance on networks and contacts reflects the time required to search for and appraise potential investments, as well as the fact that many business angels invest on a part-time basis (Mason and Harrison, 1997). Information and search-cost barriers on both the supply and demand sides of this market can be lowered through policy support for business angel networks (other policies to augment informal equity investment are also open to central authorities. These include various forms of tax relief and measures to facilitate exit from investments).

Business angel networks operate in the United States, Canada and various parts of Europe. In 1999 there were over one hundred active networks in the European Union, although eighty per cent of these were located in only three countries (Commission, 2000). The United Kingdom is the European country in which such arrangements are most numerous, with around forty-five business angel networks. The average annual number of deals per network is around nine. The networks operate at arms-length from the investment transaction itself, generally fulfilling a confidential introductory, screening and information-supply function. Some schemes in other countries offer mentoring services as well as contacts with banks and formal venture capitalists. In France there are around one hundred local investment clubs – called Cigales – that finance local business start-ups. Members of a club contribute a monthly amount to a common investment fund that is used to finance projects identified and appraised by the group (Evers *et al.*, 2001).

Most business angel networks are local in scope and operate with public support on a not-for-profit basis.[4] Experience suggests that there are critical constraints in attempting to run such networks on a for-profit basis, despite the recent emergence of privately operated initiatives (Mason and Harrison, 1997; Mason and Harrison, 1995). Private schemes take fee income for providing introductory services, or an equity stake in firms financed through the network. Mason and Harrison (1997) show that emerging private-sector networks in the United Kingdom involve larger and later-stage deals than the not-for-profit schemes, as well as a less direct involvement of investors in the investee firms. The not-for-profit schemes therefore appear to be different in kind from the newer and less numerous for-profit networks. As such they merit, in principle, continued public support in order to help close the smallest-scale equity investment gap.

Angel networks can also create synergies by linking with mentor networks, chambers of commerce, clubs of entrepreneurs and other similar bodies. Securities legislation may limit networks in acting beyond a matchmaking function. For instance, as in the United Kingdom, they may be precluded from engaging in the structuring of deals. Because of the need for close monitoring of investments the scope of business angel networks is generally local. However, national networks can also be valuable in matching investees and investors by pre-specified criteria. In the United States, for example, the Angel Capital Electronic Network (ACE-Net) has operated as a nation-wide Internet listing of small innovative companies, with access restricted to subscribers. Indeed, national-level services, especially among for-profit schemes, have become more numerous in recent years (Mason and Harrison, 1997).

Angel networks are also making increased use of information technologies to reduce informational and search costs (Lange *et al.*, 2002). New information technologies may lead to a degree of disintermediation in network operations, permitting entrepreneurs to bypass standard introduction services. It has been conjectured that this will force at least some networks to seek to add greater value through other activities. They may, for instance, become more closely involved in structuring and guiding new ventures, selecting only the most promising projects, and linking revenue streams more directly to the success of investee firms, such as in equity-for-service arrangements (Lange *et al.*, 2002).

Business angel networks possess features particularly attractive for local development policy – being non-distortionary, addressing market imperfections and mobilising local savings and know-how. However, as with other mechanisms for enhancing venture capital investment, these schemes are of limited relevance to the most marginalised enterprises. For evaluation purposes, it is also important that publicly supported networks track and maintain records of successful investments. This is rare in practice (Lange *et al.*, 2002). Proper evaluation is essential if a complete assessment is to be made of the merits of policy towards networks of informal equity investors.

Notes

1. Gomez (1999) found that individuals who are members of associations, clubs or organisations, outperform otherwise similar self-employed borrowers. On this basis, he recommended that non-profit providers could suggest to borrowers that they join an organisation related to their business as a condition for receiving a

loan. Outreach efforts aimed at attracting new clients could also target existing associations of self-employed workers and/or micro-businesses.

2. Many of the poorest individuals may have a greater need for micro-financial services other than micro-credit, such as affordable bill payment, savings vehicles and insurance (Conaty and Fisher, 1999).
3. This also implies an indirect link with the formal venture capital industry: business angel investment might fall if formal venture capital activity were for some reason to decline.
4. However, regional, national and even international networks also exist. BAMS, for example, operates in Belgium, Luxembourg and Northern France (Lange *et al.*, 2002).

ISBN 92-64-19978-0
Entrepreneurship and Local Economic Development
Programme and Policy Recommendations

PART II

Chapter 10

Recommendations on Programme Design

Recommendations on Programme Design for National Government

Consider incorporating new objectives into existing institutions rather than creating new organisations

In many countries a large number of enterprise support programmes has grown up over time. For example, in the United Kingdom, Conaty and Fisher (1999) found that there were "200 central government business support initiatives, sponsored by five departments, at an overall cost in 1995/96 of 632 million pounds". Often, the ensemble of support measures is characterised by programme overlap and fragmentation, funding discontinuity, competition among delivery agents, programme redundancy, and disorientation among intended beneficiaries. Programme assessment is also made less practicable and meaningful because fragmentation in the overall architecture of public support can give rise to non-standardised reporting and monitoring procedures (which also adds to reporting burdens on service providers). Rather than create new structures, a cost-effective course of action would often be to increase awareness of existing programmes. Before establishing new organisations, policymakers should consider incorporating new objectives into existing institutions.

Ensure flexibility in the operation of self-employment support programmes

Modalities for paying monetary assistance could vary according to the financial circumstances of the recipient. Clearly, an unemployed senior executive with accumulated savings might have less need of payments delivered as a lump sum than an unemployed college graduate. There is evidence of greater enterprise survival rates when assistance is disbursed as a lump-sum (Meager, 1993), which in part reflects the enhanced ability of lump-sum recipients to start larger and non-service-sector ventures. Advantages and disadvantages of lump-sum and regular-allowance payments are discussed in Chapter 3.

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Design self-employment and micro-enterprise support programmes such that capacities can be expanded during economic downturns

Studies have documented the sensitivity of self-employment entry to local unemployment. Accordingly, some flexibility is required in resource allocation procedures for programmes to support self-employment and micro-enterprise. The possibility should exist of enlarging such programmes during periods of economic downturn, when demand for programme services is expected to rise (changes in the stock of unemployed in terms of gender or age could also influence demand for specific types of business support).

Aim for visible points of referral to professional advisors

Owing to their limited internal division of labour small firms usually require access to varied forms of advice. Indeed, the use of external advice has been shown to be a positive function of firm size. There is abundant evidence that superior management capabilities are central to enterprise survival and growth. Access to information and advice is a key aspect of sound management.

Firms use a wide variety of sources for obtaining information and advice. These include banks, accountants, solicitors, suppliers, customers, trade associations, public agencies, and social-professional groupings. Private sources predominate in terms of frequency of use. Studies suggest that this predominance reflects the specialist knowledge possessed by private sources as well as the confidence engendered by the (self)-regulation that governs professions such as banking and accounting (Bennett and Robson, 1999). Different information sources appear to be used for different purposes. For instance, customers are often utilised for information on issues such as product development and how to sell in new markets. And government bodies are frequently referred to for regulatory information. A multipurpose and particularly highly valued information source is a small firm's network with other firms (Malecki and Poehling, 1999). Indeed, in many surveys business owners maintain that they would profit from greater contact with entrepreneurs who operate companies similar to their own.

Government programmes to provide or subsidise the supply of business advice for small firms are widespread. For example, Small Business Development Centres are present in all States of the United States and offer a broad spectrum of business counselling services. However, evidence on the impact of advisory services is limited. One recent study suggests that growth in recipient firms is most closely associated with private sources of advice such as lawyers, accountants, customers, and friends in business. This research – which did not include start-up firms – indicates that government-supported advisory services have little effect on growth but do help to rescue ailing firms (Bennett and Robson, 1999). There may also be a tendency for government agencies to provide survival rather than growth-oriented advice. This is because clients often approach government services when they are in difficulty, while survival-oriented advice is also appropriate to most firms (Mole, 2000). So it appears that, by comparison with private sources, public advisory services tend to be different in kind and cater to a dissimilar segment of the small business population.

From a practical standpoint, a comprehensive system of public outreach will be expensive, and prohibitively so if attempting to provide one-to-one service for large numbers of micro-enterprises. Furthermore, firms at different stages of development require different sorts of information and advice. These might range from the validation of business plans to advice on legislation, tax compliance, public insurance, marketing, market research, book keeping, adoption of the ISO 9000 quality standard, etc. Clearly, expertise in such a breadth of subjects is difficult to bring together in a single advisory service. Furthermore, public advisory bodies are often staffed by persons who possess a general business education but no first-hand business experience. This contrasts with entrepreneurs' frequent preference for advice from peers. All of the above considerations point to the need for a well-functioning on-call referral service to privately provided advice and mentoring.

