Entrepreneurship for Managers
Strategic Decision-Making for Business Growth
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GET A BROAD INTRODUCTION TO ENTREPRENEURSHIP
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Introduction

*Routledge-ISBE Masters in Entrepreneurship* is a series of accessible, contemporary and critical textbooks exploring a range of entrepreneurship topics. This collection of texts forms a significant resource for those studying entrepreneurship, whether as part of an entrepreneurship-related programme of study, or as a new area for students in other disciplines. That said, given the relatively short, yet comprehensive approach adopted by the authoring teams – all of whom are specialists in their field – there is scope for these discrete texts to be of use to the budding and established entrepreneur as they navigate the challenges of their entrepreneurial business.

Whilst often operating on intuition and know-how, the subjects covered in these texts can provide entrepreneurs and other professionals (e.g. business support specialists, policymakers) with a broader and more informed understanding of entrepreneurship as a phenomenon, which in turn will assist them in thinking strategically about the development and growth of the businesses they launch, run and support.

This e-book combines a selection of chapters that have been published within the series and focus on key topics including the start-up decision, managing and resourcing finances and the transition from entrepreneur to owner manager. Each chapter offers insight into distinct areas of entrepreneurial management, providing fresh perspectives and new ideas to the inquiring reader.

**Chapter 1: The Start-Up Decision**

From *Entrepreneurship* by Stephen Roper

The decision to start a business is one of the first steps in the entrepreneurial process, involving significant commitments of time and potentially financial and reputational resources, as well as coping with the risk and uncertainty involved in the entrepreneurship decision. In this chapter, Roper considers what influences an individual to move from having an idea or recognising an opportunity to then acting on it through the creation of a business. A range of factors are identified and discussed that shape the start-up decision, encompassing both the individual and institutional perspectives.

**Chapter 2: Why is Lending to – or Investing in – a Small Firm Difficult?**

From *Finance for Small and Entrepreneurial Business* by Richard Roberts

Entrepreneurs are only too familiar with the difficulty in accessing debt, equity or asset-based financing and in this chapter Roberts provides concise explanation as to why these challenges exist from the perspective of potential lenders and investors. Starting with the premise that direct commercial lending or investing into small businesses is commonly regarded as a specialised financial activity with some unique characteristics and risks, this chapter outlines three core issues prevalent in the small business funding marketplace: opacity in small business information, adverse selection
and moral hazard. Further detail is advanced on the strategies and techniques that lenders use to reduce the uncertainty involved.

**Chapter 3: Financing Women-Owned Businesses**

From *Female Entrepreneurship* by Maura McAdam

Focusing on a significant minority group of the entrepreneurial population, McAdam discusses the specific challenges faced by women when it comes to financing their ventures, commencing with an overview of the demand and supply of finance required to support sustainable ventures. This is followed by a discussion of the key societal issues pertinent to women, such as the so-called risk adversity of women, gender stereotyping and discrimination practices of financial institutions. The chapter concludes with a spotlight on the Diana Project International, a US research initiative established to investigate the growth models pursued by women entrepreneurs and the supply and demand of venture capital.

**Chapter 4: Bootstrapping the Start-Up Business**

From *Resourcing the Start-Up Business* by Oswald Jones, Allan Macpherson and Dilani Jayawarna

Continuing with the theme of entrepreneurial finance, Jones, Macpherson and Jayawarna introduce the concept of bootstrapping, often described as an alternative solution to traditional financing strategies. The chapter begins with a working definition for bootstrapping and the theoretical standpoint assumed to explain bootstrap behaviour by new entrepreneurs. Different types of bootstrapping techniques are then advanced to provide a comprehensive understanding of how the entrepreneurs' financing preferences and the type of opportunities they are pursuing will influence subsequent choices. Building on the discussions advanced in Chapter 3, the authors also include a brief note about the gendered nature of bootstrapping and an explanation for how the preferences and the nature of bootstrapping vary over the course of the business life-cycle. The chapter concludes with some practical advice as to how an entrepreneur might better position their venture for growth by adopting a range of bootstrapping behaviours.

**Chapter 5: From Entrepreneur to Owner-Manager**

From *Managing Human Resources in Small and Medium-Sized Enterprises* by Robert Wapshott and Oliver Mallett

Having explored the challenges involved in taking the decision to launch a business in Chapter 1, in Chapter 5 Wapshott and Mallett explore the realities and demands of owner-manager everyday practices and the demands of not only starting but building a business. It can be argued that, as enterprises grow, mature and become more
established, the role of everyday business management requires a different set of skills, or areas of emphasis, from those associated with a start-up. This chapter focuses on the challenging transformation from the start-up phase to the everyday management of a business with employees. Importantly, this involves adapting to the demands placed upon an owner-manager, the need for demonstrating leadership and for engaging with employment relationships.

**Chapter 6: Why Does Policy Matter to Entrepreneurs and Small Businesses?**

From *Entrepreneurship, Small Business and Public Policy* by Robert J. Bennett

The final chapter in this e-book provides another external perspective similar to that of Chapter 2, focusing on the basics of entrepreneurship and small business policies, and why they are important. Bennett presents a number of definitions to highlight how difficult it is to grasp the object at which policies are directed. The definitions used in practice, although supposedly focusing on small business and entrepreneurs, often embrace firms up to businesses of 1000 or 1500 employees. Consequently the chapter not only informs the reader of the objectives of government policy, but articulates how policy requirements differ as result of the heterogeneity of entrepreneurs and small businesses. A final discussion focuses on the importance of ‘contexts’ from global, historical and institutional perspectives as a critical factor for facilitating ‘business enabling environments.’

We hope you find each chapter informative and useful, whether you are studying entrepreneurship or an entrepreneur yourself, and encourage you to consult the complete editions of each book at: routledge.com/business

Enjoy reading!

**Dr Janine Swail & Professor Susan Marlow, Series Editors**
Entrepreneurship: The Start-Up Decision
Chapter 1: The Start-Up Decision

5.1 INTRODUCTION

In this chapter we consider what influences the individual decision to actually start a business – to move from having an idea or seeing an opportunity to actually doing something about it. This is a big step for most people involving the commitment of significant time and, potentially, financial and reputational resources. It may also involve a potential loss of security if the potential entrepreneur has to give up a secure job to take a risk in starting a new firm (Box 5.1). In other situations the entrepreneurship decision may result from necessity due either to economic circumstances or losing a job.

Our interest in this chapter is to identify the range of factors which might shape the start-up decision. Is this solely about the individual, and potentially their family, or is it significantly influenced by other more institutional factors such as the availability of finance or social attitudes to enterprise or entrepreneurship? One recent study, for example, suggests that perceptions of the difficulty of accessing start-up finance discouraged potential entrepreneurs in the UK from starting businesses, an effect which was particularly strong for women (Roper and Scott, 2009). One interpretation is that this type of factor might help to explain the lower level of entrepreneurial activity among women in many countries. Other studies have emphasized the importance of legislation and regulation in the start-up process (Djankov et al., 2002b, Capelleras I., 2008). In both cases there is a clear effect, both from individual psychology and attitudes and the operating environment on the start-up decision. Accordingly, it appears as if both structure and agency are likely to play key roles in the start-up decision.

The remainder of the chapter is organized as follows. In Section 5.2 we consider two different frameworks which have been used to reflect the start-up decision and which provide some information on the ‘conversion ratio’, the proportion of those individuals who think about entrepreneurship and then actually do it. Section 5.3 then focuses on three different approaches to the start-up decision from an economic, social and process perspective. Section 5.4 closes the chapter, integrating the start-up decision into the institutional model suggested by Lu and Tao (2010).

The main learning objectives for this chapter are as follows:

- To introduce students to economic, social and process-based theoretical perspectives on the start-up decision.
- To familiarize students with concepts of latent or nascent entrepreneurship and their measurement and their relationship to actual entrepreneurship.
- To encourage students to consider structure and agency and their interaction in the
start-up decision.

Further questions for discussion and reading are outlined in Section 5.5.

**BOX 5.1 THE START-UP DECISION – INNOCENT DRINKS**

Innocent Drinks is a UK-based company producing fruit drinks for the retail market. Richard Reed, one of the three co-founders of the company, relates how the decision to start the company was made: In the summer of 1998 when we had developed our first smoothie recipes but were still nervous about giving up our proper jobs, we bought £500 worth of fruit, turned it into smoothies and sold them from a stall at a little music festival in London. We put up a big sign saying ‘Do you think we should give up our jobs to make these smoothies?’ and put out a bin saying ‘YES’ and a bin saying ‘NO’ and asked people to put the empty bottle in the right bin. At the end of the weekend the ‘YES’ bin was full so we went in the next day and resigned. Searching for start-up finance to establish the company turned out to be more difficult as the team was turned down 20 times by banks. Eventually the leadership team was backed by an American business angel. Today the company has sales in excess of around $220 million p.a. Source: http://www.innocentdrinks.co.uk

5.2 THINKERS AND DOERS

The move from thinking about starting a business to actually starting up has received considerable attention in the research and policy literatures. The research literature has focused on the question of ‘why’ people make a particular start-up decision. The policy literature has also raised this question and has focused on trying to profile those who do and do not start businesses. In the UK, for example, a series of government surveys – the ‘Household Survey of Entrepreneurship’ – have tried to identify ‘Thinkers’, ‘Doers’ and ‘Avoiders’. Doers are those adults who are self-employed or own a business. Thinkers are those who are not currently Doers, but have recently thought about starting a business, buying into an existing business or becoming self-employed. Avoiders are those who are neither Doers nor Thinkers. In the 2007 Household Survey of Entrepreneurship which covered 7,329 adults aged 16–64 across England, 14.3 per cent were Doers, 11.0 per cent were Thinkers and the remaining 74.7 per cent were Avoiders (IFF Research Ltd, 2008). The survey also provided some information about the type of factors which shape the barriers to either thinking about or starting a business (Figure 5.1). Issues related to finance and debt, a loss of security and the risk of the business failing were the key barriers to business start-up (Kihlstrom and Laffont, 1979). Very similar sets of barriers to start-up are evident in studies around the globe. Pillai and Amma (2005), for example, in a survey of women in India highlight very similar barriers to start-up: shortages of finance; lack of expert advice; lack of market
outlets; shortage of raw materials/power; a lack of adequate training; conservative attitudes of society; and family responsibilities.

**Figure 5.1**

*Barriers to starting a business: UK, 2007*

Source: Adapted from IFF Research (2000), Chart 13.

GEM – the Global Entrepreneurship Monitor – adopts slightly different names to cover essentially the same point, distinguishing between 'nascent' and 'actual' entrepreneurs. Nascent entrepreneurs are those people who 'are actively committing resources to start a business that they expect to own themselves', but who have not yet started up a company (Bosma and Levie, 2010, p. 13). The higher the prevalence of nascent entrepreneurship the more 'dynamic' new firm activity in an economy is likely to be, and this can be measured by the percentage of the adult population who are nascent entrepreneurs (the nascent entrepreneurship activity rate or NEA). A second key factor is the 'conversion' of this nascent entrepreneurship into established business ownership. Here too the GEM data provide an easy indicator by relating the NEA to the overall proportion of the adult population in established business ownership (or established entrepreneurship activity rate or EEA). The ratio of the NEA to the EEA then provides a 'conversion' ratio: the higher the ratio the better an economy is at converting nascent into active entrepreneurship.

Based on data from the 2009 Global GEM Report, Table 5.1 summarizes the NEA, EEA and conversion rate data for selected countries. In Yemen, for example, 22.8 per cent of the adult population were categorized as Nascent Entrepreneurs in 2009 but established entrepreneurs were only 2.9 per cent of the adult population, suggesting a
Table 5.1 Nascent and established entrepreneurship and conversion ratios – selected countries

<table>
<thead>
<tr>
<th></th>
<th>Nascent entrepreneurship rate</th>
<th>Established entrepreneurship activity</th>
<th>Conversion ratio</th>
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<tbody>
<tr>
<td></td>
<td>NEA (1) % adults</td>
<td>EEA (2) % adults</td>
<td>(2) x 100/(1)</td>
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<tr>
<td>Factor-driven economies</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Saudi Arabia</td>
<td>2.9</td>
<td>4.1</td>
<td>141.4</td>
</tr>
<tr>
<td>West Bank and Gaza</td>
<td>3.0</td>
<td>6.9</td>
<td>230.0</td>
</tr>
<tr>
<td>Syria</td>
<td>3.4</td>
<td>6.7</td>
<td>197.1</td>
</tr>
<tr>
<td>Venezuela</td>
<td>13.3</td>
<td>6.5</td>
<td>48.9</td>
</tr>
<tr>
<td>Guatemala</td>
<td>17.1</td>
<td>3.3</td>
<td>19.3</td>
</tr>
<tr>
<td>Yemen</td>
<td>22.8</td>
<td>2.9</td>
<td>12.7</td>
</tr>
<tr>
<td>Efficiency-driven economies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>1.7</td>
<td>4.3</td>
<td>252.9</td>
</tr>
<tr>
<td>Russia</td>
<td>1.8</td>
<td>2.3</td>
<td>127.8</td>
</tr>
<tr>
<td>Serbia</td>
<td>2.2</td>
<td>10.1</td>
<td>459.1</td>
</tr>
<tr>
<td>Chile</td>
<td>9.6</td>
<td>6.7</td>
<td>69.8</td>
</tr>
<tr>
<td>Colombia</td>
<td>15.0</td>
<td>12.6</td>
<td>84.0</td>
</tr>
<tr>
<td>Peru</td>
<td>16.1</td>
<td>7.5</td>
<td>46.6</td>
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<tr>
<td>Innovation-driven economies</td>
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</tr>
<tr>
<td>Denmark</td>
<td>1.6</td>
<td>4.7</td>
<td>293.8</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1.6</td>
<td>2.9</td>
<td>181.3</td>
</tr>
<tr>
<td>Italy</td>
<td>1.8</td>
<td>5.8</td>
<td>322.2</td>
</tr>
<tr>
<td>United States</td>
<td>4.9</td>
<td>5.9</td>
<td>120.4</td>
</tr>
<tr>
<td>Norway</td>
<td>5.0</td>
<td>8.3</td>
<td>166.0</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>6.5</td>
<td>5.7</td>
<td>87.7</td>
</tr>
<tr>
<td>Iceland</td>
<td>7.6</td>
<td>8.9</td>
<td>117.1</td>
</tr>
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Source: Derived from Bosma and Levic, 2010, Table 3, p. 21.

