New Firm Formation and Regional Economic Development: An Introduction and Review of the Scottish Experience

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ABSTRACT. This paper introduces this special edition of *Small Business Economics* on 'New Firm Formation and Regional Economic Development'. It integrates the articles appearing in this volume with others presented at the Economic and Social Research Council Urban and Regional Economics Seminar Group conference on this theme in January 1994 in Ayr, Scotland. Many of the studies are derived from a Scottish Enterprise research programme on the contribution of new enterprises and entrepreneurs to economic development, and the factors explaining the low levels of business start-ups in Scotland. Comparative data, research and experiences from across the UK, European Union and US are called upon to improve the understanding of the processes involved. The findings are sometimes unsuspected, challenging the super-structure of business development agencies and their attitudes and behaviour towards indigenous potential entrepreneurs.

KEY WORDS. Development agencies, new firm formation, regional economic development, Scotland

Introduction

Over the last two decades there has been an increasing realisation of the importance of small and medium enterprises (SMEs) to the development and health of the economy, as any reader of this journal will be well aware. As a corollary of this, there has been a perceived need to intervene in the market to ensure that the high proportion of SMEs which fail each year are replaced and to promote the creation of new businesses to compensate for the decline in large plants. Competitive pressures from more efficient enterprises and imports, sectoral specific decline, industrial restructuring, and other forces in the marketplace have all led to differential degrees of new firm formation (NFF) across regions and nations. The different rates of success across areas in meeting the challenges of a more flexible economic world and of attempting to overcome the effects of the decline of dominant plants and industries, have led to a concomitant expansion in research and analysis into these regional developments and their business environments.

The role of governments and their agencies in addressing these changes has been well rehearsed over the years, with seemingly little left to discover or new ways to intervene to be found. Nevertheless, Scottish Enterprise, the regional development agency for Scotland, in 1993 embarked on a major enquiry into business birth rates, publishing the main findings towards the end of the year (Scottish Enterprise, 1993). The enquiry into this one area's experience is enlightening because it demonstrates that many subtle and complex factors affect potential entrepreneurs and their ability to establish and nurture a company. The variation in the importance of access to capital, the availability and provision of appropriate property, and of academic-industry links are well documented, but this series of studies appears to have uncovered evidence in a number of other elements in the infra- and superstructure of the Scottish economy which could be recognised as having powerful effects on the rates of new firm formation. In particular, entrepreneurial potential and cultural issues, which have been raised in terms of a dependency culture in certain disadvantaged and depressed communities, were explored in some depth. Critically, the research seemed to suggest that the failure of 'enterprise' to take hold in such areas was less apparent on more careful inspection. Indeed not only was this myth of an anti-enterprise culture

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severely undermined, but also the research programme revealed a reluctance of business development agencies and professionals to promote and encourage entrepreneurship amongst certain sections of the community: women, the working class, council house residents, and the young.

This introduction will set the scene for the papers in this edition of Small Business Economics by reviewing the research programme conducted by Scottish Enterprise. To publicise the results of that research and to allow a critical appraisal by a wider audience, the Economic and Social Research Council – through the Urban and Regional Economics Seminar Group – with Scottish Enterprise organised a conference on 'New Firm Formation and Regional Economic Development' in early 1994 in Ayr, Scotland. The papers delivered at that meeting which formed part of the research programme are being published separately, together with new work on new firm formation in regions in the UK, Eastern Europe and the former Soviet Union. The articles in this volume were not integral to the initial research programme, although they were included in the conference. They are complementary to the Scottish Enterprise studies in that they take many of the key issues forward.

Scotland's business birth rate

The objectives of the Scottish Enterprise enquiry were to provide improved understanding of the role of NFF in economic development and to explain why Scotland had a lower rate of business creation than other regional and national economies.

The research programme was undertaken both by in-house specialists: from the Research division and a special new ventures team drawn from several departments, and by a number of external consultancies. Ten studies were completed, using different methodologies and perspectives. The research focused on 'genuine' business start-ups, excluding management buy-outs and privatisations. The team identified two key concepts: the Business Life Cycle and Segmentation. The former gave rise to two key questions:

- Why does Scotland generate so few new ventures? and
- Why does Scotland generate so few new ventures which grow into substantial companies?

In this volume, Reid, who did not contribute to the Scottish Enterprise programme, develops the business life cycle approach from an alternative perspective. More academic and technical than most of the programme, his analysis concludes that young small firms 'experience a trade-off between profitability and growth', and very small firms grow faster than larger micro-firms. As will be demonstrated later, this trade-off may conflict with the needs of capital providers who seek quick returns. Both results suggest churning in the micro level stock of firms, with induced displacement.