The functioning of the market for advisory services to small firms was discussed in Chapter 5. The discussion indicated that it is difficult to make a generic assessment of how well this market works. But because of possible inefficiencies in the operation of this market, and also on account of concerns about access for low-income groups and the unemployed, it appears reasonable to consider sponsoring the use of private providers that cater to the smallest firms and the most disadvantaged in the labour market.[1] Such sponsorship could take the form of voucher programmes, grants or other types of subsidy aimed at reducing the cost to the target entrepreneurs of using private advice. Temporary public support to expand the use of services might also be considered where this increases awareness (and absorptive capacity) among small firms of the benefits of using particular types of services (such as the emerging applications of information technology) (Feller, 1999).[2]

If subsidies are provided for the use of private advice then consideration is needed of how to allocate these resources. Subsidising the use of services on a "first-come first-served" basis is likely to bias the supply towards better-informed firms (Storey, forthcoming 2003). Some level of charge and a degree of cost recovery will probably be required so as to avoid excessive public spending. The appropriate charging option also depends on the policy goal. As already noted, full-cost charges may be inappropriate for some low-income or unemployed individuals. And as Storey (forthcoming, 2003) describes, if the aim is to give large numbers of firms at least some exposure to the potential benefits of advice then charging might be inappropriate. If however the immediate goal is to create an impact on company performance, then charging will be needed to provide the resources for the greater commitment of time that this requires. Being clear on policy goals will help to assess the trade-offs that different options can entail.

National and local authorities can help to support the market for private advice

Countries like Denmark and Finland, among others, have instituted accreditation and quality assurance programmes for providers of business services. These often operate through national organisations such as Ministries of Industry. Local authorities could play a role in encouraging accreditation and the use of accredited sources of advice. Indeed, information to enhance the development of an efficient market for business services has the characteristics of a public good. Its supply is therefore a relevant concern for public authorities. Accreditation programmes could be particularly valuable for consultants, as these usually rely for referrals on reputation and recommendations and tend to be used less frequently than other sources of advice. More generally, without incentives for the use and supply of targeted small-scale advisory services private providers will tend to concentrate on supplying the more profitable end of the business services market.

Many different sorts of providers of advice could be included in a referral system. As well as mainstream for-profit providers, industry associations, chambers of commerce, non-governmental organisations and business mentors could all play important roles. The institutional idiosyncrasies of different countries mean that there is no optimal model of delivery.

Institutional visibility is important, given the often-confusing plethora of organisations that offer support. Points of access to a referral system should be numerous and found in locations likely to be frequented by would-be and actual business people. It is important that banks, accountants, solicitors, training organisations, chambers of commerce, business associations and others be encouraged to refer entrepreneurs for support to relevant public services. For instance, persons with failed loan applications might be referred to a development agency so as to improve the quality of loan applications, business plans, financial forecasts, etc. (and where the public sector does become directly involved in supplying services the achievement of ISO 9000 certification should be a goal). It should also be ensured that relevant information is accessible to the unemployed. Unemployed persons may visit banks or other of the above-mentioned contact points infrequently. There should be easy access to a one-stop function for would-be entrepreneurs where all relevant documentation and paperwork can be collected in a single visit.

Entrepreneurs should not face time-consuming procedures in finding advice. Authorities should prepare easily comprehensible guides to business support services as well as contacts directories. Steps should also be taken through local media to ensure awareness that this information exists. Where possible, business advisors should also possess a detailed knowledge of the local community (which a local referral system makes likely).

It is not enough simply to publicise the availability of advisory services. The value of using such services must also be made known. For instance, various studies show low take-up of advice among women (for instance, Carter, 1997) and ethnic minorities (for example, Fadahunsi *et al*., 2000). Part of the reason for poor take-up might be a lack of understanding of the potential benefits of service use. It is reasonable to assume that this problem will be most severe among the smallest firms.

In many countries the Internet has led to a significant expansion in access to business information. For example, Australia's federal government Department of Workplace Relations and Small Business established an Internet site containing extensive information for the self-employed and others. By specifying their State and/or industry, the self-employed can locate topics adapted to their specific areas of business. However, to date, research on the effects of Internet-based advisory services appears to be non-existent. There is also little experience on which to base an assessment of whether distance learning is appropriate to the needs of entrepreneurs. Knowledge of the impacts of such services could be particularly valuable to development agencies serving remote and sparsely populated areas, as well as those serving large numbers of small firms.

Should public advisory support be targeted?

As discussed in earlier sections of this book, policy has in some countries moved away from attending to the needs of enterprise start-ups. In this context, and with the aim of targeting the supply of advisory services, some analysts have proposed criteria for identifying firms that are likely to generate significant employment. Maximising the impact of development agencies' limited budgets is clearly an important goal. However, proposals for targeting advice on high-growth and other classes of firm pose a number of problems:

- Some characteristics of firms and entrepreneurs are broadly associated with growth (such as sectoral type) and survival (such as size at establishment). So it is reasonable to assume that decision-makers could increase the probability of channelling resources to firms with growth potential if they decided to target businesses possessing the relevant traits.

Nevertheless, predicting growth in individual cases remains uncertain. Venture capital funds – the *raison d'être* of which involves identifying fast-growth investment candidates, and which also have access to higher quality information than most public agencies – hold investment portfolios on account of such uncertainty.

- Depending on how advisory assistance is delivered, a policy of targeting on the basis of growth potential could involve a degree of redundancy if successful. This is because fast-growth firms are more likely than other firms to identify and develop private sector information sources.
- The process of growth in small firms is sometimes irregular, with strategies changing over time from maintenance to growth and back (Johnson *et al.*, 1998).
- In the light of the drawbacks cited above, some observers have suggested giving up on most specific targeting criteria and focusing instead on firms that have survived the start-up phase (Storey, 1993; 1994). However, the fact that a firm has survived may not be a reliable guide to future growth (although it is likely to be useful in predicting future survival).
- While studies have found a positive relationship between enterprise growth and the use of external advice, relatively little is known about the cost-effectiveness of publicly supported advisory programmes for different categories of small firm. The available studies are mostly surveys of the opinions of entrepreneurs who have received advisory services. By contrast, there are few assessments that have used carefully constructed groups of firms that have been given advice and control groups of firms that have not (a recent exception is Wren and Storey [2002]). The possibility remains therefore that the incremental impact of public assistance to fast-growth firms might be less than for survival-oriented businesses.

  In addition, the presumed inefficiency of not targeting high-growth or already established firms is that there will be a significant loss of resources when early-stage firms fail (at a high rate). Against this view it could be noted that one effect of business support has been to alter the re-employment probabilities of some entrepreneurs. Benefits from past advice can also be experienced by entrepreneurs who re-enter business, perhaps after an earlier venture has failed. Advice to start-ups might also play a role in lowering termination rates, although this possibility has barely been examined in the available research. Given this set of positive but largely unmeasured impacts, the resource loss from advising start-ups might be overstated. Evidently, further research on the impact of advisory services could help to clarify which policy choices are preferable.
- Growth-based targeting would lead to controversial inequalities in access to services that could also undermine other policy goals. For instance, in line with the research cited in Chapter 6, if primacy were given to growth

prospects then female entrepreneurs would be excluded from service support more often than males. Overall, firms in poorer communities would receive less support than enterprises in better-off areas, which tend to generate more fast-growth businesses.

Some of the above concerns become less pressing if, in practice, targeting simply involves using part of the time of staff in development agencies to ensure that companies with an ambition to grow are fully aware of – and put in contact with – the relevant sources of advice (Johnson *et al.*, 1998). Local development agencies regularly conduct surveys of local businesses. Those firms that express an ambition to grow, and that have made investments likely to induce growth, could be readily identified in such surveys. While studies show that enterprise growth is often associated with higher probabilities of survival, growth can also create risks (such as over trading) and require new knowledge and skills (such as in dealing with overseas partners). New risks might be mitigated by appropriate (in this case financial) advice, while skills and knowledge gaps could be closed through training, mentoring and access to information. But the providers of advice, training, information and mentoring need not be public, as discussed earlier. Moreover, relative to other firms, fast-growth firms often seek a wider array of advisory services, some of which are highly specialised. It therefore makes sense to ensure that these firms know where to find the advice they need. A system of advisory support along the above lines could be combined with assistance for the development of high quality start-ups.

Lichtenstein and Lyons (2001) observe that the ways in which recipients of business support are categorised can be counterproductive. Categories often include groupings along such lines as type of business (manufacturing, retail, etc.), owners' demographics, size of company, and the background of the entrepreneur. Few enterprise support schemes explicitly differentiate their clientele except by size of company. However, such categories do not correspond to a particular level of skill in the entrepreneurs concerned. It is the level of skills – and the graduation from lower to higher levels – which should constitute the organising principle of enterprise support. Rarely, the authors claim, are service providers good at working with entrepreneurs at all levels of development. This observation again points to the need for a broad system of referral to business related advice.

One final observation on the subject of business advice: research undertaken on work and family in family business by MacDermid (2000) has shown that the prescription to separate family and work life – which is frequently offered by support agencies – might not be best for family-owned firms. Families tend to run more successful companies when the lines between family-centred and business-centred activities are fuzzy.