A conversion ratio of only around 12.7 per cent. This suggests significant barriers to translating nascent entrepreneurship into business ownership compared to other countries such as Saudi Arabia or the West Bank and Gaza where the conversion ratio is much higher. More generally, conversion ratios are on average higher in the Innovation-driven economies (224.3 per cent) than in either the Efficiency-driven (162.4) or the Factor-driven economies (123.9 per cent) suggesting that Innovation-driven economies are better at converting nascent into actual entrepreneurship than those countries in the other two groups. Or, put another way, the barriers to moving into entrepreneurship are lower in the Innovation-driven economies than elsewhere.
5.3 CONCEPTUAL PERSPECTIVES

Three rather different conceptual perspectives on the start-up decision can be found in the literature. First, economic approaches emphasize business start-up as a labour market choice comparing the utility of start-up and working with little regard to the wider social or economic context within which individuals are located (Blanchflower and Oswald, 1998). Social approaches instead tend to emphasize the context and setting in which the start-up is taking place (van der Boon, 2005). Finally, process perspectives inject more temporality into the start-up decision process and emphasize the different stages of the decision process to move from ‘Thinker’ to ‘Doer’.

Economic approaches to the start-up decision are perhaps best illustrated by a simplified version of the model outlined by Blanchflower and Oswald (1998). They suggest that an individual will choose to start a firm if their utility from taking this route is greater than their utility from working for someone else. The case of Rajeev Samant and the start-up of Sula Vineyards illustrates this type of decision (Box 5.2). To see how this model works at an economy-wide level Blanchflower and Oswald (1998) start by assuming that if an individual works for someone else their wage will be \( w \) and their utility is \( u = w \). If, on the other hand, the individual starts a business they will have utility both from the profit of the enterprise and the non-financial benefits of being their own boss, say \( u = \pi + i \), where \( \pi \) is the profit from the enterprise and \( i \) is the non-financial benefit of entrepreneurship. In the case of Rajeev Samant this non-financial benefit reflected both his preference for working in India and his desire to combine an element of working both in the city and the country.

**BOX 5.2 SULA VINEYARDS, INDIA**

Rajeev Samant is a Stanford-trained engineer who worked as a finance manager at Oracle. In 1993, tired of corporate life in Silicon Valley, he moved back to India and took over his father’s 28-acre rural estate near Nashik, 180 km northeast of Mumbai. For four years Rajeev tried growing a range of different crops including organic mangoes, peanuts, roses and then table grapes, which were already common in the region. Then, a letter from a girlfriend provided the inspiration to start growing wine grapes and this led eventually to the establishment of Sula Vineyards. Seed capital for the business was provided by friends and family, and Kerry Damskey a winemaker from California’s Sonoma Valley joined the company. Sula’s first vines were planted in 1997 and today Sula is among India’s most successful wine companies and has begun to develop associated tourist businesses. Source: http://www.sulawines.com

If there is no start-up cost an individual will then start a firm if \( \pi + i > w \), i.e. they would have greater utility from entrepreneurship than from working for someone else. To see how this works for the economy as a whole we need to make some assumptions about
what determines \( \pi \) and \( w \). Assume that there are a range of entrepreneurial opportunities in the economy offering different profit rates and that the more entrepreneurial ventures there are the lower the average profitability. This suggests that the returns to entrepreneurship will be downward sloping (Figure 5.2). Also, assume anyone can find work at wage \( w \), or that the wage opportunities curve is horizontal (Figure 5.2). Taken together these suggest that if there is no cost of start-up, the equilibrium number of entrepreneurs will be at \( E1 \). To the left of this the returns to entrepreneurship are higher than the alternative wage, and to the right the returns are lower.

![Utility vs. Number of entrepreneurial ventures](image)

**Figure 5.2**
Utility-based model of the start-up decision

If there is a start-up cost, however, finance may be a significant barrier to startup for many people as the survey data reviewed earlier suggest (Figure 5.1). If this is the case, Blanchflower and Oswald (1998) argue that the level of entrepreneurship may be constrained below the market equilibrium, say at \( E2 \). This involves a welfare loss. To test the importance of this financial barrier to the start-up decision Blanchflower and Oswald (1998) use longitudinal data from the UK’s National Child Development Survey which covered all births from 3 to 9 March 1958 and surveyed children regularly thereafter. In this survey – like the UK Household Survey of Entrepreneurship discussed earlier (Figure 5.1) – the most commonly cited reason for people not becoming self-employed was the lack of capital and money. Blanchflower and Oswald (1998) found that receipt of an inheritance or gift had a positive effect on an individual becoming self-employed. This effect was larger for younger people, and provides
further evidence of the significant effect of financial constraints on the start-up decision.

A key element of the economic approach to the start-up decision is that an individual can accurately evaluate the ensuing benefits. In practice, this is very unlikely to be the case and recent studies have emphasized the over-confidence of many potential entrepreneurs. As Townsend et al. (2010, p. 193) remark:

hubris theory suggests that inflated expectations of success at the point of firm creation may contribute to subsequent failure in nascent firms as overconfident entrepreneurs start firms with insufficient capital, or over-allocate capital to high risk projects with little intrinsic chance of success.

Using data from the US Panel Study on Entrepreneurial Dynamics (PSED) Townsend et al. (2010) explore what aspects of this ‘over-confidence’ are important in shaping the probability of start-up. In particular, they explore whether it is potential entrepreneurs’ expectations about the probability of the success of their enterprise or an overly positive view of their own entrepreneurial abilities which is more important in shaping the start-up decision. The empirical results emphasize individual assessment of one’s own entrepreneurial ability as the most important determinant of the start-up decision. In other words, it is those who have the greatest self-belief who are most likely to make the most positive assessment of the returns to entrepreneurship and are therefore most likely to start businesses (see also Table 4.5).

An important critique of economic or utility approaches to the start-up decision is that they tend to be acontextual. Or, in other words, they tend to view the entrepreneurship decision in isolation from the context in which the decision is being made. In earlier chapters we have, however, emphasized the importance of context in the entrepreneurial decision, and the interaction between individual characteristics and the institutional context (McDade and Spring, 2005, Lu and Tao, 2010). The importance of the institutional context for entrepreneurship is reflected in more ‘social’ perspectives on the start-up decision which often focus on the combinations of factors which either ‘pull’ or ‘push’ individuals towards entrepreneurship. Van der Boon (2005, p. 163), for example, differentiates between these ‘push’ and ‘pull’ factors arguing that

pull factors are those that pull an individual towards entrepreneurship, frequently said to include self-fulfilment, self-determination, a sense of accomplishment, control, profit … and family security … Push factors are those which push people out of their current jobs. … Being a victim of downsizing, having aspirations threatened, or women realizing they have hit the corporate glass ceiling.

The distinction between push and pull factors reflects, of course, the distinction between opportunity and necessity-based entrepreneurship discussed in earlier
chapters. However, for many individuals the start-up decision may reflect a combination of 'push' and 'pull' factors; Caliendo and Kritikos (2008), for example, examine the start-up decision among 3,100 unemployed Germans whose start-ups were supported through two government enterprise support measures. From the sample, 83 per cent emphasized 'termination of employment' as key motive for start-up, with a further 35 per cent emphasizing the 'end of unemployment benefit entitlement'. Among the same group, 'pull' factors were also evident with 65 per cent of respondents having had their first customers and 56 per cent stating they had 'always wanted to be [their] own boss' (Caliendo and Kritikos, 2008, Table 5).

The study by Caliendo and Kritikos (2008) emphasizes the range of individual and institutional factors which can influence the start-up decision. It also suggests the temporal nature of the decision. Reflecting this, the third perspective on startup emphasizes the temporal nature of the start-up decision seeing start-up as a process rather than a single event (Van de Ven and Engleman, 2004). It has been argued that process perspectives are useful as they highlight the different steps in the decision-making process moving towards enterprise and can provide insights into the factors which influence the decision at different points in the start-up process. In terms of the earlier discussion (Section 5.2), for example, what factors influence the move from being an 'Avoider' to a 'Thinker' and from a 'Thinker' to a 'Doer'? Are these factors the same?

Some of the more detailed applications of the process perspective on the startup decision stem from the US. Liao and Welsch (2008), for example, examine the range of different activities undertaken by US individuals starting technology and non-technology-based enterprises. So, the process of establishing a new technology-based business was significantly longer than that for a non-technology-based business and it involved significantly more 'activities' such as seeking external finance, developing a business plan, etc. On a similar theme, Ndonzua and others (2002) develop a process or stage model of academic spin-outs. Based on an inductive or exploratory exercise which involved conversations with a group of staff in 15 universities recognized as having a record of success in promoting spinout companies, they identify a four-stage process model of start-up. This highlights the very different support needs of academic entrepreneurs at different stages of the start-up process as well as the key issues which arise at each of the stages. The discussion in Ndonzua and others (2002) is summarized in Figure 5.3 emphasizing the initial ideas generation and finalization processes within the university and subsequent company growth and strengthening. For an illustration of the application of the Ndonzua and others model see Box 5.3.


**Figure 5.3**

*A process model of academic spin-outs*

Source: Based on the discussion in Ndonzau et al. (2002).

**BOX 5.3 NOLDUS INFORMATION TECHNOLOGY**

Lucas Noldus, the founder of Noldus Information Technology, was a PhD student at Wageningen University in the Netherlands. His research focused on the behaviour of wasps and led to the development of the initial version of 'The Observer', a software program for behavioural research (Ideas generation). Building on this prototype program, Noldus drew on the expertise and resources available in the university – office space and incubator facilities – to develop commercially saleable versions of the software and protect his IP (intellectual property). The university was also the first customer for the software, providing a validation of its value (Finalize ideas). Noldus Information Technology was launched with support from Senter – a Dutch government agency with a mission to promote new technology-based firms. Government grants and technical subsidies also provided support for R&D and product development (Company launch). Profits recycled into the firm also provided resources for new software product development. This organic growth and reinvestment has continued and today the company employs around 100 people in Wageningen Science Park and sells a range of software and hardware products to 4,400 customers worldwide (Strengthening the firm).

Sources: [http://www.noldus.com](http://www.noldus.com) and Elfring and Hulsink (2003)

**5.4 SUMMARY AND KEY POINTS**

For most people the start-up decision marks the end, and perhaps also the beginning, of a process as they move towards becoming an entrepreneur or ownermanager. The empirical evidence suggests some commonality about the type of institutional factors
which shape this process – finance, fear of failure, market opportunities – but also stresses the difference in the extent of these barriers towards entrepreneurship. In the less developed, Factor-driven economies, for example, the barriers to entrepreneurship – reflected in a lower conversion ratio – seem markedly greater than those in the Innovation-driven economies. While this may be enabling entrepreneurship to have more positive innovation, job creation and cohesion effects in the Innovation-driven economies (see Chapter 3), it remains the case that overall levels of both opportunity and necessity-driven entrepreneurial activity are higher in the Factor-driven economies.

Differences between countries in the barriers to entrepreneurship and the balance of opportunity and necessity-based entrepreneurial activity (or pull and push factors) again emphasize the contextual nature of entrepreneurship. In an international or comparative context this emphasizes the role of the institutional environment in shaping, and being shaped by, the entrepreneurship decision (McDade and Spring, 2005, Lu and Tao, 2010). Process models suggest, however, that the entrepreneurship decision itself may reflect a number of different ‘activities’. Janice Langan-Fox (2005), for example, envisages a two-stage process in which individuals first choose to become an entrepreneur and second choose the type of business with which they get involved. Individual attributes and the institutional environment may shape both elements of the process suggesting the framework depicted in Figure 5.4.

![Diagram](image)

**Figure 5.4**

A contextualized process view of the start-up decision

Three features of this framework are perhaps worth highlighting. First, following Lu and Tao (2010) it links both individual attributes and the institutional environment to the
entrepreneurial decision process, with institutional environment moderating the effects of individual attributes. Second, as suggested by McDade and Spring (2005), individual entrepreneurship decisions may themselves influence the institutional environment. Finally, it is worth reflecting that thus far we are only at the outset of the entrepreneurial journey. Subsequent chapters deal with the next stages.

5.5 DISCUSSION QUESTIONS AND FURTHER READING

Detailed data on nascent entrepreneurship in individual countries is available in the GEM Global reports for some years. The GEM model – see Bosma and Levie (2010) – also provides a structured framework within which nascent and actual entrepreneurship can be compared. For more depth on the different perspectives on the start-up decision see: on the economics, Blanchflower and Oswald (1998); on the social perspective, Langan-Fox (2005); and on the process view Liao and Welsch (2008).

The start-up decision is strongly contextual and raises the following questions:

1. Issues related to finance and debt are often a major barrier to business startup. Why is this? What are the implications of a shortage of start-up finance?
2. Which conceptual approach to the start-up decision is most helpful in explaining the start-up decision made by (a) Richard Reed (Box 5.1) and (b) Rajeev Samant (Box 5.2)?
3. In the process model of academic spin-outs (Figure 5.3) how does the type of support needed by the entrepreneur change through the different stages of the process? Think about this with reference to Noldus Information Technology (Box 5.3).
Finance for Small and Entrepreneurial Business: Why is lending to - or investing in - a small firm difficult?
Chapter 2: Why is lending to – or investing in – a small firm difficult?

Lending money to anyone or buying any form of financial investment involves a degree of risk. Providing a loan facility to a sovereign government or a blue-chip company has some risk of default. Even so, billions are lent by banks to these borrowers every year. Also, thousands of retail investors buy shares in companies every day and an even greater number do so indirectly as well via unit trusts and pension funds.

However, without exception, direct commercial lending or investing in small businesses is commonly regarded as a specialised activity with some unique characteristics and risks. While later chapters review current attempts to introduce a new group of smaller lenders and investors into the small business funding market place, the perception that this is a specialised finance market persists.

A common misconception is that the difficulty in dealing with small business finance markets is the level of risk itself. Small businesses do have a much higher risk of default than blue-chip firms. For example, across the whole small business market place in the UK, even in a good year for trading, over 10% of all firms will cease to trade and around 2.5% of firms with a loan will default on payments. This default rate is at least five times greater than amongst listed companies. Although the likelihood of default for listed companies is very low, the value of every default can be exceptionally high but this still does not appear to be a major barrier to finding lenders.

Even so, lending or investing requires acceptance of a degree of risk in order to obtain a financial return. Adjusting the price charged to accommodate for the degree of risk allows any financial service provider or external investor to accept a level of risk. In the case of a debt provider, the price will be reflected via the interest rate; for an equity investor, it will be reflected in the price paid to acquire the shares in the business and the anticipated share of any future profit. Of course, extreme cases of high risk can be seen as too difficult to support ‘at any price’. However, these cases are rare. Many high street banks will already provide unsecured loan products to smaller firms with an assumed default rate of over 20%, although the interest rate could be close to 20% a year. Venture capital investors will probably achieve a portfolio return based on the profits from two investments in every five; the other three (i.e. 60%) would be a total loss. Consequently, a hierarchy of products exist with different risk-reward (see Figure 2.1).

Rather than the degree of risk itself in dealing with smaller-business finance markets, many investors are put off by the uncertainty around the likely return. In
effect, investors find it difficult to strike the correct price commensurate with the risk. Also, unlike other forms of financial investment, market liquidity is low, especially for equity investors, suggesting even if a mistake is made over an investment choice you may still be tied into a firm for some time. As a result, it is uncertainty of return rather than the level of risk itself that ensures small business external funding remains a specialist field of activity.

