Innovative entrepreneurs and finance for innovation

How does access to finance affect innovative entrepreneurship?

Access to finance is a key driver in the creation, survival and growth of innovative new ventures. Lack of finance typically prevents new ventures from investing in innovative projects, improving their productivity, financing their growth, covering working capital requirement and meeting market demand.

Research supports the relevance of access to finance as a key determinant of entrepreneurship and clearly identifies a finance gap in many locations for new and small firms involved in the early stages of innovation, especially in the market for high risk capital.

The importance of different types of finance varies across the stages of business development. During the seed and start-up stages, technology-driven high-growth SMEs can obtain equity financing from entrepreneurs or from family and friends. In earlier stages, self-financing is particularly important since innovative entrepreneurs cannot overcome information asymmetry and therefore rarely find any lender or investors, even for potentially profitable projects. Subsequently, financing may be supplemented by seed capital investment from informal private investors (e.g. business angels) and, in a few cases, by seed financing funds and venture capitalists. In the expansion stage, SMEs generally require increasing amounts of equity to maintain R&D and to expand marketing and sales activities, amounts that are typically only available through other sources, such as initial public offerings on stock exchanges.

What are the key policy dimensions regarding access to finance and innovative entrepreneurship?

As for innovative businesses in general, common policy challenges across five policy dimensions are particularly relevant and include:

- How can governments help innovative firms finance their activities in a context of public budget constraints? (see Debt financing [1], Other types of finance [2], Venture capital [3], and Business angels [4])
- How can credit guarantee programs reach a fair balance in terms of risk distribution among the involved parties? (see Debt financing [1])
- How can public support avoid crowding out private investment (i.e. situations when public support replaces, or drives down, private sector spending)? (see Other types of finance [2], and Private sources of funding [5])

→ Private sources of funding (see Private sources of funding [5]), which focuses on money and capital from private sources (e.g. firms, founders, family and friends).
→ Debt financing (see Debt financing [1]), which refers to opportunities for firms to secure public and private credit to start and develop their businesses (i.e. loans from banks and public institutions).
→ Venture capital (see Venture capital [3]), which deals with opportunities for early-stage businesses to obtain equity from established venture capital funds.
→ Business angels (see Business angels [4]), who are people interested in helping entrepreneurs succeed by providing both funding and expertise.
→ Other types of finance (see Other types of finance [2]), which focuses on subsidies and grants from governments and international organizations.

What are the main rationales for policy interventions in support of access to finance?

- The main rationale is that profitable investments in innovative and entrepreneurial activities are liquidity constrained due to capital market imperfections. Small and new ventures are particularly affected by these capital market imperfections. The difficulties that innovative entrepreneurs experience stem from several sources: they typically lack collateral and a track record, they are involved in innovation processes whose outcomes are uncertain, they deal with a public good (knowledge), whose return on investment is not predictable and they own assets whose nature may be intangible and difficult to evaluate (e.g. patents). The smaller and younger the business, the more opaque the information on its business performance and financial solidity will be.

- Insufficiently developed financial markets might be a further systemic failure affecting access to finance for innovative entrepreneurs, but one that only coordinated efforts can address (e.g. by supporting the creation of financial markets where IP assets can provide access to funding).

What are the main policies that influence access to finance in the context of innovative entrepreneurship?

Within the context of innovative entrepreneurship, public policy can in the following ways:

Debt financing (see Debt financing [1]) by:

- guaranteeing part of the losses caused by the potential default of the borrower (e.g. mutual credit guarantee programs)

By guaranteeing part of the losses caused by the potential default of the borrower, they increase the incentive for banks to engage in SME lending. Generally, credit guarantees see the involvement of three parties: the bank, the borrowing firm and the public authority providing the guarantee. A variant consists in mutual guarantee schemes, where an SME association typically provides a first-level guarantee on the loan of one its members, with the public sector covering an additional share of the loan.

- offering credit mediation to companies in the case of a loan rejection

Credit mediation occurs when governments appoint mediators to help SMEs deal with loan rejections. Through discussion, exchanging information, assistance in improving business plans and other techniques, credit mediators bridge the information gap between entrepreneurs and loan officers. This policy tool has been recently tested in France, Italy and Belgium.

- subsidising loans directly (e.g. through the intermediation of a national development bank)

- supporting alternative types of debt finance, such as convertible loans and subordinated loans (e.g. through fiscal incentives to lenders and the partial coverage of losses in case of bankruptcy)

Venture capital (see Venture capital [3]) by:

- creating public funds that directly invest in start-up firms
- establishing public "fund-of-funds" that invest in private venture capital firms
- promoting co-investment funds that use public money to match private investment.

Business angels (see Business angels [4]) by:

- providing tax incentives to private individuals investing in specified types of investments and businesses (e.g. through tax relief on investment, capital gains and losses)
- promoting co-investment funds that use public money to match private investment
- supporting angel associations, networks or groups (e.g. through the provision of some financing)
- offering training to angel investors, to turn interested investors into successful angel investors.

Private sources of funding (see Private sources of funding [5]) by:

- setting the framework conditions for new sources, such as crowd funding
- establishing bankruptcy regulations so that innovative entrepreneurs will be more willing to invest in innovative businesses.

References

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