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Issues of marital stability in family-owned businesses are under-researched and could have policy ramifications given that family pensions and mortgages are often tied up in family businesses. The provision of marital or spousal support for couples in which one or both are entrepreneurs is now seen in some programmes. This seems a potentially valuable development given the significant stresses and demands on time that entrepreneurship commonly entails.

Ensure access to high-quality pre-start advisory services

The effects of pre-start advice are to identify less viable business plans, to caution prospective entrepreneurs and to improve the viability of nascent firms. For instance, preparing a business plan can facilitate access to finance and help ensure that the correct level of borrowing is sought. But the self-employed often act in isolation and develop detailed business plans only infrequently. A number of studies have found that screening improves rates of survival among the self-employed. Self-screening through compulsory participation in training, counselling and/or the preparation of business plans appears particularly valuable. Redirecting persons who wish to establish a business for the wrong reasons is also important, as the consequences of business failure for individuals and their families can be severe (possibly including the loss of savings, pensions or a family home, and reduced physical wellbeing and self-esteem). In this connection, pre-start advice could also play a role in helping potential entrepreneurs to plan how to safeguard such critical assets as a home and a pension.

Persons who have been unemployed for some time are likely to require more pre-start training. Pre-start programmes should therefore be sufficiently funded and flexible to cater to varied and possibly long-term needs for advice (Cowling and Hayward, 2000). Charging for business planning assistance is also likely to greatly decrease up-take by the unemployed (Metcalf *et al.*, 2001).

Research showing that the self-employed might be unreasonably optimistic about their business prospects highlights the potential benefit of pre-start advice [see DeMeza (1999) for a discussion of this phenomenon in relation to the behaviour of borrowers]. There is some evidence that the self-employed systematically overestimate expected future income by comparison with the employed [indeed, the tendency for optimists to hold unrealistic assessments of their own levels of skill and control appears to be a generic psychological phenomenon (see Seligman, 1990)].

Carefully select monitoring and performance measures as these shape programme outcomes in diverse and important ways

The choice of performance measures for enterprise support programmes creates incentives that shape the behaviour of service providers.[3] When the continued funding of programmes depends on performance targets being met, inappropriate yardsticks can have serious and sometimes unforeseen effects on programme implementation and effectiveness. The selection of performance measures is also critical in focusing programmes so as to achieve overarching goals such as maximising additionality and minimising enterprise displacement. Accordingly, performance indicators need to be chosen with care.

For example, if the performance of a micro-enterprise scheme is assessed against the number of persons entering the programme an incentive exists to increase client throughput. Clients may be encouraged into the scheme – or be accepted when they should be dissuaded – regardless of probable business outcomes. In a similar fashion, the impact of business incubation schemes has sometimes been undermined because sponsors have adopted crude employment-based measures of success. Such benchmarks have encouraged some incubator managers to permit established firms into the schemes, leading to minimal programme additionality. In a related manner, if programmes are assessed against the number of enterprise start-ups they bring about then support might shift away from services that are likely to enhance business survival. A programme appraised on the number of start-ups achieved could also incur large deadweight costs. This might happen if support is oriented towards individuals who have a high prior likelihood of becoming an entrepreneur. And funding which is based on output measures – while having the virtue of administrative simplicity – involves making payments after providers have incurred expenditures. This can cause support to be directed towards types of services that require little initial spending (Metcalf *et al.*, 2001).

The time period over which monitoring is performed is also important. Different forms of enterprise support have different gestation periods. For example, a programme oriented towards firms working in the development of new technologies might have an impact over a number of ears. By contrast, a scheme to facilitate access to business accommodation could benefit firms almost immediately. Monitoring with an inappropriate time-frame could therefore lead to inaccurate assessments of programme performance. Similarly, an emphasis on achieving short-term effects might cause assistance to be concentrated on those who are most easily supported, with too few resources given to individuals requiring long-term help.

It has been seen that entrepreneurship support involves various policy-relevant tradeoffs, often centred on tensions between equity and efficacy. Measures of performance need to be sufficiently varied to account for and contain the different effects and tradeoffs that programmes entail. Single-variable performance measures invite distortions in the running of programmes that have complex effects. So, for example, performance measures should combine start-up data – as enterprise creation is an underlying goal – with indicators of survival – because just creating firms is not enough. Weightings could be assigned in order to reduce displacement. For instance, the highest weightings could be given to projects involving enterprises in which the size of capital invested and expected business incomes are comparatively high. It is in such cases that displacement is likely to be low. Similarly, higher weightings could be assigned to firms in manufacturing than to those in the service sector. To raise the additionality of programmes and avoid a bias towards the selection of the most promising projects, higher weightings could be afforded to the establishment and successful management of firms by individuals who face barriers to enterprise. These could include persons whose loan applications have been rejected by a bank, people whose creditworthiness is poor or difficult to assess, and individuals who do not have a bank account. It is also essential that performance measures be appropriate to programme type. For example, there is little sense in assessing business incubators primarily against job creation criteria when their services are organised to bring about business development. Measures of business development are the conceptually correct indicators in this case (see Box 10.1).

Performance measures serve a variety of functions in the relationships between programme sponsors, intermediaries and service providers. In addition to yielding evaluative information, performance indicators can define subcontract relationships and serve as an instrument of accountability [when loan repayment rates have been used as the principal performance measure in micro-credit projects, staff in some programmes have used legitimate accounting procedures so as to turn in high published rates of repayment, with programmes also being designed such that low repayment rates would not be reported (Woolcock, 1999)]. Monitoring is a tool that can furnish information essential to programme management and superior programme outcomes. It is important that monitoring not be perceived principally as a means of control. Accordingly, monitoring should be conducted in partnership (Metcalf *et al.*, 2001). Service providers should be convinced of the utility of measuring performance. In practice, monitoring is sometimes performed in a perfunctory way. Service providers are often unconvinced that the data they spend time and money to assemble are useful. The entire process is sometimes felt to add little to the direction of strategy.

Box 10.1. **Evaluating entrepreneurship support – the example of business incubators**

Business incubators are a widely used instrument for local economic and employment development. There are close to a thousand business incubators in the United States, some two hundred incubator-type structures in France, and more than a hundred incubator schemes in the United Kingdom. And these numbers are growing rapidly. Over the last fifteen years incubators have been an important instrument of regional and urban development policy in Germany. There are, in addition, many unenumerated incubator-like projects supported by subnational authorities across the OECD. Especially in local and regional tiers of government policymakers have turned to business incubation as a means of achieving a wide range of economic and social objectives. Incubators have variously been used to combat unemployment, raise rates of enterprise formation, upgrade the technological standing of firms in a given locality, commercialise university research, assist socially disadvantaged groups and expand the supply of infrastructure. However, job creation is the most common goal of the publicly supported incubation schemes.

While much literature exists on how to manage incubators, methodologically sound studies of their incremental impact are scarce. Much of the available writing is promotional and affords little useful information to those who formulate policy. There is a need to reflect critically on the criteria commonly used in evaluations of incubation programmes. For example, a widely employed performance measure is the public subsidy per job created. Conceptual difficulties exist in estimating this ratio. For instance, for a young programme that has had little time to generate employment, should one include as a cost the subsidies given for purchasing land and buildings? Or should the evaluation only count any operating subsidies? Such issues aside, the cost-per-job criterion is of little use if the jobs in question would have been created anyway outside the incubator. Therefore, assessments of the additionality of incubator impacts are also needed.

Business survival rates are frequently used to measure impact. This criterion has limits as well. First, survival rates may not be a good yardstick for assessing effectiveness if many of the surviving firms are marginal survivors. In addition, much so-called "failure" is in fact temporary. Business terminations with losses to creditors are often only a fraction of total exits. This means that closure cannot always be

Box 10.1. **Evaluating entrepreneurship support – the example of business incubators** *(cont.)*

equated with failure. In fact, around thirty per cent of entrepreneurs who closed home-based businesses in the United States between 1992 and 1996 evaluated the enterprise as "successful" (Phillips, 2002). Many who leave self-employment do so to take up alternative employment, not because of business failure. And many entrepreneurs whose ventures fail learn from the experience and establish successful firms at a later date.[1] Furthermore, rates of enterprise survival are positively related to the age of a business. So an incubator with low failure rates among older tenant firms might not be performing as well as an incubator with higher failure rates among younger tenant firms.[2] And incubators that operate in the weaker local trading environments of poorer communities will tend to register lower survival among tenants than similar incubators in more prosperous areas.

Above all, it is difficult to gauge the significance of improved survival rates if firms enter the scheme after a selection process, as is usual. In this case, the success of incubated companies may be due to intrinsic characteristics rather than the effects of incubation. The only way around this problem – the problem of correctly attributing impact – is to find a representative comparison group for the incubated firms.