What are the particular issues in small business finance markets that lead to this heightened uncertainty? Three issues are cited by most commentators. Small business data is of mixed quality; it is often called an opaque market. As a result, the related issues of adverse selection and moral hazard are often cited as being very prevalent in this market. These are three core issues that attract a lot of academic research, which is not repeated here. Rather, a short outline of all three issues and what potential lenders and investors can do to address them provides a good starting point to look at individual financing products in more detail.

**Figure 2.1**
Risk, Reward and Funding Selection

**OPACITY IN SMALL BUSINESS INFORMATION**

The market information generally available about small firms is normally very limited in both scale and accuracy. Small businesses are normally privately owned. Most firms are owned by one person. For the minority that have multiple shareholders, these are often members of the same family.

The business owners may ultimately need to file tax-related information with the
public authorities and in some cases a business register (such as Companies House in the UK). However, the depth and scale of the financial information is often very limited and only filed in arrears. This is in direct contrast with larger firms with publicly traded equity that have more detailed filing requirements and a specialised industry (brokers) looking at emerging business events, as well as professional investors and the financial press.

Of course, business owners should know everything about the underlying position of the business. However, because external providers are often much less well informed the balance of knowledge is one-sided. This asymmetric information is a market failure. In publicly traded equities and debt instruments, a legal sanction is in place to stop insider trading by the officials who hold this knowledge. However, these rules do not exist in unquoted company transactions for debt or equity (apart from general protection against fraud).

To overcome this problem, the credit reference industry has tried to collect and analyse what information is available. In some cases, firms being scrutinised volunteer information as well. However, this does not solve the problem. While credit information is valuable it is still essentially backward-looking. Also, while volunteered data is also useful, the control of its release is still in the hands of the business owner.

The existence of opaque or ‘fuzzy’ business information on smaller firms is not just a market failure in the provision of business information. Rather, as a knock-on effect, it is also a market failure in the small and entrepreneurial business finance market. The opacity, or lack of clarity, created by less than perfect information accessible to all generates the opportunity for incorrect decisions around lending and investment decisions. This is illustrated by the two related additional problems arising from information asymmetry that all external finance providers need to address in one form or another.

**Adverse selection**

The underlying poor quality of information makes it difficult for a lender or an investor to select who to fund rather than reject. Of course, the same problem does exist for the very largest firms as well but the level of uncertainty is much lower because the quality of information is much higher. The possibility of adverse selection refers to such an outcome. Either a ‘good’ applicant is denied funds or a ‘bad’ one is wrongly accepted. These two possible outcomes are often referred to as Type 1 or Type 2 errors, mirroring the outcomes of statistical hypothesis testing.

In a start-up situation, it can be argued that the roles are reversed. A funder may
have more realistic and wider market knowledge than an entrepreneur. This could be used to leverage a deal on too favourable terms to them. In practical terms, reverse information asymmetry such as this is more likely to assist the funder in more correctly assessing who to decline and could indicate the market failure is less evident in some circumstances.

**Moral hazard**

In discussions between a finance provider and a business owner, questions will be asked in order to help assess risk. It is possible that the owner will control the flow of this information in order to help a favourable outcome. In order to obtain funding, an owner may accept an offer of a very high interest charge or projected dividend schedule that they know is unrealistic to fulfil. In many countries such activity may be illegal but even if not it raises a question about honesty. However, the concept of moral hazard is much wider than a concern about honesty before a deal is arranged. Rather, the hazard extends to the behaviour of the business owner post the funding deal being arranged. Will the owner spend the funding in line with the business plan, or work as hard as promised to achieve the goal? Such issues form the core of many disputes between business owners and both debt and equity funders. Again, the heart of the problem is lack of information so moral hazard can also be called asymmetric information ‘after the event’ (while adverse selection is ‘before the event’).

**ADDRESSING INFORMATION ASYMMETRY**

All commercially based debt or equity investors will seek to reduce the incidence of adverse selection and moral hazard through a number of techniques. These activities fall into the following four main groups.

**Assessing applicant quality**

In debt markets, applications are normally appraised by a lender against a list of criteria; this may be a formal scorecard or, for larger loans, a series of tests applied against the business plan and other data supplied by the applicant. In the case of equity investors, going through a due diligence process before investment takes place is the norm. To varying degrees, a quality assessment will be included with all types of commercial finance products, as well as cash-flow-based activities.

**Terms and conditions**

Commercial funding is determined through assessment and negotiation. As a result, it is normal practice for an offer to supply finance to come with a range of terms and conditions as part of the deal offered back to the applicant. This may include regular access to private management information. A debt provider for
both entrepreneurial and cash-flow purposes may include terms such as the receipt of regular loan repayments by a fixed date each month or the operation of banking facilities (not going over an overdraft limit). For an equity investor in an entrepreneurial venture, they may ask for a seat on the board of a company.

**Asking for security and a personal stake**

Debt and equity providers will often be reassured if the business owners have personal financial exposure to the risk of the newly funded activity. Security can also include charges over personal assets attached to the business debt obligation by way of a personal guarantee outside of any limited liability. Although most equity investors cannot have security as such, many of them will often structure a deal to include both debt and equity. (Some more complex equity arrangements do offer limited security options as well.) Providers of entrepreneurial funding will often ensure the owner has a personal stake ('skin in the game').

**The price charged**

Debt funding on commercial terms for entrepreneurial and most cash-flow activities has to be priced above the cost of funding to the financial institution (where the cost includes the administrative charge to assess the loan as well). How much over this cost will reflect the view of the funder of the risk involved in each case. As debt investors can only get the return of the original funds lent plus interest, they have to charge all borrowers an insurance premium to cover the likelihood that some of them will default.

How far debt interest can be used to exert influence over both adverse selection and moral hazard is a matter for some debate. If good borrowers are charged too much they may decide to use alternative funding, especially when a wide range of providers are active in the market offering a lower price. Only higher-risk applicants will pay the higher price as they have more limited choice. Hence, in an effort to control moral hazard, a debt investor can end up with more risky customers only.

An equity investor on the other hand can structure the price of an offer in a number of ways. The price they are prepared to pay for the shares is important. This can be in terms of a price per share or what percentage of the voting rights in a business they acquire for a fixed investment sum. However, investors can also make additional arrangements linked to the price such as an understanding with the Board on dividend policy or direct board membership. Consequently, equity investors will typically look to fund higher-risk ventures than debt providers. The greater insight and control over the business they have allows equity investors to accept a higher risk in exchange for the prospect of a higher financial return (as
they have a right to a defined share of any future profits, unlike a debt investor whose receipt of interest is not linked to the success of the business). A key part in taking the higher risk is the enhanced assurances on the likelihood of a return through access to information from inside the management team.

**CONCLUSION**

Uncertainty of return rather than the absolute level of risk is the main reason why lending and investing in the small business market is seen as a specialised financial activity. This is particularly the case amongst entrepreneurial rather than established small firms. All funding – debt, equity or asset-based – seeks to reduce uncertainty through the appraisal of finance applications. This may be done simply via a standard scorecard or through a much less transparent interview and discussion process.

Moreover, a constant theme in this study is also to consider the techniques deployed by funders to try to control and reduce uncertainty. More examples of the activities commonly used are discussed in later chapters covering each of the product areas. Through looking at what funders want to achieve to control or at least better understand these risks on a case-by-case basis, applicants should find access to appropriate finance is easier to achieve.
Female Entrepreneurship: Financing women-owned businesses
Chapter 3: Financing women-owned businesses

7.1 INTRODUCTION

In this chapter the challenges faced by women when it comes to financing their ventures are discussed commencing with an overview of the demand and supply of finance required to support sustainable ventures. This will then be followed by a discussion of the key issues pertinent to women such as the so-called risk aversity of women, gender stereotyping and discrimination practices of financial institutions.

The chapter concludes with a spotlight on the Diana Project International (formerly known as the Diana Project), a US research initiative established to investigate the growth models pursued by female entrepreneurs and the supply and demand of venture capital.

7.2 LEARNING OBJECTIVES

On completion of this chapter, students should be able to:

1 Recognise the challenges faced by female entrepreneurs when it comes to financing their ventures.

2 Understand such challenges from both a demand and supply side perspective.

3 Challenge the myths and stereotypical assumptions associated with women and equity finance.

7.3 ACCESSING FINANCE

Accessing appropriate finance is a documented challenge for business owners per se; however, there is a well researched body of literature to indicate that female business owners experience additional disadvantages as a result of their gender (Bhide, 2000; Carter, 2000; Marlow and Patton, 2005). According to Hisrich (1985: 73) 'while financing is a problem for every entrepreneur, for women entrepreneurs the problem is even more acute'. This problem is particularly significant given the importance of appropriate start-up capital in terms of sustainability, growth and performance (Mason and Harrison, 1992; Becker-Blease and Sohl, 2007). Persistent and consistent across countries, there is evidence to suggest that female entrepreneurs tend to use significantly smaller amounts of start-up capital than their male counterparts (Minniti et al., 2005). In their study in the United Kingdom, Carter and Rosa (1998) found that although men and women use similar sources to finance their ventures, female entrepreneurs rely on a third of the capital used by their male counterparts. The reasons as to why women use
significantly less capital than men may be due to the fact that women are more likely to launch businesses out of necessity (Minniti et al., 2005), start businesses in low-capital intensive sectors (Orser et al., 2005), tend to be more risk averse (Marlow, 2010) and encounter discrimination in financing practices (Verheul and Thurik, 2001; Harrison and Mason, 2007). Moreover, they also command lower levels of funding, depend upon informal or more expensive sources of finance, in addition to relying on limited business networks (Thompson et al., 2009).

Consequently, there are significant differences in the capital structure of male and female-owned businesses (Verheul and Thurik, 2001). Accordingly, women are more likely to start up businesses with lower levels of initial capitalisation, utilise lower ratio of debt finance and are less inclined to use private equity finance (Marlow and Patton, 2005). Initial undercapitalisation may have an impact on growth and subsequent performance (Carter and Allen, 1997) as a direct correlation has been made between starting capital and long-term performance of the firm (Watson, 2002). Accordingly, financial constraints and undercapitalisation is often presented as a reason for the underperformance of women-owned businesses (Orser et al., 2005; Coleman, 2007).

### 7.4 Challenges Faced by Female Entrepreneurs

Despite the financing of female-owned businesses being the most researched area within female entrepreneurship (Gatewood et al., 2003; Orser et al., 2005; Harrison and Mason, 2007), there is still some conflicting evidence regarding the challenges faced by female entrepreneurs when it comes to raising finance (Carter et al., 2001). This debate is largely based on the lack of unequivocal evidence to support claims that women face credibility issues with lenders (Brush, 1992; Mahoot, 1997; Carter and Rosa, 1998). In fact, Carter and Allen (2001) identified four areas where women may face difficulties when it comes to the financing process.

First, women may be disadvantaged in their ability to raise start-up capital (Van Auken et al., 1993; Carter and Rosa, 1998). Second, women may have difficulties providing guarantees due to limited personal assets and credit rating (Hisrich and Brush, 1986; Riding and Swift, 1990). Third, they may face difficulties related to accessing informal financial networks to support the ongoing growth of their businesses (Aldrich, 1989). Finally, issues related to gender stereotyping and discrimination (Greene et al., 2001). Existence of gendered stereotypes can actually act as a barrier to women securing finance as they feed negative assumptions about the relationship between women and entrepreneurship. Whether female entrepreneurs apply to an institutional financier (a bank, a finance agency), a friend, a relative or even her spouse, they are likely to come up
against the assumption that ‘women can’t handle money’ (Bruni et al., 2004a: 262). In France for example, a married women was not allowed to open a credit account without her husband’s consent until 1965 (Veil, 1994). Furthermore, it was not until 1975, that the Equal Credit Opportunity Act was passed in the United States. Table 7.1 sets out the ‘bootstrapping strategies’ used by female entrepreneurs (center for Women’s Business Research, 2012).

### 7.5 PECKING ORDER HYPOTHESIS

The majority of women-owned businesses are financed by personal savings (love money), family and friends, credit cards and some bank finance (Brush et al., 2006). There is evidence to suggest that business owners regardless of gender have preferences for personal savings including contributions from family and friends and bank lending (Marlow and Patton, 2005). These preferences seemed to be more predominant in women as the debt-risk aversion appears to be stronger in this group (Kepler and Shane, 2007). When it comes to the capital structure supporting entrepreneurial ventures, Myer’s (1984) Pecking Order of Capital Structure Theory explains the preferential treatment given by entrepreneurs to certain types of funding at different times. This is also what Harrison and Mason (2000) referred to as the ‘pipeline’ model, whereby business owners will approach the four main sources in the following order. First, personal savings as well as investment from family and friends; second, debt financing, which is normally bank finance although it can also include hire purchase and leasing; third, government grants and finally venture capital and informal/private equity (Jarvis,
2000). Funding is sought in a hierarchical pattern, commencing with informal sources followed by bank finance and then equity funding (Cassar, 2001).

7.6 BANK FINANCE

Banks are the critical source of external funding (Verheul and Thurik, 2001; Marlow and Patton, 2005) for small firms. According to Mirchandani (1999) female entrepreneurs’ creditability and legitimacy, when it comes to securing bank loans, is influenced by the age and size of their business in addition to the industrial sector. Socio-economic positioning whereby women launch businesses which they can keep small and manage from home with little start-up capital will evidently impact on their funding requirements (Marlow, 2002). However, women are more likely to be discouraged borrowers as they perceive that they will be rejected when they apply for bank funding (Kon and Storey, 2003; Hill et al., 2006; Roper and Scott, 2007); this may in part explain the less likelihood of women applying for credit (Orser et al., 2005).

Discriminatory practices have been cited as one reason for female entrepreneurs’ difficulties in securing debt finance (Carter et al., 2001). Although more anecdotal and of an individualised nature, there is some evidence of the existence of discriminatory practices in the interactions between bank managers and female entrepreneurs (McKechnie et al., 1998). However, many bank managers refute the claim of gender bias and state that they are only interested in the entrepreneurial profile, male or female (Orhan, 2001). In fact, banks’ refusal of loans is attributed to discrimination rather than poorly constructed business plans (Buttnner and Rosen, 1992). However, women may obtain credit under less favourable conditions in comparison to their male equivalents (Coleman, 2000). This is supported by Fraser (2005) who found evidence of women being asked for higher levels of collateral and/or being charged higher interest rates on loans compared with male entrepreneurs.