On segmentation, the Scottish Enterprise programme addressed the varying rates of NFF across companies – by structure, product, process; and entrepreneurs – by background and circumstances, to investigate the operation of the process of entrepreneurial development in different market milieu.

Within this overall framework the Scottish Enterprise programme analysed a number of key issues:

Scotland's new firm performance;
Individual and sectoral case studies;
Business environment;
Entrepreneurial potential and cultural issues.

Scotland's new firm performance

This element of the study was undertaken by PIEDA using VAT trends data, and by Trends Business Research (Gallagher and Kidd, 1995) using Dun and Bradstreet records of independent companies set up in 1978 and still operating in 1990 in Scotland, South East England and the West Midlands. The Fraser of Allander Institute contributed an econometric analysis (Ashcroft and Love, 1995) of Scotland's new starts performance compared with the rest of the UK and of the impact of new firms on job creation.

These papers suggested that new firm formation would continue to be of importance for the rest of the decade, stimulated by an increased SME sector. The analysis confirmed the persistent low rates of enterprise creation in Scotland, although the growth of survivors was at least as good as elsewhere if not superior. From this Scottish Enterprise concluded that the problem was the overall birth rate, with the policy implication being that measures to expand the pool were more appropriate than 'picking winners'.

In a separate study on cross-national comparisons of business creation, Reynolds, Storey and Westhead (1994), using data on France, Germany, Italy, Sweden, the UK and US, argued that the rates of business start-ups do not differ greatly across countries. However, they have identified wider variations within countries, between regions in the European Union, with the birth rate in the most dynamic areas being two or three times higher than in the least fertile zones. Further discussion of this research is available in a special edition of 'Regional Studies', edited by Storey (1994). There was disagreement between the authors of this study with regard to the importance of, and subsequent need to avoid, displacement in policy prescriptions.

Hart and Hanvey in this volume similarly discuss these issues with special attention to Northern Ireland. Comparable results to the Scottish analyses are presented, but with greater concern expressed over the level of displacement and, therefore, in the long term sustainability of policies to promote growth through the stimulation of new enterprises.

Individual and sectoral case studies

Scottish Enterprise sponsored research on specific sectors which were considered to have significant lessons or to have a key role in the economy. A traditional Scottish industry facing both technological and competitive pressures, Clothing & Textiles, was analysed by David Rigby Associates; PACEC looked at high tech examples and academic spin outs, both areas subject to much promotion in encouraging regional regeneration; EES consultants investigated corporate venturing; and KPMG addressed the major growth sector of the 1980s – the Service sector.

The analysis of clothing and textiles showed that the popular view of company failures and declining employment was disguising the actual and potential contributions of new firms to the industry in Scotland. However, their role was restricted by a lack of innovation and dynamism. Evidence from Italy and Germany suggested there was the potential for a more significant contribution to the economy, with development through a growth in the number of new, small firms rather than in the size of existing companies seen as the best way forward.

PACEC, on high tech and academic spin offs, reported minor differences in the factors explaining low levels of NFF in these specific sectors and in the overall economy. The research base within industry was perceived as inadequate, with few organisations acting efficiently as incubators for spin-outs and new high tech companies. The infra- and super-structure were deemed deficient in these respects, with poorly developed and weak specialist resources, social networks and information flows within the high tech community. The lack of demand for high tech companies is highlighted, outwith the North Sea oil industry, constraining development of a home base, and putting firms at a cost disadvantage in export markets. In comparison with other areas, notably Massachusetts, policy support critically was seen as less extensive.

Problems in establishing a high tech firm are compounded by the actual process of formation and growth, with the lack of support and ambition at home stunting development opportunities. All this seemed minor compared with the situation of academic spin offs, the authors argued, where major restrictions were identified in Scottish higher and further education institutions and in their business, funding and cultural environments in promoting new firm formation. Entrepreneurship was perceived as alien to academic traditions, risky and stigmatising, so that significant barriers to entry into the market place had been erected.

Westhead and Cowling in this issue look at high tech NFF again and come to question the certainty of such conclusions. They believe that the debates on the major factors are still unresolved. In a US study, Muniak has argued recently (1994) that there are essential conflicts between the promotion of regeneration policies, based on high tech, at the urban and at the national level. In the same vein, and as seen here, much of the policy and analysis in the UK seems to suggest that the needs of local and of national economies may not be coincidental with regard to the encouragement of high tech and academic entrepreneurs. Policies to improve NFF in the country as a whole may lead to differential effects across regions, perhaps providing strong virtual and virtuous cycles of uneven development.