However there are complications in identifying comparison (or control) groups. For example, many databases that contain information on non-tenant firms do not cover enterprises that fail early on. Most firms that fail early, for instance, will not have registered with Chambers of Commerce. The following approaches have been suggested to finding a set of comparable firms:

- When accepting a tenant into the incubator, incubator managers could seek to identify a similar local non-tenant firm at the same time. Assisted firms may be in a position to help identify comparable enterprises.
- Firms that have applied to enter an incubator might have different characteristics from firms that operate in the same sector but which have not sought external assistance. Incubator managers could therefore seek to monitor firms that are accepted into the incubator but which for administrative or other non-substantive reasons failed to take up a place.
- Control groups might also be identified from among the clients of enterprise support agencies located close to the incubator – if agencies have maintained appropriate data. Such agencies may have worked with many early-stage firms similar to those assisted by incubators.

Box 10.1. **Evaluating entrepreneurship support – the example of business incubators** *(cont.)*

- An incubator containing firms with affiliates might use data collected from the affiliate enterprises if these share significant common characteristics and are sufficiently numerous to form a control group.

The burden of evaluation cannot be borne by incubator managers alone. Approaches using control groups need to be implemented with the support of evaluation specialists.

Even if the problem of identifying a control group is surmounted, increased rates of survival and improved corporate performance are only to be expected in any group of firms that receives assistance. This highlights the point that for the evaluation of public policy what matters is the ratio of costs incurred to benefits generated. In other words, how much has the public sector needed to invest to bring about the changes in enterprise performance? Cost-benefit ratios would allow comparisons of incubation against other measures employed to achieve similar outcomes. Unfortunately, such work is lacking.

Incubators can also have long-run indirect effects that are difficult to measure. For example, a few successful start-ups in a deprived area may help communities view entrepreneurship as a realistic option. Technology-oriented incubators can sensitise academics to the problems of industry. And in Germany some have held the networking of local development organisations to be a major effect of incubators.

By evaluating and monitoring schemes against the wrong criteria sponsors could limit the chances of eventual success. Contrary to common practice, the focus of incubation should be on enterprise development rather than employment growth. Most job creation appears to occur after tenant firms graduate from incubators. Employment growth will follow successful commercial outcomes. Therefore, measures of incubator performance should record different dimensions of enterprise development. These might include, for example, the time that enterprises need to establish market niches or develop new products, the adoption of advanced management practices, and the use of superior technologies. A concentration on job counting in programme evaluations might result in schemes being classified as unsuccessful when they could in fact yield jobs over time. This is particularly likely if evaluations are undertaken in the early stages of a programme.

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Box 10.1. **Evaluating entrepreneurship support – the example of business incubators** *(cont.)*

1. For example, the process of learning from the discontinuation of a business is illustrated in Stokes and Blackburn (2002).
2. See *The Evaluation of Business Incubators*, by Professor Peter Bearse, in OECD/LEED-SOFIREM (2000).

Metcalf *et al*. (2001) note that service providers may face different performance measurement requirements from a range of sponsors. In this regard, governments can act to ensure consistency of performance measures across similar programmes. Bringing about a degree of standardisation in requirements for performance data can reduce administrative burden, especially for service providers that receive funds from more than one source. Such standardisation could also improve comparability across government-funded programmes, which would facilitate the generalisation of best-practice.

Systematically evaluate programmes and ensure that evaluation findings inform policy

Strategies must entail an explicit commitment to evaluation and monitoring. The paucity of reliable evaluative research on programmes to support entrepreneurship is striking, and was highlighted in the OECD's 1998 flagship publication *Fostering Entrepreneurship*. The shortage of high-quality evaluations strikes a marked contrast with the large sums of public money spent on promoting entrepreneurship. The inadequacy of evaluation was a common observation in a set of six national reviews of self-employment commissioned by the OECD in 1998. In Australia, for example, Chapman *et al.* (1998) reported that only one among a large number of State and Federal programmes had been examined in detail. Similarly, OECD (2000a) reviewed management training programmes in six countries and found that evaluations had been undertaken in only two of these. Furthermore, there is evidence in at least one country that the schemes that are evaluated most frequently are those that are known to have been relatively successful. In addition, monitoring and audit approaches on the part of assessing agencies often substitute for genuine attempts at economic impact assessment.

There is also a conspicuous lack of good evidence of the impacts of local development policies more broadly. For example, a recent study on local councils in the United Kingdom found that many "are uncertain whether their efforts result in real opportunities for local people". This occurs despite the fact that councils in England and Wales spend "322 million pounds on economic development each year, and also manage billions of pounds of domestic and European regeneration funds" (The Audit Commission, 1999).

The scarcity of rigorous evaluation seriously undermines opportunities for designing effective and efficient policy. The evaluation deficit is doubly regrettable in that local development initiatives are often intended to fulfil pilot or experimental functions. This, indeed, is one of the claimed justifications for local development approaches *per se*. But this experimental function is lost when programmes are not properly evaluated. In fact, fundamental questions concerning the merits of a developmental role for local governments are hard to respond to when evaluation practice is deficient. Furthermore, co-ordinated evaluation could provide particularly useful results precisely when enterprise development programmes are locally implemented. For instance, a great deal of policy-relevant information could become available if similar types of programme were to use different implementation models in different localities. For example, with proper evaluation, local differentiation in the *modus operandi* of micro-credit schemes could help shed light on the relative efficacy of mechanisms such as weekly or monthly repayments, group- or individual-lending, etc. (Morduch, 1999). As things currently stand, "best-practice" in many widely used entrepreneurship programmes has only a weak empirical basis, and knowledge gaps are the norm. In addition, many publicised estimates of the costs of job creation are unhelpful to policymakers, and even misleading, because they result from non-standard or inappropriate evaluation methodologies.

The shortage of good evaluations has various causes

There are a number of reasons why institutional resistance to evaluation appears common. Perhaps the principal objection among programme managers and implementing agencies stems from fear that support will be withdrawn if programmes receive a negative assessment. But the evaluation deficit also reflects the practical and methodological challenges of rigorous evaluation. For example, measuring such effects as deadweight, displacement, and substitution is notoriously difficult. Chapman *et al.* (1998) describe an evaluation of the NEIS Programme by the Australian Productivity Commission. This sophisticated study sought to estimate maximum and minimum net programme benefits by establishing upper and lower values for key parameters. The highest estimate of programme costs employed the highest likely displacement rate, the highest probable deadweight values, and the lowest assessment of effectiveness. To quantify the lowest programme cost the lowest probable displacement and deadweight figures were used, along with the highest estimate of effectiveness. This approach led to a calculated upper cost to the programme of AUS$ 95 000 per job created, and a lower cost of – AUS$ 2 800. The study fixed on a final figure of AUS$ 19 000.

The wide range of these estimates is indicative of the technical difficulty of undertaking methodologically sound evaluation. Such a broad range of outcome values has been seen in a number of large and complex evaluation exercises. The perplexity that such results sometimes cause among policymakers can provoke mistrust in evaluation. Box 10.1 illustrates some of the complexities – and practical responses – involved in evaluating business incubators, a commonly used tool for local development.

The direct and indirect costs of evaluation can also produce aversion to assessment. For instance, programme managers often view evaluation and monitoring as an intrusive source of administrative burden. In addition, the more systematic evaluations have often been useful in deciding whether a policy has worked or not, but have been weak in describing how the policy might be improved (Bartik and Bingham, 1997). This may have diminished the perceived usefulness of evaluation among programme administrators. Furthermore, because the benefits from evaluation can accrue to agencies other than those that sponsor the studies, there is an incentive for local authorities to under-invest in evaluative knowledge. Evaluation can also appear to be an unrewarding exercise when government initiatives are numerous and the population of active programmes changes constantly.

Furthermore, a weak understanding of basic evaluation principles, and a lack of suitably trained evaluators, places local authorities in a disadvantageous position when subcontracting evaluation studies. At considerable public cost, private consultancy organisations might be asked to ascertain replies to the wrong questions. Methodological short cuts might also lower costs for the consulting bodies, but for an uncritical public authority they could fundamentally limit a study's relevance to policy learning.

Evaluating enterprise development programmes involves a common set of challenges

Evaluations of enterprise development programmes – whether advisory services, micro-credit, training, or other schemes – face a standard set of evaluation challenges. The ultimate aim is to attribute changes in target firms or persons to the effect of a given programme. But simply comparing the situation of assisted firms or persons before and after a programme is inadequate. Other factors besides the programme may have caused any change of state. In fact, the observed difference in state in the target group (firms or persons) is a result of the following three sets of influences:

- The impact of the programme
- Unrelated factors

  Extraneous influences might include a change in the policy context, or fluctuations in the business cycle. Trend changes in the target population could also be important. For instance, firms might register improved productivity not because of counselling or advice but because of a tendency to employ higher-quality information (possibly as a consequence of using new information technologies). And so-called "maturational" trends may also need to be accounted for. For instance, new firms, as well as firms in a new industry, might be operating on a learning curve that leads to improvements in performance over time.