Evidently, bank lending policies and procedures may disadvantage or discriminate against women (Carter and Shaw, 2006). However, rather than discriminating against women as a group, it appears that it is the size, age and industrial sector of their ventures that contributes to their inability to secure bank finance. According to Coleman (2000: 49) ‘banks discriminate on the basis of firm size, preferring to lend to larger and one would assume more established firms’. Furthermore, Fay and Williams (1993: 65) state ‘bank staff are not guilty of discrimination in such situations, rather applicants’ socialization and work related experiences have disadvantaged them compared to male applicants’. However, difficulties faced by women when raising finance may well be the result of their failure to conform to the normative entrepreneurial image (male) as opposed to discriminatory
practices by finance providers (Bruni et al., 2004a). Added to this, bank managers’ perceptions of female entrepreneurs may ‘reflect men’s inability to split the feminine image into two: a woman and person; the business woman wanted to be treated just like any other person, but for most bank managers “any other person” means a man’ (Hertz, 1986: 191). Thus, women may not fit the stereotypical image of the ideal entrepreneur (Ahl, 2004) and so are under constant pressure to demonstrate their entrepreneurial ability (Orhan, 2001). In fact, studies focusing on bank managers’ perceptions of entrepreneurs confirmed that male entrepreneurs scored higher on characteristics affiliated with successful entrepreneurship than female entrepreneurs (Buttner and Rosen, 1992; Carter and Allen, 1997). Although Buttner and Rosen’s (1992) study supported the existence of gendered stereotypes amongst bank managers’ evaluation of business plans, there was no evidence to support the influence of such stereotypes on their lending decisions. Evidence with regards to discrimination in financing practices is mixed due to the difficulty in the attainment of reliable data thus making it difficult to unequivocally support claims that supply-side discriminatory practices are prevalent (Carter et al., 2007). Thus, although gender matters (Alsos et al., 2006), it would be wrong to conclude that women’s restricted access to debt finance particularly bank loans is solely the result of discriminatory practices (Orhan, 2001).

7.7 DEMAND-SIDE RISK AVERSION

In addition to issues related to the supply of finance, there also appears to be debt aversion among female entrepreneurs. In fact, there is a significant body of evidence which represents women as risk averse and as having a lower propensity towards risk than men especially when making financial decisions (Minniti, 2009). So, for example, evidence drawn from a range of academic disciplines and enacted scenarios supports the notion that young males have the highest degrees of risk tolerance whilst women of all ages exhibit risk avoidance (Byrnes et al., 1999; Kepler and Shane, 2007). Drawing upon evolutionary analyses as explanatory devices (Kaplan and Hill, 1985; Smith and Bird, 2001), it is suggested that women’s traditional protective parenting role, their socialisation as carers and nurturers and greater vulnerability to violence has discouraged risk taking, embedded within a greater sensitivity to loss and so, promotes risk avoidance. Thus, women are portrayed as cautious borrowers with a preference for informal funding (Fraser, 2005; Carter and Shaw, 2006). This finding remains constant even when variables such as business size and sector are manipulated (Watson, 2002; Hill et al., 2006; Carter et al., 2007; Roper and Scott, 2007).

Accordingly, femininity and risk aversity become interlinked; this association is
deemed problematic as it informs women’s reluctance to use formal financial products or to seek higher levels of investment to support sustainable start-ups and to promote future growth (Marlow and Patton, 2005). As a result of a supposed lower tolerance to risk, women are believed to prefer the less risky option of higher safety as opposed to higher profits (Watson and Robinson, 2003; Kepler and Shane, 2007). In fact, the extant evidence regarding women and entrepreneurial risk taking portrays women as disadvantaged. So for example, Brush et al. (2006) found that women had a preference for businesses with lower failure probabilities and were less willing to exchange gain for risk, in addition to spending more time and effort minimising risk. However, the idea that women are more risk averse than men has been contested by those who claim that women’s risk aversity must be sited within the entrepreneurial context which is perceived to have high levels of risk and as such is a rational response (Sonfield et al., 2001; McGregor and Tweed, 2002; Marlow, 2010).

7.8 VENTURE CAPITAL

Although gender differences in securing debt finance have been given considerable attention (Buttner and Rosen, 1988; Riding and Swift, 1990; Coleman, 2000; Orser et al., 2005), less attention has been paid to women’s experiences of accessing external equity finance (Mason and Harrison, 2000; Brush et al., 2001a). Within the area of gender and venture equity finance, there is a dominance of research that relies on US samples (Hill et al., 2006), leading to calls for more research which explores the experiences of women business owners in other geographical regions (Orser et al., 2005) as findings from US samples may not be directly transferable or reflective of other contextual settings (Ahl, 2004; Harrison and Mason, 2007). Whilst there are acknowledged disadvantages associated with equity funding such as constraints upon entrepreneurial prerogative and pressure to expand sales and market share (Busenitz et al., 2004; Wijbenga and Postma, 2007), the benefits are well documented. The importance of venture capital is noted by Bygrave et al. (2002: 105): ‘entrepreneurs are the engines that drive new companies and financing is the fuel that drives them. Hence, financial support, especially equity finance for starting a company, is an important entrepreneurial framework condition’. Venture capital investment supports early stage growth (Barney et al., 1996; De Bruin and Flint-Hartle, 2005) with such firms achieving higher survival rates and leading roles in product and process innovation (Sandberg, 1986; Feldman, 2001; Franke et al., 2006). Despite this recognition, in all of the GEM countries combined, approximately only 15,000 companies were funded in 2008 compared to tens of millions that were funded by informal investment. As such, the likelihood of raising venture capital is very rare;
in fact evidence indicates that fund managers only invest in approximately 5 per cent of the opportunities presented to them (Berlin, 1998). Interestingly, it is claimed that in the United States, ‘a person has a higher chance of winning a million dollars or more in a state lottery than getting venture capital to launch a new venture’ (GEM, 2009: 57).

Women are less likely to apply for venture capital funding than their male counterparts (Orser et al., 2005); thus, a gender gap/disparity exists when it comes to securing venture capital (Morris et al., 2006). Although women-owned businesses account for 30 per cent of businesses in the United States, less than 5 per cent are financed by venture capital funding (Brush et al., 2002). Of those women who are successful, they on average obtain significantly lower amounts of venture capital than their male counterparts (Gatewood et al., 2003). According to Greene et al. (2001) reasons for women’s difficulty in securing venture capital include the structural barriers faced by women in this process, women’s aversion to such finance (as there is evidence to suggest that women may value the retention control more than men) (Cliff, 1998), and women’s lack of human capital which is deemed necessary by such finance providers. Furthermore, venture capitalists traditionally are attracted to high technology sectors which have the promise of high return; as women’s businesses tend to be located in the retail and service sectors, they may not be of interest to venture capitalists (Brush et al., 2001b). And although women may be found in high technology start-up teams they are however, ‘noticeably absent from the leadership positions in venture-funded start-ups’ (Brush et al., 2001b: 1).

Furthermore, women’s reduced time spent within the labour market, coupled with industrial experience gained predominately in the retail and service sectors may diminish their credibility when it comes to accessing equity finance (Boden and Nucci, 2000). In fact, Carter et al. (2003) found that human capital (graduate education) influenced an entrepreneur’s ability to gain venture capital funding; with human capital referring to resources acquired as a result of education, managerial experience and industrial sector knowledge (Teece, 2011). Another reason cited for women’s lack of engagement with venture capital may be inadequate networking, as this is an important catalyst in the successful acquiring of venture capital (Becker-Blease and Sohl, 2007). The preference by women to have female-dominated networks coupled with the male dominance of the venture capital industry diminishes the likelihood of women’s networks overlapping with venture capitalists (Gatewood et al., 2009); therefore access may be difficult without appropriate networks and gatekeepers. In effect, it is likely that women will have difficulties gaining access to key individuals who may be
influential in helping them secure equity funding (Manolova et al., 2007).

### 7.9 BUSINESS ANGELS

Research on equity finance has predominantly focused on venture capital finance; however, business angel finance is a critical source of venture capital especially at the seed and start-up stages (Mason and Harrison, 1999; Brush et al., 2002). Business angels are typically high net worth individuals who provide risk capital, in addition to providing a new venture with focus, credibility, networks, experience and expertise (Mason and Harrison, 1999; Becker-Blease and Sohl, 2007). In fact, access to the business angel’s ‘gold plated rolodex’ is often regarded as the key difference between venture capitalist and business angel finance (Amatucci and Sohl, 2004). Such capital is often regarded as the important preliminary stage of securing formal venture capital (Freear and Wetzell, 1992; Mason and Harrison, 2000). Despite this importance, business angels are notoriously difficult to identify and prefer to remain on the margins of the investment community (Mason and Harrison, 1999). Consequently, there has been a paucity of research with regard to women’s access to angel financing (Mason and Harrison, 2000). According to Brush et al. (2004: 56) ‘although finding and engaging angel investors is a challenge for anyone, women entrepreneurs have experienced particular difficulty’. In Becker-Blease and Sohl’s (2007) comparative study investigating whether women and men have equal access to angel capital, the authors in fact found no significant differences in the percentage success rate of women (13.33 per cent) and men (14.79 per cent) obtaining capital investment. However, biological gender did emerge as a differentiator in the disproportionate share of applications made, with women only submitting 8.9 per cent of proposals within this sample.

Another study focusing on five women who had secured business angel finance by Amatucci and Sohl (2004), identified challenges in the process due to lender stereotyping assumptions regarding their ability as entrepreneurs despite their educational and work experience. The exploration of women’s role in the supply (equity provider) and demand (equity seeker) of equity also identifies the limited number of female business angel investors (Mason and Harrison, 1992; Becker-Blease and Sohl, 2007). In fact, Harrison and Mason (2007) posit this figure to be approximately 5 per cent of all business angel investors. This is of significance, as there is evidence to support homophily within the business angel market, whereby entrepreneurs have a strong preference to submit proposals to angel investors of the same sex (Becker-Blease and Sohl, 2007). To conclude, the low proportion of women-owned businesses acquiring angel capital should be considered in relation to the low number of female entrepreneurs seeking such
capital and the limited number of female business angel providers.

7.10 THE DIANA PROJECT

The gender gap in venture capital has been the driving force behind the Diana Project International, a research initiative set up to investigate growth models pursued by female entrepreneurs and the supply and demand of venture capital. According to Brush et al. (2001b), women are constrained by myths associated with their gender when it comes to attracting venture capital. The persistence of such myths and stereotypical assumptions may in some way explain why women’s ability to secure

BOX 7.1 SPOTLIGHT ON THE DIANA PROJECT

The Diana Project is a research collaboration focused upon the study of female business owners and their business growth activities. The original purpose of the Diana Project was to investigate the apparent disconnects between the high growth potential of women owned businesses and the resources needed, particularly equity funding, to finance this growth. There are two primary objectives:

1 To raise the awareness and expectations of women business owners around pursuing growth for their firms, and to educate these women about the characteristics of equity funded businesses and how the equity funding process works.

2 To increase recognition among equity capital providers about the advantages of investing in women owned businesses.

The Diana Project has expanded into the Diana Project International which is focused more broadly on scholarship regarding all types and forms of women’s entrepreneurship and growth. Diana International serves as a convenor for researchers interested in this topic, holding bi-annual conferences in locations around the world. Diana International highlights high-growth, women-led ventures around the world. Currently more than 250 researchers from 37 countries and even more than 45 universities are involved in this consortium. Diana International has produced 7 International Conferences, 3 books and 7 Special Issues of Academic Journals. This research is used as an impetus and foundation for the implementation of policy, training and resources that help advance the state of practice of women entrepreneurs.

By Professor Candida Brush and Professor Patricia Greene

Source: http://www.gemconsortium.org/docs/download/768

equity finance is limited. These myths are the guiding framework used by the
Diana Project International to explore the gender gap in equity financing strategies between male- and female-owned ventures. The Diana Project International claims ‘that there is a substantial funding gap that limits woman’s opportunities to grow their ventures aggressively and to lead high-value firms’ (Brush et al., 2002b: 1).

7.11 SUMMARY

Within female entrepreneurship, finance is the most researched area and as a consequence there is evidence to suggest that gender differences exist when it comes to raising external finance. Some of the reasons cited to account for such differences include the dominance of women-owned businesses in retail and service sectors, the risk aversity of women and gender stereotyping and discrimination. In fact, discrimination has been offered as a reason for undercapitalisation of women-owned businesses in relation to their male counterparts. However, the findings are mixed. In fact, there is little evidence of explicit discrimination and women’s difficulties in raising finance may be more due to industrial sector (low growth and limited market expansion potential) and poorly constructed business plans rather than an outcome of their characteristics or their ability to run successful enterprises. More recently, greater attention has been paid to the challenges faced by women when securing equity finance. Although to date the majority of such research has focused on US samples, interesting insights have been provided into the gender equity finance gap. In fact, the question as to why so few women use venture capital to fund their ventures was the initial driving ethos behind the Diana Project International.

**BOX 7.2 EIGHT MYTHS ABOUT WOMEN AND EQUITY CAPITAL**

1. Women don’t want to own high growth businesses.
2. Women don’t have the right educational backgrounds to build large ventures.
3. Women don’t have the right types of experience to build large ventures.
4. Women aren’t in the network and lack the social contacts to build a credible venture.
5. Women don’t have the financial savvy or resources to start high growth businesses.
6. Women don’t submit business plans to equity providers.
7. Women-owned ventures are in industries unattractive to venture capitalists.
8. Women are not a force in the venture capital industry.

Source: www.dianaproject.org
7.12 DISCUSSION POINTS

• ‘Women are more risk averse than men.’ Critically evaluate this statement using examples to justify your answer.
• Identify ways in which women can effectively ‘bootstrap’ their ventures.
• Select two of the eight myths identified in Box 7.2 and discuss their impact on women’s attainment of equity capital.
CHAPTER 4

Resourcing the Start-Up Business: Bootstrapping the start-up business
Chapter 4: Bootstrapping the start-up business

8.1 INTRODUCTION

Unless pursued in a perfect financial market, securing resources to exploit business opportunities is beyond the capabilities of most young entrepreneurs. In addition to facing disadvantage due to the liabilities of newness, these entrepreneurs often have limited potential for internal cash generation through realization of economies of scale. This puts pressure on the entrepreneur to enter into negotiations with traditional institutional sources such as banks. When they are inexperienced and lack a reputation in debt markets, external finance is difficult to access, expensive and often makes a negligible contribution to the early stage resource base of the entrepreneur. More specifically, financial investors are sceptical of new entrepreneurial ventures' potential for success due to substantial information asymmetries. High monitoring cost, moral hazards and associated mistrust are overheads for financiers who make unfavourable investment decisions. As a mechanism to shield them from financial risks and to recover overheads, lenders often put additional constraints on lending terms, making external finance prohibitively expensive for the entrepreneur (Cassar 2004). This puts more pressure on the entrepreneur as expensive repayments further limit the cash-flows that are essential to set-up and run a successful new venture.

Given problems in securing market solutions to resource needs, there has been a push for entrepreneurs to seek resources by applying different kinds of financial bootstrapping methods. Bootstrapping promotes personal, intangible and opportunistic mechanisms to enhance entrepreneurs' ability to use and extract value from resources without necessarily gaining the ownership of the resource at hand. These methods collectively reduce the need for outside finance, improve cash flow and enable entrepreneurs to operate their businesses in a resourceful and creative manner. Bootstrapping has become a vital part of entrepreneurial finance, with as many as 80–95 per cent of entrepreneurs utilizing some form of bootstrapping in the early stages of business start-up (Bhide 1992, Harrison et al. 2004). The general assertion is that venture creators can use bootstrapping effectively to improve the chances for entrepreneurial success and provide opportunities for future growth if it is managed strategically.