Corporate venturing covers assistance to entrepreneurs or SMEs to exploit new ideas, corporate restructuring through staff creating new independent businesses, and the development of new profit centres and subsidiaries to exploit new products, processes and markets. EES suggested that Scotland is poorly provided with such approaches to regeneration and restructuring, which is unfortunate because, by reducing risk and establishing new ventures with better prospects, they offer an effective, additional element in promoting NFF, especially in the high tech area.

The service sector has provided almost all the new jobs in the UK in the last decade or so. Considered as having relatively few barriers to entry, the services should present a promising area for improving Scotland's business birth rate. In looking at particular professions, technological and personal service companies, KPMG considered that perceived problems in raising finance were the key difficulty facing such entrepreneurs. Costs of finance were an associated concern, though few entrepreneurs seemed to appreciate the risks to the lender in supporting such activity. As demonstrated in the other studies, there was less dynamism in these companies than was apparent in their counterparts in the South East or the US, with relatively little extra-regional or export marketing.

Business environment

Studies for Scottish Enterprise expanded on this to consider property (PIEDA), business angels (KPMG), and finance generally (Stoy Hayward). Continuing market failure seemed to be identified, even in the recession, with the market for small units relatively tight. Shortages of serviced office accommodation, and facilities for 'bad neighbour' new enterprises were spotlighted amongst other problems not being addressed fully by the private sector, predicting more severe constraints in the upturn. Despite lower land values than in comparable areas, rents were high in private sector developments. The critical role of the public sector in providing accommodation was clear, although faith that the market would respond to further demand was held by the consultants and developers.

In this volume, Mason and Harrison, and Cowling and Clay, extended the work of the Scottish Enterprise programme into the central factor of finance. Venture capital is not only a relatively insignificant source of external funding for new ventures in Scotland, but also, the agency claims, the outlook is 'anything but optimistic'. Existing, seemingly endemic problems with access to seed-corn and start-up finance are threatening to become more severe in the near future. Together these findings suggest an attempt to close this widening gap with a move to the provision of risk finance by the public sector and by the private investor, the so-called 'business angel'. Some of the chapters on finance in 'Scotland's Business Birth Rate' are titled 'Finance – The Big Issue?', 'Informal Investment – A Neglected Source?', and 'Finance – The Ongoing Debate', each suggesting that little has been resolved. The equity gap is contrasted with the availability of money; the question of access is a major and persistent feature in the Scottish business environment, and to a greater extent than elsewhere. Given the significant power and size of the Scottish financial sector, the invention and introduction to the world of investment and unit trusts, and the strong history of (savings) banking, there is an argument that 'improvements in the behaviour and performance of both lenders/investors and actual/potential business founders' can and must be encouraged (Scottish Enterprise, 1993).

Drawing on search cost ideas, Mason and Harrison, in this edition, suggest the public sector should underwrite the costs of bringing together business angels and entrepreneurs seeking finance, so overcoming inefficiencies, indivisibilities and risks in the market. Cowling and Clay, also in this volume, in considering the UK Government's Loan Guarantee Scheme, argue that this relatively cost-effective job generation and enterprise support package could be extended to aid more new firms.

Entrepreneurial potential and cultural issues

While many of the factors influencing enterprise creation and regional economic development raised in the Scottish Enterprise enquiry and covered in this volume are common to most communities, with the arguments well rehearsed elsewhere, the identification of entrepreneurial potential and cultural issues as significant does add an extra dimension to our understanding of the processes involved in NFF. The research directly challenges the business development community in Scotland to address its own behaviour and attitudes to potential entrepreneurs. Extensive interviewing across several countries, and literature reviews, were used to establish the comparative levels of interest in entrepreneurship, perceptions and experience of entrepreneurship, and social attitudes towards enterprise. Perhaps because of a particular reaction to Thatcherism, but undoubtedly related to a specific economic and social history, the perception of entrepreneurs in Scotland was less positive than elsewhere. Recognition of their contribution to the economy was not sufficient to undermine the key role reserved for government intervention. Persistent unemployment, poverty and deprivation, against a relative economic decline of eighty years duration (Danson, 1991), have thralled Scots to the philosophy of collective intervention to generate jobs. Entrepreneurs were seen in these surveys as being less caring and community oriented than the respondents.