- How the programme is observed

  Measurement reliability is important, as some indicators are less consistent than others. Observations might also focus on the wrong variables. And analysts might be looking in unrepresentative locations, as a programme implemented in a distressed locality is likely to have different impacts from an identical scheme in an affluent area. Bias in the way respondents reply to surveys is also a common problem. For instance, participants might exaggerate the efficacy of a marginally beneficial scheme thinking that this could increase the likelihood of future assistance (Bartik and Bingham, 1997). There can also be problems of response bias in firm surveys. Large firms for instance are more likely to respond to surveys than small firms. And surveys of owner-managers might be more likely to report impediments to enterprise development that stem from factors external to the firm – such as inaccessibility of finance – rather than problems internal to the firm for which the entrepreneur bears responsibility.

Evaluations need to assess what would have happened without the programme

Identifying changes in target groups and correctly attributing these to the effects of programmes implies a knowledge of what would have happened to the target groups if they had not participated in the programme. In other words, if evaluators have no idea what might have happened to target firms in the absence of a programme then they cannot know that it is the programme that was responsible for the observed changes. Evaluations therefore need to distinguish genuine programme impacts by discounting impacts from extraneous sources and discounting changes in the target firms that would have occurred in spite of the programme.

Accounting for so-called selection bias is also a key part of identifying the situation that would have prevailed without the programme. Selection bias refers to the possibility that there are unobserved characteristics which have led a firm or person to be included in a programme and which are also likely to affect business performance. There are two forms of selection bias. The first is self-selection. For instance, entrepreneurs who seek assistance in the use of new technologies might be particularly forward-looking, open to change and prepared to accept risks associated with new investments. These characteristics could be associated with superior enterprise performance, irrespective of whether the support programme is beneficial or not. The second form of selection bias stems from administrative selection. This occurs in the many cases where administrators choose programme participants. Because administrators usually try to maximise the impact of a programme by selecting "good" participants, there will be a tendency for participants to perform better than control groups regardless of the effects of the programme. Selection bias can be of considerable importance. In a recent evaluation of one component of a major small-firm support programme in the United Kingdom Wren and Storey (2002) showed that failure to account for selection bias would double the scheme's estimated impact.

Evaluations essentially take three generic forms. Each has strengths and weaknesses in being able to eliminate extraneous effects, minimise selection bias, and approach an accurate assessment of genuine programme impact. The different evaluation methods are as follows:

- Experiments

  Experiments represent the highest evaluation standard. Comparisons are made between target firms or persons that are assigned randomly to two categories: those that receive assistance (the target group) and those that do not (the control group). Random assignment can sift out the influence of extraneous factors because these affect the target and control groups equally. The process of random assignment also minimises selection bias. This is because, after random assignment, observed and unobserved characteristics linked to participation in a programme are equally present in the control and target groups. For instance, in the case of self-selection cited above, the forward-looking, flexible and risk-friendly entrepreneur is just as likely to have been assigned to the target group as to the control group. However, a drawback to a random assignment evaluation is that some firms are overtly excluded from assistance. So random assignment might be most acceptable in situations where there is excess demand for programme support (Bartik and Bingham, 1997).

- Quasi-experiments

  Quasi-experiments compare the assisted firms or persons and a similar non-assisted group. Unlike experiments, the assignment process is not random. The search for a control group occurs after the programme has commenced. The critical issue therefore is how to choose statistically a control group that is similar to the treatment group. Quasi-experiments take a variety of forms. Some compare the target group with the entire population of firms in the sector concerned. Others choose control groups that share key characteristics with the treatment group (such as firm size, sector, owner characteristics, enterprise age, location, etc.). Another form of quasi-experiment only considers the target group, but relies on members of the target group receiving different intensities of treatment. For example, if the number of hours of participation in a programme of business advice varies significantly among participants this variation can form the basis for impact assessment even if data on non-participants is unavailable.

- Participant opinion

  This technique involves members of the target group being asked to provide their own assessment of how the programme has affected performance. As previously discussed, entrepreneurs may have strategic reasons for giving some types of response. For instance, entrepreneurs might reply positively to surveys that will determine whether a soft-loan scheme is continued, regardless of the intended use of the funds. Respondents may also be unable to accurately assess the extent to which participation in a programme has been beneficial. For instance, surveys of firms created in business incubators have revealed that perceptions of the benefits of programme assistance change significantly over time. Evaluations of technical extension programmes in the United States have shown a tendency for firms to overestimate benefits immediately after assistance by comparison with views expressed later (Shapira, forthcoming 2003).

Many evaluations of enterprise support programmes bear little relationship to the three evaluation methods outlined above. They are instead a form of process control. Process control is concerned with practical questions such as whether intended expenditures have been made, whether activities have been performed on time, etc.. Studies of this sort are important, as deficient operational practice can have an effect on whether a programme performs well or not. However, process control and other forms of audit provide little information for policymakers. Policy must address wider questions regarding the types of programmes that do or do not work, the fundamental design features of programmes, and how well programmes perform on a range of efficiency criteria (such as the cost to the public purse of each job-year created).

The three evaluation approaches described above were presented in descending order of strength of causal inference, generalisability of results, and cost. These are important considerations that have to be balanced by institutions concerned with evaluation. For instance, budget constraints may preclude experimental approaches or limit the number of programmes to which the more rigorous techniques are applied. Experimental techniques also have the strength that the underlying principle of randomly assigning beneficiaries and non-beneficiaries is readily understood by policymakers. Quasi-experiments involve statistical assumptions – and sometimes equivocal results – that often have little intuitive force for non-experts. In practice, more than one evaluation method might be used to evaluate a given

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programme. Quasi-experimental evaluation techniques have been widely applied in many areas of social and economic policy. But their application to entrepreneurship programmes has been fairly limited. Nevertheless, self-employment support schemes have been subject to experimental and quasi-experimental assessment. Manufacturing extension services (particularly in the United States), a small number of management training programmes, and a handful of micro-credit initiatives (mainly in the developing world) have also been evaluated using quasi-experimental methods.

The experimental evaluation methods will mainly be used by central authorities

On account of the costs and the expertise required, the use of experimental forms of evaluation will generally be open to central authorities only. The large sample sizes needed for experimental techniques also make them less relevant to local sponsors of evaluations. Performing evaluations can itself involve economies of scale (with certain fixed costs for instance in the collection and organisation of information) and of scope (as insights from one evaluation might be applied to others). Such economies imply that evaluations are often best undertaken by higher levels of government. Public authorities should use the most rigorous evaluation technique that is practical. The cost of experimental evaluations means that they are particularly appropriate when programmes are large or are being implemented on a test basis prior to the possibility of major expansion.

Locally performed surveys and case studies can reveal important information for policy

Local authorities should take an active role in developing case studies as well as surveys of programme participants (however, if the programmes themselves are small a significant outlay on evaluation may be unmerited). Properly designed survey methods are required to maximise the validity of assessments.[4] It is important to explicitly seek to estimate the likely counterfactual or "without the programme" situation. For instance, if a company has used the premises of a business incubator, but reveals that it could have occupied other property in the absence of the programme, then there was no public benefit to providing the property services. Asking questions about counterfactual situations may have to proceed in stages, depending on the impact in question. For instance, suppose the evaluation goal is to assess the impact of a property-based incubation scheme on employment. If half of the incubated firms state that they would have used alternative similar accommodation without the scheme then these can be discounted. A second counterfactual question would then be put to the remaining firms that genuinely needed the service. They should be asked whether the number of their employees would be have been different had they not used the incubator. If the responses are accurate, this difference is the employment effect attributable to the incubator. To get a further indication of what might have happened without the programme, evaluators can complement the responses of participants by looking at what did happen to similar firms or persons. Firms are themselves often in a good position to identify competitors that have broadly similar characteristics, and which could thus constitute a comparison group.

Qualitative information gathered through surveys and case studies can also be useful in explaining why a programme has or has not worked (quantitative techniques could help in this regard if sufficient data were available on important and varying features of programme design). Qualitative techniques can also draw attention to less tangible programme benefits (such as those discussed in Chapter 9 in connection with micro-credit).

Choosing the right performance outcomes and the right timing

The choice of outcome indicator must depend on the type of programme being evaluated. Employment creation objectives are usually paramount. However, job creation criteria are inappropriate to some initiatives, at least as a measure of primary impact. As discussed earlier, there are dangers in assessing entrepreneurship support initiatives solely in terms of job creation. For instance, much entrepreneurship support is productivity enhancing and in certain circumstances could create pressure to shed labour, especially over the short-run. Some programmes have their primary impact on product quality, overall productivity, labour productivity, total sales, the ability to sell to wider national or international markets, etc. When employment criteria are used then choices exist among a variety of outcome and efficiency measures. These might include, for example: total employment creation; whether new jobs involve full- or part-time employment; employment allocation (among the unemployed, low skilled, highly skilled, etc); the cost per job-created; the cost per job created for the previously unemployed, etc. The right outcome measure must reflect the specifics of individual programmes.