In this chapter, we intend to demonstrate the use of bootstrapping as an alternative solution to traditional financing strategies. We first provide our working definition for bootstrapping and the theoretical position we take in explaining bootstrap behaviour by new entrepreneurs. We follow this with a discussion of different types of bootstrapping techniques entrepreneurs can consider when resourcing their ventures. Understanding how the entrepreneurs' financing preferences and the type of
opportunities they are pursuing influence choices is important for those who wish to pursue a career in entrepreneurship. Also included in the discussion is a brief note about the gendered nature of bootstrapping and an explanation of how the preferences and the nature of bootstrapping vary over the course of the business lifecycle. Finally, we discuss how an entrepreneur might better position their venture for growth by adopting a range of bootstrapping behaviours.

8.2 LEARNING OBJECTIVES

- To analyse the importance of bootstrapping as an alternative resource strategy for those who face capital market imperfections.
- To describe different types of bootstrapping available for the entrepreneur to resource their ventures.
- To explain how the entrepreneur’s motives and gender roles influence the bootstrap decision.
- To demonstrate bootstrapping as relevant to business lifecycle.
- To evaluate the potential of bootstrapping as a business growth strategy for the entrepreneur.

8.3 DEFINING THE CONCEPT AND THEORETICAL PERSPECTIVES

Financial bootstrapping has developed around the idea that resources not owned or controlled by the entrepreneur often play a key role in pursuing new opportunities for those who are resource-constrained. It essentially acknowledges resource acquisition that is either internally or externally generated and is often available at zero cost, or at least, below market price. Harrison et al. (2004: 308) define bootstrapping as a venture strategy that involves creative and economical means for ‘marshalling and gaining control of resources’. They highlight two forms of bootstrapping strategy that operate in practice. The first form involves being resource ‘rich’ without recourse to bank finance or external equity finance. There are instances where entrepreneurs have no alternatives other than to resource the venture activities through borrowings from personal credit cards or cash generated by cross-subsidizing from other activities. The second form includes strategies that minimize the need for finance by securing resources at little or no cost. Such strategies largely refer to network advantages as social contacts often provide the entrepreneur access to free resources or resources accessed through subsidized rates (see Chapter 5 for a fuller discussion of entrepreneur networks).

The traditional view of bootstrapping coincides with a number of theoretical perspectives (see Figure 8.1). First, pecking order theory (Myers 1984) indicates that due to the existence of asymmetric information and monitoring costs, the higher risks associated with start-ups mean external financers demand higher returns on loans. Consequently, entrepreneurs are likely to resort to internal finance and will only raise
external funds when retained earnings are depleted. Resource-constraint theory provides another interesting perspective to the idea of bootstrapping. It argues that entrepreneurial ventures may grow despite owning a limited resource base through more efficient use of limited resources at hand. For example, entrepreneurs can exploit available resource inputs more effectively by recombining them to make unique resources useful to build competitive advantage (Baker and Nelson 2005). Development of cash management skills and the use of network ties to gain access to resources are other typical examples within this context.

A third, and the most widely used, theoretical explanation for overcoming the inherent deficiencies of gaining access to formal finance and still running a successful venture is based on resource-dependency theory (Pfeffer and Salancik 1978). Resource dependency takes on the 'open systems' model to the problem and defines organizations as strategic agents that are strongly influenced by their external environment (Bretherton and Chaston 2005). As entrepreneurs do not possess all the resources they need, the environment in which their firm operates

![Figure 8.1: Bootstrapping: a theoretical explanation](image)

is a very important resource base. Indeed, the extent to which an entrepreneur is dependent upon a given environment/social group can be determined by the organization's need for the resource controlled by that environment/social group. Therefore, the types of responses that organizations exhibit depend on the level and nature of dependencies they develop (Villanueva et al. 2012). As new ventures develop, dependencies will change, and therefore some alteration to the availability and desirability of the bootstrapping techniques is inevitable. This suggests that organizational theory also plays an important role in explaining the bootstrapping
behaviour in new ventures (Ebben and Johnson 2006).

8.4 DIFFERENT TYPES OF BOOTSTRAPPING METHODS FOR THE ENTREPRENEUR

A number of models have emerged to explain the process of bootstrapping and the associated practices. Common to all these models is the view that entrepreneurs at inception are less likely to be funded through traditional sources and that capital minimization is a common practice. While the former rests on the notion that seeking alternative means to raise cash are important start-up and survival strategies, the latter recommend practices that minimize cash flow and business expenses, thereby opening up opportunities for exploring and expanding new ideas.

Work by Winborg and Landström (2001) has made a major contribution to our understanding of bootstrapping techniques (see Figure 8.2 for a summary). Their in-depth study using a sample of over 800 small businesses revealed the qualities of financial bootstrappers whose behaviour differed according to internal, social and quasi-market modes of resource acquisition patterns. These modes of bootstrapping generally fall into five groups (see Table 8.1).

The first group, 'owner-financed' bootstrapping includes methods the owner and his/her family and friends use to acquire necessary resources for the venture. These methods include using personal loans or own savings, cross-subsidizing through multiple assignments, using a private credit card for business expenses, withholding salary, and relatives working for the entrepreneur for free or belowmarket salary (see Box 8.1).

The second group, payment-related bootstrapping, is a combination of the practices associated with 'minimization of accounts receivable' and 'delaying payments'. These methods together provide cash-flow advantages to the entrepreneur through speeding up invoicing, using interest on overdue payments, negotiating longer terms with suppliers and practice leasing then making full payments during equipment purchase.

Customer-related bootstrapping (Group 3) includes practices such as obtaining advance payments, ceasing relations with late-paying customers and charging interest on overdue invoices. While all of these methods tend to improve cash flow from customers, some of these can have a negative long-term effect in terms of maintaining customer relationships.
BOX 8.1

With my computer recycling company I was quite convinced that there was a viable enterprise in it and started working on it. My daughter had just been born and my wife wasn’t happy as she wanted me to go and get a job with somebody else, and I was convinced and I took on a supermarket free of charge, an old derelict supermarket in Toxteth – 5,000 square feet, and I filled it with computer equipment within weeks – just going out myself driving a van and picking stuff up and bringing it back, but those first six months were hard, and I just deferred any salary and ended up building up £20,000 worth of debt on credit cards – in the next year we got £40,000 worth of grants from the Liverpool City Council and I was able to pay that back and I said, ‘never again’ but I have done it again since, particularly the salary deferment because when things are tight or when you are trying to get over a hump, particularly with cash flow, but yes, all of the above salary deferment, credit cards, yes I’ve done them all.

[Paul, Wigan Recycling]

Figure 8.2
Bootstrapping techniques

These three methods are more internally oriented as they involve actively seeking means to improve internal cash flow either through introducing more discipline to entrepreneurial practices or through perseverance of the owner and his/her relatives.
The fourth group, 'joint-utilization bootstrapping', consists of a range of activities aimed at absorbing and borrowing resources at no/low financial cost from the entrepreneur’s social networks. The presence of interpersonal relationships with resource owners is instrumental in gaining access to this socially oriented resource acquisition. Some of the most common methods of joint resource utilization include bartering, sharing or borrowing employees, premises, equipment and other assets. Methods to take advantage of economies of scale, such as coordinating purchases with others, working in partnerships and outsourcing are also useful means of resource sharing for this relationship-based entrepreneurship. The degree of trust between parties appears to explain the level of usage and impact of this method of bootstrapping.

<table>
<thead>
<tr>
<th>Table 8.1 Bootstrapping: internal, social and quasi-market modes of resource acquisition</th>
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</table>
| **Internal mode of resource acquisition** | **Owner-related financing and resources** | **Use of manager’s credit card**  
| | | **Loan from relatives/friends**  
| | | **Withholding manager’s salary**  
| | | **Assignments in other businesses**  
| | | **Relatives working for non-market salary**  
| | **Customer-related methods** | **Cease business relations with late payers**  
| | | **Lease equipment instead of buying**  
| | | **Best conditions possible with suppliers**  
| | | **Offer customers discounts if paying cash**  
| | | **Choose customers who pay quickly**  
| | **Payment-related methods** | **Use routines for speeding up invoicing**  
| | | **Use interest on overdue payment**  
| | | **Delay payment to suppliers**  
| | | **Delay payment of value-added tax**  
| | | **Use routines in order to minimize stock**  
| **Social mode of resource acquisition** | **Joint-utilization of resources with other firms** | **Borrow equipment from others**  
| | | **Own equipment in common with others**  
| | | **Coordinate purchases with others**  
| | | **Share premises with others**  
| | | **Share employees with others**  
| | | **Practise bartering instead of buying/selling**  
| | | **Raise capital from a factoring company**  
| | **Subsidy finance** | **Subsidy from local, regional and national support and funding bodies**  

In addition to these four key bootstrapping methods, we have examples where subsidy finance or philanthropic capital from government and public organizations forms a major part of the resource formula for some entrepreneurs. This quasimarket mode of resource acquisition is particularly relevant for social entrepreneurs to discharge their
social duties.

8.5 VARIATIONS IN THE USE OF BOOTSTRAPPING

While all these methods are useful for gaining access to resources, it seems fair to assume a significant variability in the extent to which entrepreneurs rely on financial bootstrapping. Recent research shows how the use of bootstrap strategies varies per entrepreneur preferences, motives and business lifecycle stage. The following discussion addresses these contingency perspectives on bootstrapping.

8.5.1 Entrepreneurs' financial motives and the use of bootstrapping

Winborg (2009) provides empirical evidence to suggest three groups of new business founders, differing in terms of their relative importance of motives for bootstrapping. The first group's – 'cost-reducing bootstrappers' – choice of techniques is governed by their desire to minimize costs during financial or nonfinancial transactions. By minimizing outgoings, these entrepreneurs operate their businesses with low-levels of resource demands. The second group, 'risk-reducing bootstrappers', have a preference for bootstrapping as it helps to reduce the risks of entering into contracts with formal financial providers. These entrepreneurs perceive their ventures to be risky and are more likely to pursue bootstrapping rather than more formal means of resourcing their ventures (Carter and Van Auken 2005). Empirical evidence suggests that both these groups of entrepreneurs consider bootstrapping as an effective resource acquisition strategy and therefore seek every opportunity to access bootstrap resources rather than using them as a 'last resort'. The third group, 'capital constrained bootstrappers', choose to utilize bootstrapping as a means of overcoming financial constraints, and therefore, for them, bootstrapping is very much a survival strategy.

8.5.2 Gendered nature of bootstrapping

It has been argued that obtaining external finance is much more difficult for female entrepreneurs than for male entrepreneurs. Traditionally, women's limited human capital and the general trend that they operate small, service-sector firms, with less focus on growth, are the main supply- and demand-side challenges for female-owned businesses. Since external finance is difficult and costly to obtain, bootstrapping is vital for female entrepreneurs. There is also some variation in the type of bootstrapping techniques used by male and female entrepreneurs. Brush et al. (2006) revealed that while bootstrapping is a common phenomenon among female owners, how they use the various techniques is based on the type and the stage of their business development. At the emergent stage of their businesses, female entrepreneurs minimize capital by reducing labour costs. As they progress, their emphasis changes to focus on minimizing capital by reducing operational costs. Jayawarna et al. (2012) also observed clear gender differences in the use of bootstrapping techniques. While men
engaged in far more payment-related bootstrapping (customer and delay payment) activities than women, women made more use of joint-utilization and owner-related methods. Research evidence suggests that women have a significantly higher tendency to withhold salary, forgo income and subsidize the business with their personal credit cards than men (see Box 8.2).

<table>
<thead>
<tr>
<th>BOX 8.2</th>
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<tr>
<td>At the start, I charged ridiculous rates like £75 per day – stupid tiny amounts of money and got a few case studies of things that were working under my belt really. I think my first client was a photographer, something like that. I was working for one-man bands really and charging ridiculous fees. I also did some work for the previous company I had worked for and that subsidized the work that I was doing in the business.</td>
</tr>
<tr>
<td>[Anna Heyes, Active Profile]</td>
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According to Gupta et al. (2009), entrepreneurship is a ‘gendered profession’ (p. 409) and gender stereotypical differences place limitations on women’s ability to accrue necessary resources for their businesses. Following this line of argument, Jayawarna et al. (2012) studied how men and women bootstrap their resources following stereotypical views that female entrepreneurs are more cautious, have less business competence, are less strategic, less interested in growth and adopt a more participative management style compared with male entrepreneurs. The study confirms the importance of bootstrapping to both male and female businesses, but the techniques have distinct gender-related patterns. Women in general have a higher tendency to use owner-related and joint-utilization methods, whereas men’s bootstrapping practices are largely limited to payment-related techniques. This supports the broader view that individuals draw upon their own personal values, preferences and ambitions when choosing among alternative strategies (Carter et al. 1997). The results also provide strong support for the gendered nature of resource acquisition through payment-related methods; men make greater use of payment-related methods than women. It is possible to argue that a risktaking propensity, proactive thinking and perceived higher financial skills help men develop relationships with external parties, and these relationships are beneficial to negotiate payment-related resources with customers and suppliers. Similarly, behaviours associated with women entrepreneurs – including low risktaking, limited commitment to growth, participative management and limited business skills – are linked with higher use of owner-related and joint-utilization methods by women.

The association between resource acquisition patterns, networking behaviour and generalized gender characteristics also confirms that there are clear structural barriers, which mean that women are disadvantaged when starting new businesses (Greene et al. 2001, Manolova et al. 2006). For example, negotiating competitively to acquire
external finance, through brokers and bootstrapping supplier- and customer-related resources via weak ties, appears to require stereotypical masculine behaviour. Clearly, this presents problems if women are to acquire similar levels and types of resources as men. Concentration on strong ties means that female entrepreneurs will find it more difficult than men to obtain the resources necessary to grow their businesses (see Chapter 5 for a discussion of networking and resource acquisition).

8.5.3 Lifecycle approach to bootstrapping

Lifecycle research suggests that the financial structure followed by the entrepreneur should differ across the stages of organizational lifecycle, as different approaches are needed to finance the growth of the business at different stages (see Chapter 7 for more information). Within this hierarchical financial structure, it is argued that entrepreneurs will first seek funding through flexible internal sources, followed by bank financing (debt) and, finally, expensive equity capital financing (Cassar 2004). The administrative tasks of setting-up a business are diverse and entrepreneurs need to produce products/services cost-effectively to minimize financial burdens. Additionally, they have less formal organizational structures and therefore are resistant to formal contracts and relationships. Consequently, the use of informal, internal financing, such as bootstrapping, is more common among entrepreneurs in the emergent and early stages of business development. The purpose of bootstrapping at this stage is aimed towards minimizing expenses and meeting short-term cash-flow needs. As firms move from these early stages to stages of stability and growth (Chapter 10), resource constraints are likely to ease. Therefore, resource acquisition behaviour changes from an internal reactive approach to an external proactive approach, which minimizes the need for bootstrapping. During growth stages, entrepreneurs rely more on formal rules and procedures to ensure organizational and administrative efficiency, which makes formal financing a possibility for the entrepreneurs.