Although further analysis showed a lower pool of self confessed, potential entrepreneurs, there was still a substantial proportion of the adult population who believed they had the ability and desire to run their own business. These statistics suggest that there was no anti-enterprise or dependency culture; rather, with much unexploited potential, a barrier to converting desire into reality seemed to be abroad. Interviews with the business development industry and amongst opinion formers demonstrated complacency, a less than positive attitude to policies promoting new, small and medium enterprises, and a dependency culture: where it was believed that native Scots entrepreneurs could not be dynamic animals in the regeneration process. A misperception of the characteristics of indigenous people, and therefore of potential entrepreneurs, was not uncommon, with some agencies suggesting higher barriers were required to limit entry by local businesses into the market. Failure was seen in a very negative way, and in contrast to the US where it is far more acceptable to fail and try again.

Many of the concepts at the heart of regional economic development strategies: such as the encouragement of inward investment, the avoidance and fear of displacement, the provision of business advice, suggest that they may in their implementation corrupt the promotion of NFF in ways not identified before. So, while dominant and branch plants have been considered as destroyers of entrepreneurship (Fothergill and Gudgin, 1982; Storey, 1982), the reality may be more complex. There is evidence that regional development agencies and government departments have been opposing management spin-outs, effectively scuppering the opportunity for technology based developments in sanctioning the closure of R&D laboratories in nationalised industries, and dampening enthusiasm and support for management/worker rescues of branch plant closures (Strathclyde Regional Council, 1988; Danson, 1991). The rationale being that, with the views of overseas owners and future investors paramount, the position of inward investment agencies cannot be compromised in the international market for mobile capital.

As mentioned above, concerns over displacement dominate much thinking, while there is scant recognition given to the longer term processes of innovation, dynamism and efficiency. Protecting the status quo is preferred to encouraging indigenous start-ups (Scottish Enterprise, 1993, p. 23).

This research is indicative of a wider, growing interest in the concept and importance of social networks in the entrepreneurial creation process. Again these particular studies revealed Scotland as having a more extreme set of rules and social mores in determining support and advice. Those who would have most difficulty establishing a business elsewhere – the young, women and the working class, appear to face higher hurdles than in the South East of England and beyond. Lack of security and of alternative employment in the event of failure, and the effects on family life of creating a new firm are the major concerns of potential entrepreneurs according to the Scottish Enterprise report (p. 24). The report believes these problems could be overcome in some instances by wider discussions with informed contacts and with existing entrepreneurs. This seems all the more important given the less than positive attitude of business development organisations. Unfortunately, the low level of entrepreneurship identified in the programme above becomes self perpetuating in these circumstances, compounding the earlier barriers to enterprise.

Knowing an entrepreneur is an important 'rocket' in the process of converting potential into actual business creators; those who are most dissuaded from making the transition are least likely to have a set of relevant contacts. In cross reference to the details on financial support, the greater severity of funding problems in Scotland is associated with the lower penetration of the ideology of the property owning democracy. With the UK funding bodies' preference for mortgages on the borrower's home to be used as collateral, there is an additional barrier to establishing the company where owner occupation of housing has tended to be low traditionally.

McNicoll (1995) discusses this set of elements in more detail, concluding that positive encouragement to progress the idea of becoming an entrepreneur would often be sufficient, within the environment of all the other hurdles and obstacles, to prevent most potential new ventures from failing to reach the starting line.

Conclusion

In the Scottish Enterprise enquiry extensive research on one particular regional economy suggests that complex interrelationships between a number of factors can restrict the flow of potential entrepreneurs to the marketplace. In the case of Scotland these are often seen in more extreme forms than elsewhere in the UK or developed world. Of greater concern, given the lack of state intervention to expand production or manage aggregate regional demand, the greater competition for foreign direct investment, and the increased competitive pressures within the single European market, are the revealed preferences of the business development agencies and professionals established to promote new firm formation.

Successful launches of new enterprises are delivered in many instances despite the business culture and industry, rather than because of its efforts. This argument by the Scottish Enterprise report is supported by frequent references to the very different conditions in Massachusetts, Germany and the South East. However, the experiences of Scotland are repeated in more or less similar ways across deprived and depressed regions of the UK and EU, as the work of Hart and Hanvey, this volume, amongst others has shown. The specific problems of Scotland and the interest generated by the research programme relate to the discussions on social networks and their exclusivity in a small nation, and to the problems of financial systems in a global investment centre.

This volume, along with the special edition of '*Regional Studies*' (Vol 28, No. 4) and the proceedings of the conference on 'New Firm Formation and Regional Economic Development', has progressed many of the themes and issues raised in this area. Nevertheless, as Westhead and Cowling in this issue of *Small Business Economics* here, the jury is still debating many of these. Further research and action is required, undoubtedly, before entrepreneurship can play a full role in the regeneration of the regional economies of the European Union.

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