More generally, the outcomes to be evaluated should be clarified during programme design, and certainly prior to programme implementation. Prospective programme managers should be asked to detail the steps required to evaluate the programme's impact, including the collection of data for evaluation purposes. Preparing for and undertaking good-quality evaluations is in itself a pedagogical exercise that has the potential to improve thinking about programme design. However, in general, evaluation should not be done by "in-house" staff alone. Programmes should also be evaluated by independent external experts, possibly an Audit Office (ideally, the body that implements the evaluation would work with programme managers but would not be dependent on continued contracts from the sponsor of the programme). Central governments should place evaluation data, possibly presented in an anonymous form, in the public domain. This could facilitate academic appraisals (Storey, forthcoming 2003). It could also serve as a form of evaluation quality control. There is in addition a need to standardise evaluation practices, such that generalisations can be more easily derived from the mass of evaluative work done across local areas.

Deciding when evaluations are to be performed is also important. As described in the earlier recommendation on programme monitoring, different programmes have different gestation periods. Some offer the possibility of almost immediate benefits, while others require months or even years before change is evident. The job-creation impact of entrepreneurship support programmes tends not to be felt over the short-term. Furthermore, the impact of some programmes might be significant initially, but decline over time. Programmes can also have long-term effects that go beyond the immediate objectives of the schemes. For instance, there might be changes in subsequent reemployment possibilities for those who have participated in entrepreneurship schemes. For this reason the time period over which an evaluation is performed might need to exceed the duration of participation in the scheme by months or even years, depending on the type of programme being examined.

Evaluation is mostly concerned with what has happened at some point in the past. However, the evaluation function must have a future orientation, because a key reason for doing evaluation is to improve the quality of future policies. Evaluators should be encouraged to consider the implications of evaluation findings for various possible courses of policy. For instance, "prospective" evaluations might be concerned with the diminishing returns found in some programmes. An example is the evaluations of self-employment support programmes described in Chapter 3. These studies make clear that net benefits will quickly fall if such programmes are greatly expanded. Evaluators should be sensitive to the need to clearly articulate such conclusions for decision-makers.

Evaluating programme effects on entire localities

The issues of evaluation methodology outlined above are usually discussed in relation to the assessment of the impact of programmes and policies on target firms and persons. Similar concerns of methodological validity should also apply to evaluations of the impacts of entrepreneurship policies on local development more broadly.[5] A number of points stand out in this respect:

- By themselves, entrepreneurship development programmes are often too small relative to the local economy to have registered significant effects

(Bartik and Bingham, 1997). The discussion in Chapter 4 of the frequently modest short-term employment impacts of entrepreneurship programmes highlights this point.

- Locations that are home to particular policy initiatives sometimes have few comparator localities if the policy in question is highly inclusive. For example, if programmes are implemented in all locations that have some cut-off rate of unemployment the only places left to compare against will be those that probably have important dissimilar features. In principle, it is within the scope of many national government agencies – and possibly supranational organisations such as the European Commission – to allocate assistance such that comparisons between similar localities might be attempted. This could be particularly valuable for pilot programmes that serve as forerunners of much larger schemes. However, explicitly excluding a community from certain types of assistance for evaluative purposes could be politically contentious (although Bartik [2002] rightly notes that, in practice, the allocation of programme resources to local areas is often the result of political or arbitrary criteria).
- Evaluations that successfully attribute outcomes to an entrepreneurship support programme are only a first step in assessing impact on the local economy. Evaluators need to go beyond the immediate effects of the programme and trace its income and employment multipliers as well as its fiscal consequences. In the context of local development, an "income multiplier" simply refers to the continuous process by which an injection of spending in a locality first translates into increased incomes, and then causes a second round of local spending. This process can be followed over a number of rounds of spending, although observing effects soon becomes impractical owing to their rapidly diminishing size. The local multiplier concludes when all the associated spending occurs on goods and services from outside of the locality (for instance through firms' purchases from out-of-area suppliers). Employment multipliers are concerned with the impact of successive rounds of spending on job creation.

  The measurement of multiplier effects requires knowledge of consumption patterns among residents as well as an understanding of the relationships between input use and outputs in local firms. Applying input-output models raises particular methodological and practical questions. For instance, employment-output coefficients change over time, while the updating of input-output matrices might be infrequent and thus unreliable. The size of a multiplier can also change with the size of a locality: if larger areas are home to a greater range of firms then that area's propensity to purchase from out-of-area markets will be lower. However, the important measurement issues in estimating area-based multipliers are understood (see Wilson [1968] for an overview). But calculating multipliers can be expensive. Studies of this sort have been undertaken in a number of local development evaluations. But they have usually been limited to major investment subsidies or infrastructure expenditures where impacts are likely to be significant and the costs of the assessment are small by comparison with the costs of the policy being examined. Particularly in the United States, a number of quantitative policy models have been used to simulate income, employment and fiscal effects across regions or large urban areas. The REMI model is perhaps the best known and is described in Treyz (1992). A discussion of how *ex post* evaluation findings can inform *ex ante* policy simulation using such models appears in Persky *et al.* (1997). A practical guide to the use of economic impact models is contained in Poole *et al.* (1999).

- For area-based evaluations the challenge of evaluation validity is considerably more complex than for the assessment of individual programmes. For instance, the number of extraneous economic influences that can affect an entire locality is extremely high. In addition, poor localities are often the focus of multiple combinations of public programmes. This complicates the problem of isolating the effects of any single initiative.[6]

Earlier chapters have considered in detail the routes through which the outcomes of entrepreneurship support can affect local economies. The fact that specifically local impacts can be mediated by economic developments separate from the entrepreneurship programmes – such as labour in-migration – needs to be considered in the evaluation logic. For instance, to determine the impact of an entrepreneurship scheme on local employment requires various steps (see Storey, 1990). Bringing together a number of earlier discussions on the problem of enterprise displacement, the role of labour in-migration, and knowledge of the "without the programme" situation, it would have to be established:

1. Whether at the time of the evaluation the full employment impact has been achieved. This may be difficult to assess, even by the firms themselves.
2. How many of the jobs resulting from Step 1 are jobs that would not have arisen without the programme?
3. How many of the jobs from Step 2 do not involve displacement of jobs in other firms?
4. How many of the jobs identified in Ttep 3 provide employment for residents or in-migrants.

   In addition, policymakers will often wish to know:

5. Of the employed residents identified in Step 4, how many have left unemployment and/or how many come from particular target groups (the young, ethnic minorities, women, etc.)?

6. Are the jobs in Step 4 of short or long duration, and are they of high or low quality.
7. Has an original problem situation actually been significantly changed by the intervention? A programme might be successful in generating new jobs of high quality at low cost, but the overall impact could be small relative to the scale of the problem.

Governments can also help by setting evaluation norms and standards

Public authorities should develop clear evaluation standards and guidelines. Central authorities in some countries already do this (such as the General Accounting Office in the United States). Central authorities could work with subnational governments to encourage enhanced evaluation practice. In this case, local governments might be better placed to state the methodological norms expected of subcontracted companies that perform evaluations. Indeed, adherence to evaluation standards could be made a condition for programme support and subcontracts. Aside from upgrading the quality of evaluation, greater uniformity in evaluation practice could also help address the current situation in which programme outcomes are often not comparable because of opaque and/or non-standard evaluation methodologies. Indicative standards could even apply to survey design. Across programmes, standards could facilitate data collection, for instance by building data collection protocols into programme design (collecting evaluative data from the inception of a programme could also lower the cost of evaluation and monitoring).

Recommendations on Programme Design for Local Government

To help counter displacement effects ensure a strong marketing component in assistance programmes and consider restricting the terms of business support

As discussed in Chapter 2, the problem of displacement is likely to be greatest among the types of firms typically present in poor localities – those in mature low-growth, easy entry markets. One way to help attenuate displacement is to assist firms to trade outside their local area. Most newly established enterprises initially serve local markets and begin to sell across a wider area as the business matures. However, there is some sectoral variation, with service sector firms more closely linked to local customers. Because low average disposable incomes is a feature of disadvantaged areas, a local sales orientation can involve constraints on growth. Enterprises that serve wider markets tend to have greater longevity than those that sell within a shorter radius. And more rapid growth and higher probabilities of survival have been found in firms that export from the time of inception (McDougall and Oviatt, 1997. See also Gorton, 1999).

Simpson *et al.* (2001) highlight the damaging effects of the weakness of marketing strategies and plans in a selection of small-scale social enterprises in the north of England, a problem stemming in part from inadequate marketing budgets. Conversely, Bradshaw and Burridge (2001) found empirical support for the view that the collection and use of market information plays an important role in the export success of small firms. Enterprise support agencies should possess, or have access to, national and international databases that facilitate sales over wider geographic areas. Furthermore, marketing techniques vary by type of business activity, and training in this field needs to be specialised. For instance, there are differences in marketing consumer and industrial products, as well as differences in selling from start-ups and established firms. Start-ups, for example, may need to concentrate on finding a partner or a distribution outlet, whereas established firms might already possess dedicated marketing budgets and access to distribution networks.

Using panel data from seven European countries, Havnes and Senneseth (2001) find that small firms operating in networks serve broader geographic markets. Dana (2001) also concludes that networks involving small and large firms can expedite access to international markets for small companies, and at lower cost and risk (policy recommendations on business networks are set out below).