While entrepreneurs may use diverse sets of activities, lifecycle theories imply that the stage of the firm should affect the type of bootstrapping used in the same way as it affects the actual use of bootstrapping as a resourcing strategy across various stages of business development (see Figure 8.3). In other words, the type of bootstrapping used in different lifecycle phases should reflect differences in entrepreneurs’ need for capital as suggested by organizational development theories. In terms of the type of bootstrapping utilized, the stage model suggests that the methods change as the business develops. Certain methods are more widely used at the beginning of the lifecycle with different approaches becoming important as the entrepreneur gains experience in capital markets and building relationships with stakeholders.

Ebben and Johnson (2006) use resource-dependence theory to explain why entrepreneurs use different types of bootstrapping at different stages of business; they
also explain why certain bootstrapping methods are more prevalent than others. Their findings indicate that entrepreneurs who are forced to use boot-strapping methods at the early stages of start-up tend to adopt more attractive methods as they gain legitimacy and leverage. Resource-dependency theory is very relevant in explaining why entrepreneurs rely heavily on owner-related bootstrapping at the start and why this trend declines over time. As entrepreneurs pass the hurdle of information asymmetry, and establish close ties with investors, they are no longer keen to risk their personal wealth by making further financial investments. Resource-dependence theory also predicts that joint-utilization bootstrapping techniques should decrease over time. The entrepreneur’s personal credibility and the firm’s legitimacy are valuable resources for those operating in resource-poor environments. In the early stages, joint-utilization of resources acts as an effective way to obtain organizational legitimacy (through building relationships), which when developed could act as an effective way to access valuable resources from external parties as the business develops. Once the entrepreneur gains business credibility, they reduce their dependency on others for resource access purposes.

![Figure 8.3]

*Bootstrapping and business lifecycle*

Significant increases in the use of customer-related bootstrapping techniques over time explain the importance of maintaining strong relationships with customers. Initially, limited customer relationships mean that imposing trading rules is not
possible, and, instead, entrepreneurs should consider offering credit terms to improve sales and thereby increase working capital. With long-term customer relationships, entrepreneurs can replace credit terms with credit rules as these relationships help the firm to gain leverage to impose customer payment terms directed at enhancing cash-flow. Moreover, formal organization systems developed over time should lead to structured approaches to managing the customer base, which includes implementing systems that speed up billing and provide incentives for upfront or earlier customer payments (see Box 8.3). Unlike customer-related methods, explanation for the declining pattern of payment-related methods is not straightforward; the negative effects of compromising on time and quality of supplier service for cost and cash-flow are a possible explanation for the limited acceptance of favourable payment arrangements with suppliers and customers as a firm matures.

**BOX 8.3**

We have moved on from our early suppliers. The thing with suppliers is there are a lot of agents who are middle men and they take a couple of per cent, and unless you can get the factories, you can’t build a relationship and make them understand about good quality and what you expect from them, and so a lot of them we have moved away from and changed because other people will give us better prices – we now try to deal with the core factory that manufactures the product rather than those agents and buy bulk.

We’ve always been cash rich and have worked hard at chasing payments and things like that – we just run the business with common-sense. I think our systems contribute a lot in making that efficient because the systems we use invoice customers on the day which will then say you have 30 days to pay – it will then send reminders and issue a statement on the day saying we are now ready to collect money from you.

We went from a very labour intensive company to a systems base about six months before we moved here [to the warehouse]. When we implemented the system it enabled us, from one stock source, to sell across all of our channels and to know at any point in time what we had in stock. When an item was sold it would be deducted, the system creates an invoice, prints a dispatch note and addresses. It is able to tell us our daily sales, plot a graph and basically took out 90 per cent of the labour, which was just incredible.

[Ben Wilson, *Jazooli*]

**8.6 BOOTSTRAPPING AS A GROWTH STRATEGY**

Availability of resources continues to be the single largest predictor of entrepreneurial success and resource access though bootstrapping continues to contribute a major part in the resource formula for new entrepreneurs (Harrison et al. 2004). The main
questions are:

• Does bootstrapping create value, or simply reduce costs?
• Is it practical to use bootstrapping as a substitute for more traditional sources of funding and other resources?

Thus far, research evidence attempting to check the relevance of bootstrapping as a firm performance indicator has been mixed at best. Accessing resources through bootstrapping is contrary to the teaching of the traditional resource-based view, which predicts firm performance comes from the availability of ‘strategic resources’. Those who follow this view argue that while bootstrapping is a useful strategy for entrepreneurs to improve their chances of success, strategic approaches to bootstrapping are not practised by most entrepreneurs. The practice is largely reactionary in nature; entrepreneurs who already have acquired external finance are less likely to consider bootstrapping (Myers 1984). Many entrepreneurs use bootstrapping as a short-term reactive financing strategy largely focusing on cost reduction. Therefore, it is reasonable to assume that relying on bootstrapping may constrain firms from growing as fast as might otherwise be the case. Ebben (2009) also found detrimental returns from some forms of bootstrapping. The negative effects from higher levels of customer- and payments-related bootstrapping on profitability are due to the breaking up of customer–supplier relationships due to the rules imposed for short-term cash flow advantages. Vanacker et al. (2011) provided at least five reasons that undermine the use of bootstrapping as a growth strategy for entrepreneurs:

1 As bootstrapped firms tend to be undercapitalized, the resources acquired through bootstrapping will be largely insufficient to finance growth.

2 Resources obtained through bootstrapping underestimate the venture’s potential for future growth in the eyes of the stakeholders.

3 Managing bootstrapping activities takes time and limits the entrepreneur’s ability to concentrate on more critical tasks such as developing new opportunities.

4 Obtaining access to cheap resources through social contacts may bring imperfect resources.

5 The opportunity costs of identifying resource-rich social contacts are high; some techniques, such as delay-payments to suppliers can damage relationships with network providers.

Cornwall (2010), using evidence from a number of case studies, however, provides three explanations to clarify some misinterpretations about the relevance of bootstrapping as a resourcing strategy. First bootstrapping should not be seen as the cheapest way to resource a venture, but as a creative way to access the full benefits from the limited
resources available to new entrepreneurs. Second, evidence confirms that bootstrapping is not simply a survival strategy for new ventures, but it is a resourcing method for high-growth, high-potential ventures. Third, bootstrapping is also used as a resourcing strategy by businesses that make extensive use of debt and equity finance; it is not a choice between bootstrapping and gaining access to external funding through debt/equity.

Taken together the evidence suggests that entrepreneurs should use bootstrapping as a proactive strategy for preserving ownership and maintaining control of useful resources. At the emergent and start-up stages, entrepreneurs work in an environment characterized by resource constraints. It is possible to argue that, if the demand for resources exceeds availability, they need to be more efficient in the deployment of available resources. This causes entrepreneurs to develop management skills that help to exploit resource inputs from the external environment and effectively recombine those with the available internal resources (Smith and Smith 2000). This practice stimulates entrepreneurs to find more innovative ways to achieve growth in areas that resource-rich entrepreneurs would not necessarily consider. The general contention is that the use of bootstrap strategies is desirable as it helps entrepreneurs to focus on the efficient and more creative use of resources (Bhide 1992, Timmons 1999). This is particularly the case with women entrepreneurs as it signals to potential investors that they have the ability to generate internal funds, to control costs in creative ways and to gain access to other resources when access is limited. Effective execution of the start-up activities indirectly informs investors and other stakeholders that the entrepreneur has the potential to satisfy their growth expectations that come with their investments (Brush et al. 2006).

Interest in bootstrapping lies in the general agreement that there are benefits that go beyond its use as a creative means to access resources at the early stages of business start-up to greater opportunities for real growth. Jones et al. (2010a) adopt the concept of bricolage (see Chapter 9) to suggest that bootstrapping is a dynamic capability in new ventures. Bricolage helps flexible and innovative adaptation of acquired bootstrap resources through learning processes embedded in a firm’s routines (see Chapter 9 for a full discussion of dynamic capabilities in new ventures). Following this line of argument, there is evidence that bootstrapping contributes directly to entrepreneurs’ resourcing formula for value creation. There are examples that indicate that many successful companies, including Microsoft, Apple and Dell, relied on bootstrap finance and other resources when they started as small ventures, and this provided the foundation for achieving very high-growth (Tomory 2011; see Box 8.4). The environment created through bootstrap practices encourages entrepreneurs to make the most efficient use of their limited resource base. Bootstrapping not only introduces ‘a discipline of leanness’, which forces firms to spend and use resources wisely.
(Timmons 1999: 39), it also promotes rapid growth using ‘capital raising ingenuity’ (Brush et al. 2006). This practice of leveraging and stretching available resources provides an explanation for why some apparently undercapitalized ventures outperform ventures that are resource rich (Baker et al. 2000).

**BOX 8.4**

When Bill Gates and Paul Allen decided to form their own software company, Microsoft, they were determined to build it without outside financing and follow a ‘bootstrapping’ model. To avoid unnecessary overheads they moved into an inexpensive apartment and negotiated with MITS, the manufacturer of the Altair, for computer time and office space in their first years. Everything was funded through their savings from employment and ‘late night poker games’ (Gates et al. 1996, p. 19). Human resource has been a major challenge: they were understaffed and hired students on a part-time basis. Everybody worked over-long hours including the owners and were paid below industry averages.

Steve Wozniak and Steve Jobs raised $1,300 needed to get Apple started by selling Wozniak’s scientific Hewlett-Packard calculator and Jobs’s Volkswagen van. They were not only operating out of Jobs’s parents’ garage but received subsidized help from Jobs’s family in the assembly line and in day-to-day business operations. Additionally, they relied on their network of friends who offered free service and financial assistance, which included a $5,000 loan received from a friend of Wozniak’s father. Bills were largely paid by Wozniak’s salary from his job at Hewlett-Packard. This bootstrapping model of financing at the inception stage helped Wozniak and Jobs to give a sound foundation for Apple, which eventually formed as Apple Computer Inc. in 1977 after venture capitalist Mike Markkula underwrote a bank loan of $250,000.

At the age of 18 Michael Dell converted his informal business of upgrading IBM PC-compatible computers into an entrepreneurial venture, Dell Computer Corporation, using his savings of $1,000. Hit by cash deficiencies, Dell have employed every measure to ensure minimum spending and cut unnecessary operating costs. Dell, together with an engineer whom he hired to design his first computer, worked long hours in his own bedroom until he hired a few employees and moved to a 1,000-square-foot office to start formal manufacturing operations. Rather than employing additional staff, the foundation team increased their work hours to save financial resources towards staff salaries.

Source: Tomory (2011)

Bootstrapping strategies free new ventures from excessive debt and thereby take the pressure off entrepreneurs when seeking growth opportunities. Most importantly bootstrapping is a less risky option than external debt for nascent entrepreneurs, as
they have limited experience of investing finance wisely when it is available. Bootstrapping helps nascent entrepreneurs learn financial and resource discipline and provides valuable lessons in how to run an efficient business (Bhide 1992). In the long run, bootstrapping can be the basis for acquiring other resources such as new equipment, premises, outside equity investment or venture capital, which can support the next stage of growth (Carter et al. 2003, Brush et al. 2006). Also resourcing through bootstrapping provides flexibility to the entrepreneur in terms of the approach to the business. As informal options are often readily available and access to these options is dependent on short-term needs, bootstrapping helps embed dynamic capabilities within the nascent firm (see Chapter 9). Increased flexibility of resources (rather than the restriction of external resource-providers) is particularly useful for nascent entrepreneurs who want to change the strategic direction of their ventures whenever they feel is necessary. Moreover, entrepreneurs who actively engage in bootstrapping are able to respond more effectively to their customers (Carter et al. 2003, Brush et al. 2006). Flexibility in acquiring resources is particularly helpful for dealing with unpredictable sales and acts as a survival strategy for firms in competitive markets (Bhide 1992, Baker et al. 2000).

It may very well be that the bootstrapping impact on firm performance and its inimitability is an idiosyncratic contingency. Following Ebben's (2009) research it is reasonable to suggest that bootstrapping only has a systematic impact on the bottom-line when it is embedded in the firm's strategic objectives and provides solutions for strategic problems. A properly aligned process for bootstrap resources represents a core capability and can become a form of organizational capital. Jones and Jayawarna (2010) suggest that networking activity has a strong mediating role on bootstrapping on the performance of start-up firms (see Chapter 5 for more details). The study was based on the argument that the decisions to use joint-utilization and payment-related methods (Winborg and Landström 2001) are strategic, while owner-related techniques are largely used in reaction to cash flow problems and have little impact on longer-term business outcomes. Joint-utilization techniques are particularly important for start-ups as they incur very limited costs. Techniques such as sharing staff can provide valuable human capital, and equipment or premises sharing can release other capital to invest in resources essential for business development (Carter and Van Auken 2005).

8.7 BOOTSTRAPPING IN SOCIAL VENTURES

In the current economic climate, financial capital, albeit important, is used by only a small proportion of social enterprises. Non-monetary, alternative sources of funding have become a major resourcing strategy for social enterprises. A study by Jayawarna and Jones (2012) explored the role of bootstrapping in gaining access to non-monetary
resources for social enterprises during recession. Access to skilled voluntary labour (volunteer-based bootstrapping), competent, committed and ethical leadership (leadership-associated bootstrapping), and accumulation of social capital (relationship-oriented bootstrapping) has a critical role in this process (see Figure 8.4). Relationships may affect access, sharing and mobilization of bootstrap resources in the early stages of a social enterprise in multiple ways (Jayawarna and Jones 2012). Results indicate that relationship formation is one of the most useful mechanisms for social enterprises to accumulate and exploit social capital as well as brokering structural holes with key stakeholders. Social enterprises tend to establish close relationships with those who have a strong control over key bootstrap resources to overcome strategic and institutional weaknesses. A key finding is that relationship-based bootstrapping is as important to social enterprises as it is to traditional enterprises (Guo and Acar 2005, Meyskens et al. 2010a, Meyskens et al. 2010b, Moizer and Tracey 2010). Findings provide strong support for the resource-dependency model as social enterprises cannot generate sufficient resources internally and therefore largely depend on their task environment for additional inputs. Voluntary labour also forms a key alternative human resource for social entrepreneurs. There are instances where the entire management team serve wholly in a voluntary capacity and receive no financial compensation, beyond expenses, for their work.

**Figure 8.4**
Non-monetary forms of resourcing in social enterprises
Volunteerism as a bootstrap resource is not normally found in conventional enterprises, although, in social enterprises, it raises important organizational questions about addressing skill shortages and extra resource demands for voluntary management to gain full benefits of this resource (Guo and Acar 2005). Research by Jayawarna and Jones (2012) also provides empirical evidence for the role of community leadership in accessing and utilizing bootstrap resources. The study identifies the importance of leaders who encourage staff and other stakeholders to develop their own capabilities to access resources. More particularly, the research provided explanations as to how social and ethical values of leaders can promote collaborative relationships and generate change by combining indigenous commitment based on friendship and solidarity. Experience, skills and competence of leaders are also enabling mechanisms to realize resource needs in the form of credibility, reputation and firm references.

