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WHAT DO WE KNOW ABOUT THE RELATIONSHIP BETWEEN ENTREPRENEURIAL FINANCE AND GROWTH?

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In the aftermath of the financial crisis, the recovery of the UK economy has been sluggish, and a key concern of policymakers is that private sector firms should have adequate access to finance. Available data suggest a significant decline in both debt and equity finance flows to SMEs. While the degree of success of recent policy initiatives is yet to be fully understood, a widely held perception is that the funding gap of a large proportion of firms is yet to be bridged. The attendant concern is that the prevailing funding gap may be limiting firm growth in the private sector.

Policies targeting funding gaps, with the ultimate aim of promoting firm growth, require an analysis of both the factors that affect funding gaps and the nature of the relationship between funding gaps and business growth. However, these are complex and nuanced issues that are not completely understood. The core aim of this paper is to distinguish between issues that are well understood, and issues (and relationships between economic variables such as funding gap and firm growth) that are less clear (or ambiguous). It does so by drawing on, and examining, the academic literature on the relevant issues. The evidence examined and reported is not restricted to the UK context, and draws on experiences of a wide range of countries. It is therefore not a commentary on funding gaps and the funding gap-firm growth in the UK context per se, but rather an attempt to identify the gaps in the academic literature that should be addressed to better inform policy making in the UK context.

It is well known, for example, that a firm's access to bank finance can increase if it is able to post collateral, if it has a steady relationship with banks, and if they are able to obtain trade credit from their business partners. In this respect larger, established firms with a good track record and good credit ratings tend to get the funding they need while start-ups where entrepreneurs are not able to adequately demonstrate their commitment to the business (for example, through self-finance), high growth and other riskier firms may be less fortunate. However, the academic literature on firm's financial decisions and their access to finance indicates that the underlying issues go well beyond traditional discussions of failures in entrepreneurial finance markets to include contingencies such as differences in: entrepreneurs' objectives, ownership types of firms and firm life-cycle stages.

Entrepreneurs may feel discouraged from applying for finance for a variety of reasons such as inadequate information about alternative sources of finance, the perception (rightly or wrongly) that they will have their applications turned down by finance providers, and lack of ambition about business growth. Further, the psychology of entrepreneurs with similar business attributes may differ significantly: they can either be loss averse and hence reluctant to borrow, or over-optimistic about their business prospects and hence over-estimate their financing gap. Similarly, firms with certain organisational structures may be less enthusiastic about funding sources that can reduce the entrepreneurs' control over the firms.

Some of these bottlenecks can be addressed by supply side policies aimed at promoting the provision of credit and equity finance, some others may require different forms of intervention, such as access to information and advice about alternative sources of finance. Yet other bottlenecks are much more intractable. Ambiguous and less understood issues concern the relative impact of entrepreneurial cognition, different ownership and board configurations (for example, family owned firms, management buyouts), financing needs of firms at different stages in their life-cycle, and supply side factors on access to finance and business growth.

In the context of non-bank finance, there is similar evidence about the impact of VC financing on internationalisation and growth of firms. In addition, issues such as cherry picking of good firms by VCs, heterogeneity among VCs, and how VC characteristics are related to the development of portfolio companies have received greater attention. Evidence from systematic worldwide studies also suggests that private equity (PE) funding has a largely positive impact on operating profitability of firms. Further, PE-backed buyouts in the UK have exhibited higher average growth than non-PE-buyouts.

However, there is lesser clarity about some other issues. For example, there is scope for debate about how the growth/lifestyle objectives of businesses/entrepreneurs, and the importance of retaining control might affect decisions to look for VC or equity funding (and non-bank source of external funding, in general). Similarly, it is not well understood as to how choice is made between alternative forms of non-bank finance, such as VCs, private equity, and business angels, and how these different forms of financing differently affect firm performance.

Having identified the areas of research that merit greater focus, both because the underlying issues have not been unambiguously resolved, and also because greater clarity about these issues are required for formulation of effective policy, the paper sets out the lines of inquiry that will be followed in the course of the ERC's research (subject to availability of appropriate data). In addition, it briefly discusses the policy interventions that are being pursued by governments and central banks in the UK and comparable OECD countries and emerging market economies.