Displacement might also be reduced by restricting the terms of business support

In Germany, in order to address the displacement problem, self-employment support has been restricted to businesses likely to create a specified minimum level of income. The assumption is that larger businesses will enter less contested markets. In a similar fashion, other schemes restrict assistance to ventures with larger capital requirements. Other approaches to countering displacement have involved excluding certain business categories from support, such as retail outlets (which could be highly displacing), and seeking to work with firms in non-saturated markets. It is also claimed that credit-based schemes could facilitate the creation of more highly capitalised enterprises. This, in turn, might shift start-up activity towards sectors for which capital constraints have prevented oversupply and towards manufacturing (manufacturers also usually sell to geographically wider markets). Cowling and Mitchell (1997) found that the United Kingdom's Small Firm Loan Guarantee Scheme had helped to assist start-up among individuals wishing to initiate relatively large projects. And evidence has been cited earlier in this publication on how lump-sum financial payments to facilitate self-employment appear to increase the size of new ventures.

However, strategies aimed at increasing average firm size or screening for sectoral type have the drawback that they can raise programme deadweight. That is, they will tend to assist persons who are likely to create a venture without the programme. However, Meager (1993) notes that restrictive eligibility for self-employment support in Germany did not seem to have raised deadweight unduly. This may be because the scheme provided a level of subsidy that rose with the duration of prior unemployment. Restrictive selection criteria will also have a tendency to lower access for women and poorer income groups that generally initiate smaller projects. In addition, a criticism of some micro-credit schemes is precisely that they work with loan amounts that are too small. Schemes may have to undergo reform before becoming a significant vehicle for facilitating the creation of ventures larger than microenterprises.

Encourage the creation of team-based firms

Firms established by groups of entrepreneurs tend to register superior performance on a number of criteria. Among a sample of micro-enterprises Cowling and Hayward (2000) found higher rates of survival in partnerships.

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Storey (1994) also identifies teams as a contributor to growth in start-ups. And a recent survey of more than a thousand entrepreneurs in East Asia and Latin America showed that the most dynamic firms are led by entrepreneurial teams (IADB, 2002). Research also indicates that for early-stage venture capital investments a largely subjective assessment of the entrepreneur or team has greater weight than formal financial appraisals (Murray, 1998). A team is more likely than an individual to possess the know-how and experience sought by investors. Lechler (2001) showed that the quality of social interaction in entrepreneurial teams is positively related to the success of the firm. A strong relationship was also observed between intra-team social interaction and client satisfaction. In this connection, co-operatives are a form of team in which the members are both employees and directors. Co-operatives may be particularly suited to the home situation of some women, possibly allowing for greater flexibility than other company structures. Co-operatives can, for instance, make it easier to attend to emergency child-care needs and family commitments (Davis *et al.*, 1999).

Various enterprise support schemes have specifically aimed to build team-based firms. Examples include the "Go" programme in the German Lander of North-Rhine Westphalia and the MIDAS Initiative operated by the University of Central England. Team-starts comprise only a minority of new firms, and the creation of co-operating teams that embody complementary skills can be challenging. Nevertheless, team-oriented initiatives appear promising in building viable firms likely to contribute to job creation.

Examine where the public sector can play a catalytic role in establishing private-sector-led networks

Business networks are today of widespread interest to both the public and private sectors. The omnibus term "network" covers varied forms of informal and formal collaboration. Of relatively recent policy attention – particularly among regional and local authorities – are formal mechanisms of co-operation among groups of small firms, and sometimes among small firms and larger enterprises.

It is a widely supported proposition that entrepreneurs who develop and maintain ties with other entrepreneurs outperform those who do not (Kanter, 1995). For example, a study of the self-employed in Toronto found that being a member of a club, team, association or organisation that meets regularly was positively associated with business success (Gomez, 1999). On average, active members of any of these forms of association earned forty per cent more than non-members. A survey of entrepreneurs in East Asia and Latin America showed that networks, and the presence of other entrepreneurs within the network, are strongly related to business dynamism. Networks were seen to facilitate the identification of business opportunities, access to resources, and support in the management of the firm (IADB, 2002). And a study of one thousand seven hundred new businesses in Upper Bavaria showed that informal social and family-based networks increased the probability of survival and growth (Brüderl and Preisendörfer, 1998). Firms in fast-growth regions also appear to establish more networks than those in less dynamic areas (Huggins, 2000). And numerous studies suggest that there is a higher propensity to network among technology-intensive firms.

Formal business networks pursue diverse goals

Formal business networks – those that are structured, rules-based or governed through contracts – operate with varied forms and objectives. Some aim at general sharing of information, while others tackle more specific goals. Networks can allow rapid learning – and small companies often favour the peer-based learning that networks permit. Networks can also facilitate the reconfiguration of relationships with suppliers. In some instances networks have led to a new division of labour in a group of firms, allowing individual companies to reap economies of scale and scope. Indeed, some network initiatives, such as the Danish Network Programme begun in the early 1990s, have explicitly aimed to help small firms acquire efficiency, as a group, on a par with larger enterprises. In fact, networks have spurred co-operation on issues as diverse as training, technological development, product design, marketing, exporting and distribution. In June 2001 some ten thousand small firms located around Barcelona – about half that city's total population of small firms – organised through six territorial networks to purchase electricity at a rate some thirty per cent below what they had paid previously.[7]

Forms of networked collaboration of particular relevance to the self-employed and micro-enterprises include mutual credit guarantee associations, peer-group lending/borrowing arrangements, schemes to link micro-entrepreneurs with larger businesses, and joint marketing initiatives. Networks can also help to counter the common problem of isolation among entrepreneurs. They can provide encouragement and motivation and help respond to racism and sexism. Owing to more limited experience and fewer business contacts, young firms and newer entrepreneurs are likely to have greater need of networks (NCOE, 2001a). Renzulli *et al.* (2000) examined nascent entrepreneurs – persons in the earliest stages of attempting to establish a business – in order to assess the effects of network composition and heterogeneity. Greater network heterogeneity – which permits the drawing of information from multiple sources – was seen to significantly increase the probability that actors actually start a business. Networks containing higher shares of kin, who presumably afford similar sorts of information, were associated with lower start-up probabilities.

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Networks of peers have a role to play in assisting a proper strategic orientation for the self-employed and micro-firms, as well as in avoiding documented business pitfalls. Networks can also be of help in assisting firms to trade outside the locality by supporting joint marketing, the creation of joint catalogues, collective sponsorship of trade-related travel, etc. Networks involving small and large firms can play a role in helping smaller firms reach international markets more quickly and at lower cost and risk (Dana, 2001). Westall *et al.* (2000) describe a demonstration programme operated by the Philadelphia Development Partnership that links micro-entrepreneurs with larger corporations through intermediary firms. These intermediaries are medium-sized companies already engaged in business with the larger corporations. Under the programme they subcontract business to the micro-enterprises. The authors hold that this arrangement may provide a more acceptable relationship for the large firm between it and micro-enterprises.

Furthermore, some government agencies have realised that networks can be a cost effective tool for aggregating demand and delivering services to small firms. Hence, in the United States, networks have been employed for federal programs such as the Manufacturing Extension Partnership (for supply chains and joint research and development), the Department of Commerce (for marketing co-operatives), and the Department of Labor (for training alliances) (Rosenfeld, 2001). And, in a somewhat different arena, many States are active in bringing small firms together in order to lower the costs of health insurance (Phillips, 2002).

But the formation of effective and sustainable business networks can be a demanding challenge

Networks however are not a panacea for small firm development. The formation of structured and durable systems of co-operation is often difficult. Robson and Bennett (2000) showed that for a sample of small firms operating in the same subsector in the United Kingdom few benefits had derived from networks. Collaboration in supply chains showed the only significant relationship between co-operation and the performance of small and medium-sized businesses. Using an international panel data set Havnes and Senneseth (2001) found that networking was associated neither with growth in employment nor with expansion of sales. However, the authors did find that networked small firms served wider geographic markets, a result that is of interest to local policymakers for reasons previously discussed. Reese and Aldrich (1995) ascertained that the time given to creating and maintaining business contacts was not significantly related either to enterprise survival or general business performance. Poor results from some network programmes might be explained by the possibility that entrepreneurs who need to compensate for a lack of skills or knowledge resort to networks for help. Indeed, examining Asian immigrant-owned businesses in the United States, Bates (1994) concluded that social networks tended to be used intensively by the firms most likely to fail.