8.8 SUMMARY AND KEY LEARNING POINTS

It is commonly reported that new businesses have difficulty in accessing finance and other resources. Such businesses can engage in 'bootstrapping' activities as a way of compensating for this lack of resource capacity. Defined as a creative means to overcome resource constraints when entrepreneurs launch and grow their successful venture, bootstrapping covers a variety of strategies and techniques for entrepreneurs who are either at the early stages of setting up a small business or running high-growth, high-potential ventures. Techniques such as using the parental home as a base (as in Jazooli), subsidizing from other activities (as in Active Profile), salary deferment and use of credit cards (as in Wigan Recycling), and bartering and sharing equipment are some of the bootstrap activities that are worth pursuing for entrepreneurs when considering starting a new business. Although entrepreneurial finance has been widely studied, the use of bootstrapping as an alternative resourcing strategy has attracted much less interest from academic researchers. While the limited available literature largely agrees with the ideas put forward by Winborg and Landström (2001), new research evidence points to the importance of considering the business lifecycle, entrepreneurial motives and gender in explaining the usage of different bootstrapping methods. Taken together the key learning points from this chapter are:

Bootstrapping is a key organizational capability, which influences the ability of new firms to respond to their resource needs in a more efficient and cost-effective way. It is focused on enhancing cash flow and minimizing outgoing and maximizing income.

- The literature largely agrees that there are four different types of bootstrapping
techniques for entrepreneurs to resource their ventures: owner-related, payment-related, customer-related and joint-utilization methods.

• Research categorizes bootstrapping into either internally or externally oriented activities. While internal activities aim at maximizing outcomes from the limited available resources, external methods of bootstrapping often target the securing of external sources of resources through sharing or jointly utilizing with other businesses or individuals.

• While the use of owner-related and joint-utilization techniques declines as the venture matures, which fits with theories of entrepreneurial risk-taking, use of payment-related techniques tends to increase over time, which coincides with theories of resource dependency (Pfeffer and Salancik 1978) and organizational learning (Argyris 1992).

• In addition to the direct benefit of gaining access to additional resources, bootstrapping can indirectly benefit entrepreneurs through (1) encouraging efficient use of resources; (2) overcoming the problem of information asymmetries; (3) introducing discipline to resource use; and (4) enabling flexible work delivery.

• Examples of the use of bootstrapping techniques can be found in ventures of all types and sizes, operating at different stages of venture development.

8.9 DISCUSSION QUESTIONS

• What are the key reasons that influence new entrepreneurs to seek bootstrap resources to set up and run a new venture?

• How do a resource-based view of the firm, resource-dependency theory and resource-constraints theory help to explain the need for bootstrapping in new ventures?

• What might be the potential techniques of bootstrapping that a nascent entrepreneur can bring to their business? How might they access these resources and what are the short- and long-term benefits (and challenges) of using bootstrap resources in the new venture?

• How does the business lifecycle help to understand the dynamic and practical nature of bootstrap behaviour by different entrepreneurs?

• Why is it challenging to define a generic set of bootstrap techniques that an entrepreneur might use to start a new business? (Use gender, business sector, business age and entrepreneur character, preferences and motivations in your discussion.)
Managing Human Resources in Small and Medium-Sized Enterprises: From entrepreneur to owner-manager
Chapter 5: From entrepreneur to owner-manager

The demands of not only starting but building a business commonly invoke the independence, risk-taking and dynamism associated with entrepreneurs. However it can be argued that, as enterprises grow, mature and become more established, the role of everyday business management requires a different set of skills, or areas of emphasis, from those associated with a start-up. This Chapter focuses on the challenging transformation from the start-up phase to the everyday management of a business with employees. Importantly, this involves adapting to the demands placed upon an owner-manager, the need for demonstrating leadership and for engaging with employment relationships.

**Entrepreneur to employer**

Of the five million enterprises classified as SMEs within the UK economy, approximately four million are individuals trading on their own, without employees. As we will discuss, there is a range of reasons why these businesses, and other small enterprises with employees already, may not want to hire new staff. However, in purely economic terms, research such as that by the Centre for Business Research (CEBR, 2014) suggests that rates of financial turnover per employee increase with employee numbers. In terms of employment rates and economic prosperity, it is therefore understandable that governments might want to target the self-employed, one person enterprises and encourage them to take on employees. Mathematically at least, if every one-person enterprise in the UK took on one employee this would create four million jobs!

For example, the Federation of Small Businesses, ‘the UK’s largest campaigning pressure group promoting and protecting the interests of the self-employed and owners of small firms’ (FSB, 2015; emphasis in original), argued in a report on the role of small businesses in employment and enterprise (Urwin and Buscha, 2012: 9) that:

> Our analysis suggests that 74 per cent of those we observe becoming self-employed with employees come from the self-employed who previously had no employees, while a further 13 per cent come from the ranks of employees in micro-businesses. Individuals making this transition are therefore a particularly important part of the entrepreneurial pipeline and generator of jobs. In light of the evidence [...] we would argue that supporting self-employed individuals to take on an employee is a highly important – and arguably overlooked – means of helping the unemployed and non-participants get back into work. This may also widen access to entrepreneurship.

However, none of this is straight-forward. While many governments work hard at limiting the obstacles to employing new staff and to encourage a growth mindset
among business owners, small businesses tend not to grow beyond their initial size and very few could be considered ‘high growth’ (see Storey, 2011). While there is a broad range of reasons why small businesses do not grow into medium or large businesses, Sloan and Chittenden (2006), among others like Scase and Goffee (1987), offer evidence suggesting that the appetite for growth may be limited. We return to this discussion later in this Chapter in the section ‘Assumptions of growth’.

For those who do want to grow their employee numbers, for example a start-up enterprise or growth-oriented entrepreneurs, they must engage with a number of steps. Formally, in taking on a first employee the business owner will have to comply with specific legal requirements. In the UK, for example, new employers are advised to:

1. Decide how much to pay an employee (complying with national minimum wage legislation)
2. Confirm that the proposed recruit has the legal right to work in the UK
3. Conduct background checks on a potential employee's criminal record and suitability for certain roles, such as those requiring security clearance or caring for vulnerable people
4. Obtain employers’ liability insurance
5. Prepare and send details of the job, including terms and conditions, to the employee
6. Register as an employer with the tax authorities

(Source: https://www.gov.uk/employing-staff)

Beyond these immediate legal issues, moving from self-employment or as part of a start-up team can give rise to numerous other considerations and challenges. Whether businesses are able to cope with these challenges, and how they cope with them, may influence the success of the business and how it develops.

**Task:**

Moving from being a self-employed, one person enterprise to becoming an employer will give rise to numerous fresh considerations for the business owner, especially in respect of the employment relationship. Focus on the context of an economy that interests you and try to map out as many of these challenges as you can think of.

**The challenges of moving from entrepreneur to owner-manager**

Taking on employees creates fresh challenges for entrepreneurs and in this section we begin to characterise the nature of these different pressures. The transition to becoming an owner-manager and of having to engage with the challenges associated
with human resource management have been noted by some commentators as one of the key obstacles to establishing a business and that ‘an inability on the part of some founders of new ventures to successfully manage HRM issues is an important factor in their ultimate failure’ (Baron, 2003: 253). The key challenges can be broadly considered in terms of resources, delegation and skills.

**Resources**

The first pressure likely to strike the small business owner is the added costs within their business. Growth requires resources and, for employment growth, this creates demands on finances, time and management effort such that appointing a new employee and getting them to a point where they can make a contribution to the business can prove tougher than may be initially thought. The considerations of taking on a new employee extend beyond whether the business can afford their salary.

As a founder and director at a communications firm, explained to us:

‘... in taking people on it’s always about the balance of risk and reward. You know, you’re committed to pay them a certain amount, which puts pressure on the business to earn more money.

And of course, if you’re new in business you forget about that. Well we don’t now...when you learn, you learn about the actual true cost of employing somebody. And the true commitment of employing someone is very different than just what it looks like in the advert, 20 000 a year. By the time they’ve got holidays, insurance, pensions, you know all those kind of things...’

A quick Internet search for guidance on the typical costs of employment for an employee returns a wide range of estimates. Issues around additional computing equipment and IT licences required, training provision and employment-related benefits can all influence the costs beyond a basic salary. Using one online calculator suggests that an employee earning £25 000 gross annual salary will cost the business over £42 000, subject to certain assumptions being made about benefits and, of course, not taking into account the additional income that employee can *generate* for the business which should at least cover these employment costs.

The considerations of hiring a new employee extend beyond these types of financial resource implications. For example, the founder director also revealed the precarious nature of resourcing particular projects or contracts as well as some sense of a moral dimension in the decision to employ a member of staff. He felt that businesses owe it to their employees not to engage in ‘hire and fire’ practices as business demand fluctuates:

‘... it’s a big risk to take, you know, one’s always in the stage of can you deliver? or

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do you want to be in a position where you can deliver it before you pitch for [work]? So that dilemma is always facing us. As we’ve recruited, we are becoming more inclined to...go towards contracts once we’ve got a base amount of people because, I don’t mean this ruthlessly, you take on a big burden when you employ someone full time.

And also I think there’s a moral dimension as well, that it’s a fluid business. You could take someone on and then in a few months’ time you could be saying ‘goodbye’ to them because there isn’t enough work. Well at least we’re being straight and up front with people, you know ‘we’ll give you a contract and it’s a rolling contract’ and that seems to be an emerging position at the moment.

While this business may have overcome the challenge of staff recruitment, how can an owner-manager keep the business operating or growing as they incorporate new employees and new ways of working? Taking time away from hands-on activities that earn money for the business today in order to ensure new staff know how to develop the business and generate income into the future may be especially challenging for owners who are closely involved with earning money for the business (see Cardon and Stevens 2004). While, during a start-up phase, this kind of direct owner-manager involvement in all aspects of the business may be necessary to ensure quality and control costs, such intensive involvement in all aspects of the business cannot be sustained as the enterprise grows. This will require degrees of delegation.

**Delegation**

As a start-up transitions into the day-to-day running of a business, entrepreneurs can find the accompanying change in their roles and responsibilities challenging – moving from the excitement of building a new venture towards something requiring more traditional management and monitoring. Perhaps one of the biggest challenges in this regard is that of delegation (Churchill and Lewis, 1983). Delegation involves handing certain tasks over to another person so that they can undertake the work required. In this way, rapid growth and fast-changing management structures can create opportunities for career-advancement and skill acquisition not available in more rigidly hierarchical large firms. However, learning to delegate can pose difficulties for business owners who are accustomed to making decisions alone and implementing them as they see fit (Charan et al., 1980). Reluctance to release some control to others in the business or to accept that established projects and practices may be loss-making can create tensions. Employees might resent constraints and interference (Packham et al., 2005) while owners’ strong adherence to pet projects or views can hold back the business and drain resources (Patzelt et al., 2008).

When we discussed this process with Jane, the owner of several successful enterprises,
she revealed that her passion was in creating start-up ventures rather than what she saw as the more mundane aspects of managing and monitoring performance over time. Jane’s response to this was to step away from daily involvement in her newest venture and hand it over to managers who oversaw related parts of the broader business. However, we also talked to some of Jane’s employees and, for them, this change was difficult to accept:

...it is a bit disheartening because I have gone from a point where Jane says to me ‘I am going to give you the business, you run it as you wish.’ I have been doing that for a year and a half. And now [under the business manager] it is a case of being told: ‘I need you sat where I can see you. I need you to take your lunch at this time. I need you to call me if you are going to be late. You sacrifice your break even if you are doing work.’ It has gone from being an integral part of the start-up to being an employee. And I could be an employee elsewhere for a lot more money. And one thing that we often say actually is, and we wouldn’t want to do it, but what we are doing right now we could be doing in my front living room, me and my colleague. We could essentially be setting up a business doing exactly what we are doing on two laptops in one of our front rooms. We are here because we want to work for Jane and we want to work with Jane.

Reaching the stage at which work is gladly handed over to an employee can take time for an owner who has traditionally worked alone and may have started a venture for the apparent independence it offers. While there might be some intention to recruit staff who can be trained in the skills and approaches to work that the owner-manager prefers, research by Packham et al., (2005) suggests that this is easier said than done. Packham and his colleagues conducted group interviews with SME owner-managers in Wales about their perceptions of the development of management skills and practices within their firms. All the participants in their study felt that management development was intertwined with growth decisions but some reported problems delegating due to a lack of belief in the ability of existing staff to rise to the challenge.

Common to accounts of owner-managers in SMEs, there was a reluctance to introduce formal systems to support delegation and management because they were seen as bureaucratic and inappropriate for their business. Within this context, owner-managers might prefer the apparently simpler route of recruiting employees who can make a practical contribution straight-away. Such an approach is not quite as simple as it may appear and, in Packham et al’s study, this approach was viewed as entailing difficulties in not only recruiting but also retaining those staff who already had the required management skills.

In light of these challenges it might be understandable when some entrepreneurs conduct the management of their firm through a ‘key employee’ as they start up new
ventures. Work by Schlosser (2014, 2015) in Canada details how entrepreneurs may rely on a particular employee who they perceive as effective, reliable and with whom they have enough shared history for them to be deemed trustworthy. In this way, trust, willingly making oneself vulnerable to another (Rousseau et al., 1998), can be an important element in the decisions of owner-managers of relatively informal, unstructured businesses. These trusted and so-called key employees can reduce some of the uncertainties associated with entering a new business venture as well as free the business owner from the challenges of day-to-day staff management. Consequently, Schlosser (2015) indicates, key employees might accompany an entrepreneur through multiple start-up ventures, providing some sense of security for the business owner.

Skills

For an owner-manager whose venture is becoming an established business with employees, this places an emphasis on a different set of skills than those that might have proved useful in getting the venture off the ground (Coad et al., 2013). In addition to the psychological step of relinquishing some control over part of the business, as an employer the business owner will have to develop the skills of giving clear instructions and, perhaps, learning to accommodate ways of working different from their own. Similar to difficulties in delegating to staff they do not fully trust with their business operations, sometimes an owner-manager can grow frustrated by employees’ apparent inability to anticipate what they want done.

Recounting a recently held team meeting with two new starters, the owner-manager of a recruitment firm told us about his exasperation at these staff not knowing about a particular ‘Star Job’ feature on the company website. When asked to clarify whether he had alerted the new starters to this feature, he responded simply that new staff ‘don’t show any initiative’, perhaps implying that he had not shown them. On this and other occasions, the owner-manager struggled to come to terms with the relative lack of investment from employees who, rather than sharing his love of the business, worked for their pay cheques. This difference of view is perhaps understandable given that he was the sole owner of the business and his employees were focused on their own careers and ambitions.

Managing as an employer also impacts how the entrepreneur conducts themselves in the business on a day-to-day basis. While self-employed, a business owner is largely accountable only to their external clients but, with employees, an owner-manager can also find themselves ‘on-show’ even when not in front of clients. For example, as we discuss in Chapter Six, important in many areas of the employment relationship are perceptions of procedural justice – that employees are treated fairly and without favouritism or prejudice. This new element of scrutiny can place demands on the owner-manager’s conduct, especially when it is seen to vary from what is required of
employees or the image projected externally to clients.

