New business, not small business

We need to make start-ups, instead of small businesses, part of the priority sector, says Shubhashis Gangopadhyay

I heard an interesting presentation at a recent conference.* The paper on which the presentation was based starts with what the author describes as a myth that we religiously believe in and, indeed, propagate to others. This is a myth about start-ups. Start-ups, or new businesses, have no record and, hence, find it hard to obtain credit from formal institutions like banks. This is the belief held by most — and, indeed, taught in classrooms in a number of different courses and programmes. Policy makers swear by it, while politicians and non-governmental organisations keep reminding us about the inherent contradictions in the free-enterprise system.

Coupled to this is our belief that small businesses are the creators of employment and if we support the growth of small businesses, employment will grow. "The growth of small businesses leading to greater employment", unfortunately, can be interpreted in two ways. First, the greater the number of small enterprises, the greater is the employment. Second, if we support small businesses and help them grow into big businesses, employment will increase. Regardless of the interpretation, and given our primary belief, we spend endless policy-making time to find the correct mix of interventionist packages to help small businesses.

Before we get back to the paper, let me make an observation. Very few companies start big; they grow big. And all companies need to start. Anything that encourages the birth of new companies is, therefore, considered a good thing as such firms increase employment and generate income. However, from this it does not follow, logically that is, that supporting small businesses is a good thing; at best, we can say that supporting start-ups is a good thing.

I make this point because in our policy circles and in many academic circles, there is a strong support base for policies oriented towards small businesses, but little or no support for start-ups and entrepreneurship. This is in spite of our firmly held belief that start-ups do not get funded by institutions like banks. On the other hand, there is an associated belief, among many who are active in policy circles, about the importance of venture capitalists and to an extent private equity and informal institutions like friends and family as sources of credit for start-ups.

There is a lot of work done on this by academics in the United States. First, let us see the importance of venture capitalists. Remember that venture capitalists are most active in the US. A paper by Manju Puri and Rebecca Zarutskie shows that only 0.1 per cent of "new" firms are funded by venture capitalists. Another paper, by Alicia Robb and David Robinson, demonstrates that credit cards, friends and family form a negligible part of the financing for start-ups. The presenter argues that new firms actually receive funding from three major sources: venture capitalists, informal sources and bank lending. One caveat, so that we do not get confused by the apparent contradiction here. Informal sources are important to those start-ups that get funding from such sources; it is just that very few start-ups get any funding from such sources.

The primary source of funding for start-ups, as estimated by David Robinson, is bank lending! Almost uniformly across entrepreneur-type and sector, start-ups receive about 50 per cent of their funds from banks. Only in high-tech start-ups is bank lending lower; but that too is at 40 per cent. In garage businesses, including your mom-and-pop stores, bank lending is around 45 per cent. Indeed, debt continues to be the major source of funding for at least the first four years of the firm's life. And when it comes to employment growth, it is not small business that provides them; start-ups do. Small businesses are those that do not grow and, hence, do not grow employment. Start-ups die a lot, but new ones come up; and since there is a net increase in young firms, employment grows. The data are from the Kauffman Firm Survey. According to their website, the Kauffman Foundation is one of the world's largest foundations devoted to entrepreneurship.

We learn two things from this paper. First, it is wrong to think that US banks do not support start-ups. Second, the new institutions like venture capitalists may not be as important as we think they are for furthering entrepreneurship. Third, start-ups generate employment, not small businesses. Indeed, the author ends by saying that the US should scrap the Small Business Administration with the New Business Administration.

So, what do we learn from this? Start-ups and entrepreneurship are good for employment and income generation. Second, start-ups should not be mixed up with small businesses. Third, formal institutions should be revamped and reoriented towards start-ups, not small businesses. Maybe we need to make start-ups part of the priority sector, not small businesses. There is so much talk about our financial sector and it invariably centres on stocks, initial public offerings, derivatives and other sophisticated things like venture capitalists and private equity. However, there is little or no urgency in trying to make banks more responsive to the demand for capital by start-ups.

One final word needs to be said. This study was done using US data. Can such a study not be done in India? Maybe we will learn different things about start-ups and entrepreneurship. As long as we keep thinking that we need to learn from other countries, it will not be done. As long as we do not get data from our own economy, it will not be done. As long as research funds are not made available to universities and their social science researchers, such studies will not be done for India. Where is our Kauffman Foundation that funds the collection of data and makes them available to researchers?

* "The Financing Choices of Young Firms", David T Robinson (2013)