The following recommendations are suggested for the development of business networks:

- **Implement broad campaigns to introduce the networking concept to businesses**

  It is important to create informed demand for network services. Some comprehensive network schemes have failed to secure financial support from private firms once public subsidy was withdrawn. In part, this may reflect the fact that the private sector is sometimes presented with a menu of services previously determined by public development agencies. In terms of influencing corporate performance the most successful business networks typically organise around specific commercial objectives. Therefore, public authorities and business associations should seek to raise awareness of the benefits and opportunities of networks. This is in order to increase informed demand for programmes built around goals specified by the private sector. Participants' expectations also affect the longevity of networks (Huggins, 2000). For instance, business clubs and fora – membership of which usually entails little expectation of short-term financial gain – often operate over extended periods of time. This again suggests that networks should be formed around objectives determined by businesses, in this way incorporating private-sector expectations into programme design. Furthermore, failures are often attributable to the fact that participating firms dedicate too little staff and managerial time to network programmes (Huggins, 2000). This finding further highlights the importance of ensuring that schemes be demand driven. Lastly, policy-induced networks that have taken on a formal structure, for example through contractual agreements, often require significant time and skill to create. If resources are limited, a superior use of public funds might be to pursue the marketing of the network concept – possibly combined with the creation of informal networks – with the aim of reducing barriers to associative activity. More formal networks might then be left to firms to organise themselves.

- **Expect to provide some financial support for feasibility work, start-up activities and the costs of network brokerage**

  Barriers to the spontaneous emergence of networks include aversion to and/or unfamiliarity with inter-firm co-operation, as well as problems of co-ordination. Public action, at least in a catalytic role, is frequently needed. One practical way for the public sector to encourage networks might be to emphasise support for projects submitted jointly by groups of firms.

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However, funding for networks should be phased out as participants start to associate more formally and receive benefits.

- **Work with realistic time-frames**

  Public policy needs to be patient, with a period of three to four years often required for a significant business network programme. Moreover, programmes of network development should be a constant in the enterprise support landscape, with the formation of new networks around new goals an ongoing practice.

- **Ensure the presence of experienced network brokers**

  As with many forms of enterprise support, the quality of management is critical. Persons with direct experience of SME development should be employed as network brokers, providing advice and guidance for firms hesitant at the prospect of co-operation. By acting as a source of neutral mediation, network brokers can also help allay concerns over loss of control and unfair appropriation of benefits. For instance Baines and Robson (2001) found pervasive distrust among a sample of self-employed workers in the cultural sector. But suspicion was seen to coexist with a desire to obtain information and counter the commercial disadvantages of working alone.

  Establishing teams of brokers and facilitating exchanges of experience among them can help improve effectiveness. Such exchanges can also help to maintain motivation in what can be an isolated and demanding task. Accreditation programmes might be valuable, as practitioners often assert that generic knowledge of bringing about collaboration matters most for the broker function, rather than sectoral expertise. Information technology also holds the promise of expanding network access and creating better links with education, training and other institutions. However, practitioners usually attest that frequent face-to-face encounters are essential for maintaining engagement among networked firms.

Notes

1. In this connection, it is relevant to note that while advice and training raises costs in self-employment support programmes, evaluative evidence from the United States indicates that this has made a number of schemes cost effective (Metcalf, 1998).
2. If policymakers judged that markets consistently fail to supply the necessary advisory services to new and small firms then less temporary forms of intervention might be called-for. However, as noted earlier, evidence of systematic failure in this market is hard to find.
3. The role and importance of performance measures is treated thoroughly in Metcalf *et al.* (2001). This section draws from that work in a number of points.

4. Oldsman (2000) recommends that, when undertaking surveys:
   - The population to be surveyed should be clearly defined and an appropriate sampling strategy adopted;
   - Survey questions should be worded clearly. Questions should be included that:
     - address the entire range of programme effects, including immediate, intermediate and final outcomes,
     - include explicit reference to the counterfactual,
     - include multiple questions for the same concept using different scales,
     - ground responses in empirical data
     - avoid asking those surveyed to make calculations.
   - Methods should be employed to maximise the response rate and minimise response bias (the likelihood of response bias might be reduced if there is anonymity among respondents).
5. In a textbook world local policymakers would allocate public resources to different programmes based on knowledge of the *marginal* cost of achieving given common objectives for different programme types. For instance, if employment creation were the principal goal of local development policy, an economically efficient resource allocation could be achieved if policymakers had information on the *marginal* costs of creating a job through such programmes as investment attraction, enterprise start-up grants, training, etc. An efficient allocation would obtain when the marginal costs of job creation were the same across programmes (Storey, 1990). In practice, however, most evaluations provide information on the *average* cost of employment creation. In addition, the marginal cost of job creation will vary over time depending, for instance, on the scale and duration of the programme itself and the character of the local labour market. The textbook ideal, then, would necessitate a constant cycle of complex evaluation across many programme types, and is effectively unattainable.
6. Nevertheless, creative approaches might be open to agencies willing to attempt inroads into this evaluation challenge. For instance, Boarnet (2001) and Bondonio (2000) describe econometric approaches to evaluating Enterprise Zone (EZ) programmes across heterogeneous localities in the United States. However, it should be added that EZ initiatives in the United States often use a range of incentives, including fiscal policies and financial assistance, that by type and magnitude go beyond the sorts of scheme considered in this book. The EZ emphasis is often on expanding overall business activity and performance, whether in firms that are new, established, of local origin or transferred from elsewhere.
7. *El País*, Wednesday 27th June, 2001, page 61.

ISBN 92-64-19978-0
Entrepreneurship and Local Economic Development
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PART II

Chapter 11

Recommendations for Further Policy-relevant Research

Preceding chapters have highlighted the scarcity of (high-quality) programme evaluations and the fact that there are few empirical assessments of the impacts of entrepreneurship on local economies. Areas in which further policy-relevant research could be valuable include the following:

Studies of the local impacts of entrepreneurship over time

- Longitudinal studies are needed in specific localities examining the key dimensions of enterprise demography and local economic and labour market performance. Ideally, studies would be undertaken using similar methodologies. The OECD Secretariat would be well placed to facilitate, oversee, standardise and ensure the policy relevance of such studies across some or all of its member countries. A research process of this sort would involve minimal financial outlay for individual member countries, but could potentially make a considerable contribution to policy-relevant knowledge.

  Case studies that simply describe programmes, institutions and enterprise conditions at a given point in time will add little to the existing body of knowledge. This is particularly true because of the considerable periods that can be required before new firms register significant growth (if indeed they do). Studies should follow localities over time and examine the entire process of enterprise out-migration, start-up, (distinguishing between voluntary and involuntary exits and corrected for the fact that survival rates in areas of high-unemployment will generally be lower than elsewhere), growth, closure and in-migration. Data should also be collected through channels that permit the inclusion of micro-enterprises that might otherwise fall below the attention of statistical agencies. Incremental effects in the labour market could focus on changes in employment and wages (and possibly other aspects of job quality) over the short- and long-term. Attention should be given to impacts on persons in different parts of the wage distribution as well as the unemployed. Assessments should consider the ways in which employment creation has affected the labour market experience of local residents and in-migrants. Studies could go beyond the use of gross statistics, considering the effects of enterprise size and sectoral type. Surveys could also examine the motivations of those who have become entrepreneurs. Ideally, a number of studies would be undertaken in different types of locality, such as outlying urban estates, inner city areas, remote rural localities, and towns dependent on a small

 ENTREPRENEURSHIP AND LOCAL ECONOMIC DEVELOPMENT – ISBN 92-64-19978-0 – © OECD 2003

number of economic activities. In some countries significant experience and data sources already exist. For instance, detailed geographic information systems have been developed by many private and public organisations.

Studies of specific types of programme

- Research is needed on the costs of job creation – as well as a broader range of costs and benefits – in different types of programme used for enterprise development. As a complement to this information, data should be sought on the costs of providing employment per person removed from the unemployment register. Information of this sort could help public bodies to better allocate scarce budgets. For instance, business incubators, despite their proliferation, have hardly been subject to systematic economic assessment anywhere. Similarly, in OECD member countries, micro-credit programmes have rarely been exposed to rigorous forms of evaluation. Data on the cost-effectiveness of a variety of schemes should be combined with qualitative and if possible quantitative information on the effects of different operational modalities.
- The impact of business advisory services on firms with different size, age and other characteristics merits greater empirical analysis. Assessments should also consider how impacts vary across different types of provider. Advisory programmes are in operation almost everywhere, but few rigorous appraisals have been undertaken. In addition, evidence on the effects of Internet-based advice is almost non-existent, and is particularly relevant to remote localities and agencies that deal with large numbers of very small firms (for which the costs of one-to-one interaction could be exceedingly high).
- It would also be useful to further evaluate the strengths and weaknesses of different modalities of implementing self-employment support. For example, it would be helpful to know more about how programme outcomes differ when financial support is provided either as a lump sum or as an ongoing payment. Evidence on a broad set of possible effects of self-employment assistance would also be valuable. These could include post-programme asset accumulation and physical wellbeing.
- Despite there being large numbers of insightful qualitative studies of micro-credit, further research would be valuable on how different design and operational arrangements affect programme impact (economic as well as financial) and sustainability.
- As described in Chapter 5, more work is required, using appropriate methodologies, on the effects of management training and education on the performance of new and small firms. Issues of training quality, as well as training volume, require attention.

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OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(84 2003 01 1 P) ISBN 92-64-19978-0 – No. 52847 2003