Within the context of an owner-manager introducing new timesheets and a renewed focus on people’s time-keeping at a growth-oriented small firm that we worked with, one employee reported his frustration at seeing the owner and his girlfriend arrive well after the start of the usual working day with no acknowledgement or offer of an explanation. The owner-manager was working by far the longest hours in the business and he was trying to regain some degree of work-life balance by making staff more accountable for their output. However, by not clearly communicating his justifications for reducing his own hours while requiring timesheets from employees, the owner-manager was open to charges of hypocrisy. The types of skill involved in managing these types of issue are a long way from the external focus of business start-up and may not be what a new owner-manager expects or is prepared for.

In general terms, owner-managers can be confronted by a lack of know-how concerning aspects of managing employees (Churchill and Lewis, 1983). As Cardon and Stevens (2004) point out, certain aspects of managing staff may arise somewhat infrequently. Owner-managers may, for example, be ill-practised in how to motivate employees in a given situation, identify particular training needs or, perhaps, how to discipline or dismiss someone. Such knowledge and skills can, of course, be acquired as necessary but, as Beckman and Burton (2008) report, those businesses founded by people with a narrow experience base of a particular function can sometimes struggle to appreciate the value of other functions. There has to be caution in assuming that an owner-manager will somehow intuitively know when to take appropriate advice about managing employment relationships in their business.

**Task:**

Imagine you are running a business and have recently taken on your first employees. (a) How would you acquire the best ways of managing your employees? Try to be as specific as possible on the kinds of sources you might draw on (hint: don't forget popular representations of entrepreneurs and managers portrayed in the media as a source of information). (b) Discuss each source with your colleagues and rate each in terms of how accessible the source is and how likely it is you think each source would provide useful information.

**From Entrepreneur to Owner-Manager?**

The challenges associated with moving from being a self-employed business owner to an owner-manager with employees have been characterised as a transition from entrepreneur to owner-manager. This perspective has, however, been criticised as ‘dangerous and misleading’ when it comes to understanding management in small businesses (Watson, 1995: 35). These criticisms suggest that the perspective
over-simplifies how businesses develop in three main respects: assumptions of growth, the challenge of change and the underlying ‘from / to’ logic of this perspective. We consider each of these in turn.

**Assumptions of growth**

We started this chapter by identifying how governments are attracted to the idea of boosting employment in small firms given what this can achieve for reducing unemployment figures and, potentially, growth in gross domestic product (GDP). However, we must not assume that all self-employed people, or even all small firms, want to take on more employees (Scase and Goffee, 1982; Sloan and Chittenden, 2006). Caution is required, then, when faced with suggestions that the self-employed or the small firm are at the start of a pathway towards growth.

Taking on a first employee can represent a major step for many and it is a step that some would rather avoid. Some may view becoming an employer as hampering the independence they sought when becoming self-employed (Scase and Goffee, 1982). This is a thought we have found echoed in our own research:

...what you tend to find is that while you have this sort of passion and commitment and all that sort of stuff, staff generally don’t...You know, now I don’t really want all that hassle and aggravation that staff give you really.

Opting for self-employment or to run a small business may frequently be driven simply by a desire to earn a living rather than the first step on the path to building a larger business. For some, this represents a lifestyle choice and such ‘lifestyle businesses’ have been defined as ‘those providing an income for the household or family and not having a growth orientation’ (Fletcher, 2010: 454). While fulfilling important functions in the economy in terms of employment provision and providing income to owners and any employees, lifestyle businesses have tended to be overlooked relative to the attention granted to growth-oriented enterprises. However, labelling lifestyle businesses as ‘trundlers’ (Storey, 1994: 119) or ‘static’ (see Burns and Harrison, 1996: 41) risks misrepresenting the nature of these businesses and therefore limiting understanding of an important element of the economy (Bennett, 2014).

Moreover, growing a business can be achieved without additional employees, for example by increasing financial turnover from existing operations or using sub-contractors to increase capacity (Bischoff and Wood, 2013). This suggests that ‘growth’ is not a particularly helpful concept without qualification and that ‘non-growth’ might actually be ‘different growth’ in certain cases. Nevertheless, there remains a persistent view that most small businesses harbour ambitions to grow. This style of ‘acorns to oaks’ thinking (Weatherill and Cope, 1969) has been challenged in detail by Gray (1998) on the basis that it views small businesses as generally growth-oriented
and destined to pass through specific stages of growth. In contrast, Gray highlights evidence suggesting that the motivations behind starting and running a business frequently do not include ambitions to grow or hire more employees. Moreover, among those businesses that do pursue or achieve growth, it is often with a view to achieving a particular end, such as to sell off the business as a going concern, rather than as an ongoing pursuit of growth for its own sake.

Gray's analysis highlights an apparent tension between politicians' objectives and those of small business owners. As MacDonald et al. (2007: 78) have commented:

Where SMEs are involved, perhaps the crucial link is between policy of any sort and cold reality. For instance, a simplistic view of SMEs is still common among policy makers who are capable of seeing SMEs simply as nascent large firms that should be exploiting innovation to realize their growth potential. SMEs, it would seem, have no business being small.

Yet, despite such refutations, assumptions accompanying acorns to oaks thinking still remains commonplace today, a topic we will return to in Chapter Eight.

The challenge of change

A further criticism associated with the transitions businesses are assumed to undergo relates to the ease with which change may be implemented. Writing on the related theme of changing management styles, Charan et al.'s (1980) widely-cited paper 'From Entrepreneurial to Professional Management: A Set of Guidelines' presents a step by step approach to the transition.

Charan et al.'s starting point is that, to continue growing, small businesses must successfully navigate 'a transition from an entrepreneurial to a professionally managed system' (1980: 1). Within the ordered framework presented, the business owner first recognises a need to change their working practices before conducting analysis on how the business currently operates. In subsequent steps the business owner decides on a new formal structure which is implemented gradually, complemented by the training of suitable middle-managers. This process, according to Charan et al., culminates in a revised organisation structure that allows an owner to delegate decision-making, enable decisions to be made on the basis of data and to avoid over-reliance on particular individuals.

Although Charan et al. acknowledge the potential difficulties associated with aspects of these stages, there remains an underlying sense of a step-by-step map towards successful organisational change. The result is that the change process is over-simplified with limited consideration given to tricky issues such as whether the entrepreneur can recognise the need to change in the first place and accept that some response is required. Further, Jayawarna et al., (2013) identify that motivations may
change over the course of time in a business, highlighting that the business environment is not necessarily constant – the kinds of approach and solutions that worked at one point might become unsuited to the enterprise in terms of environment, goals or the consequences of previous decisions.

Adapting the work of Miller (1992), we can start to understand how difficult it can be for an entrepreneur to recognise that change in their approach may be required. Miller has described the 'Icarus Paradox' to help explain why successful organisations might not see a need to change what they're doing. The Icarus story from Greek mythology is well known: Icarus and his father Daedalus were being held prisoner on an island so Daedalus created some wings to help them fly away to freedom. The wings were made of wax and feathers so, before they made their bid for escape, Daedalus warned his son not to fly too close to the sea or the sun. The plan was a success, with Icarus using these wings to soar away from the prison, until, carried away with his new-found ability, he wanted to go further and higher and he continued to climb, taking him toward the sun. Closer to the sun's warmth, the wax holding Icarus' wings started to melt. Melted wax wings don't work very well and, while Icarus could defy his erstwhile captor King Minos, the same couldn't be said for gravity. Icarus fell from the sky to a watery fate.

The point of this story, as Miller sees it, is that organisations can bring about their eventual downfall by continuing to do the things that have made them successful to-date. Miller breaks down the Icarus paradox into two main issues: (i) success can lead to failure; and (ii) actions that lead to success at one time do not always lead to success.

The first point is quite simply to highlight the risk posed by hubris, brought on by success. In Miller's own words 'Icarus flew so well that he got cocky and overambitious' (1992: 31). The same can be said of some businesses where early success can lead them to underestimate the challenges of a competitive environment or new product launch. The second point is described as being 'too much of a good thing' (1992: 31) and is explained as organisations extending practices that they believe have made them successful to the point of dysfunction. For example, a business that attributes a large degree of its success to careful planning may come to be overly rigid by seeking to plan every last detail. In the case of a small business, it could be that the business enjoys early success through a profitable contract with a single supplier but, over time, the business tailors its operations increasingly to meeting the wishes of that client such that it loses the ability to diversify its client base and grow. Dependent on a single client, a small business may find itself subject to the demands and decisions of that client (Rainnie, 1989).

At the heart of Miller's analysis is the idea that organisations exist in dynamic environments and must, therefore, remain dynamic to account for changes in that
environment. Simply repeating the practices associated with prior success may reflect
that a business is not seeking to adapt to environmental changes. In the case of the
entrepreneur who takes on employees, they might remain wedded to their original
vision for the business (Beckman and Burton, 2008) and preferred ways of working,
while failing to spot when the skills required to start a business should be altered in
favour of the skills to manage it on an ongoing basis (Breslin, 2010). Phelps et al.
(2007) suggest that businesses will change their management structures when the
problems caused by existing practices are thought to outweigh the risks of adopting
new practices. As we will discuss in greater detail in Chapter Eight, however, identifying
these 'tipping points' while in the midst of day-to-day business operations can
represent a significant challenge for busy owner-managers (Mallett and Wapshott,
2014) and many may find themselves too close to the heat of the sun, failing to adapt
to their changing circumstances.

The underlying 'from / to' logic of this perspective

Watson (1995), whose paper 'Entrepreneurship and professional management: a fatal
distinction' prompted us to include this section of the chapter, presents an interesting
and detailed consideration of how businesses change as they grow and criticises the
underlying logic of a transition 'from' one state 'to' another. He argues that such an
approach to understanding how businesses develop risks distracting attention from the
ways that all businesses need to consider an appropriate balance of creativity and
innovation with operational control. Watson's point is that, by adopting the 'from / to'
logic of the transition perspective, we may come to misunderstand how both small and
large businesses operate.

Criticising the 'naive evolutionism' (1995: 35) of perspectives that imply one stage of
development is left behind as a new business form replaces the old, Watson suggests
that there can be significant overlap in the management orientations found in both
small and large businesses. Each may require, albeit to differing degrees,
entrepreneurial and more traditional management behaviours if they are to be
successful in coping with the challenges presented by their competitive environments.
Importantly, the establishment and ongoing management of a small firm does not
remove the need for entrepreneurial creativity and innovation but nor can the
increasing pressures of employment relationships and management tasks within the
firm be ignored.

While we cannot assume that all owner-managers will want to grow their businesses
and that the processes of change may be simple or linear, there remains a different set
of challenges and potentially different skills required when deciding to take on
employees. For example this may relate to recruitment and selection, training and
development, reward and recognition or to staff exit – the core topics covered in this
book. The ‘from entrepreneur to owner-manager’ transition might better be understood as a series of questions and decisions that the owner(s) must address as their business, and its relationship to the wider operating environment, changes. How (and if) these questions and decisions are addressed will shape the business and the employment relationships within it (Levie and Lichtenstein, 2010).

Conclusion

In this chapter we have highlighted how entrepreneurship is not solely concerned with business start-up. If a business wants to grow, or indeed does grow, this often entails getting to grips with managing employees and a range of new demands such as generating sufficient resources to pay employees and learning to delegate in order to make the most of the people employed.

The challenges associated with a shift from being a self-employed business owner to an owner-manager with employees have been characterised as a transition from entrepreneur to owner-manager. This perspective has, however, been criticised as misleading and even as dangerous when it comes to understanding management in small businesses because it risks over-simplifying the ways in which businesses develop. This over-simplification can be considered in respect to assumptions of growth, the challenge of change and the underlying ‘from / to’ logic of this perspective.

The key point to take from this chapter is that managing a small business can present different challenges or require different emphases compared with the start-up of a new venture. To overcome these challenges, entrepreneurs may require new skills and knowledge, some brand new, others a change in style depending on the starting point of their business and considerations such as the operating environment, knowledge that relates to the topics covered in this book. In the next Chapter we start to consider in greater detail the factors facing SMEs that can shape or influence the employment relationships and practices we associate with these enterprises.
Entrepreneurship, Small Business and Public Policy: Why does policy matter to entrepreneurs and small businesses?
Chapter 6: Why does policy matter to entrepreneurs and small businesses?

INTRODUCTION

Public policy for entrepreneurs and small businesses is usually dealt with in a single chapter in most texts. This book aims to take the topic apart at greater length to provide a core text for specialist MSc/MA and MBA options and as a take-off point for dissertations. It is aimed at international readers using a range of case materials that allow varied policy approaches to be understood. The book aims to help you understand small businesses and entrepreneurship policies, what they do, and how they vary between countries.

Small entrepreneurial businesses in this book are defined functionally: (i) directly managed by their owners, and hence are personalised, and (ii) independent from the control of other business (not mere branches, franchises or subsidiaries, and not state-owned) so that their risks, decisions and strategy are their own. They may also have (iii) a relatively small market share (‘price takers’ rather than ‘price makers’), but this is not always the case in localised markets and developing economies where some small firms may be dominant suppliers. One example, using the definition of the 1953 US Small Business Act (P.L. 85-536, as amended), defines a small firm as ‘one that is independently owned and operated and which is not dominant in its field of operation’.

A functional definition allows us to understand businesses, but policies use various definitions. Policies are difficult to make effective. The problems of definition and effectiveness are seldom clear from government statements. The research literature and established texts on policy are also not uniformly helpful. In general there has been a strong tendency for policy makers and politicians to treat entrepreneurs and small businesses as simple categories and vaunt new initiatives as faultless recipes for economic success. Similarly, many research authors feed demands for intellectual support for policies that ignore full policy costs, displacement of existing firms, deadweight and dependency. It is because of these complexities that this book has been written. At the very least it is hoped that you, and policy makers, will improve over past experiences.

The learning objectives of this chapter are:

- to understand the policy needs of different types of entrepreneurs and small businesses;
- understand the objectives of policies;
- understand the context for policies: the ‘business enabling environment’.
WHAT ARE ENTREPRENEURSHIP AND SMALL BUSINESS POLICIES?

The public policies discussed here are explicit or targeted, and also policies that are not explicit but nevertheless impact small businesses and entrepreneurs. Examples of targeted policies are loan guarantees, support for exporters, advice and information provision. Examples of non-targeted policies are effective educational policies that encourage independence, judgement, skill development and other key factors underlying entrepreneurship; efficient labour market policy; or policies aimed at other non-business objectives that influence small businesses and entrepreneurs disproportionately (notable are tax policy and other regulations), as well as macro-economic policies, such as interest rates, which affect all businesses but have deep impact on entrepreneurial risks.

Individual policies are contained within the social and institutional norms of each local situation, country or multinational trading bloc: often referred to as the ‘business enabling environment’ (BEE). These norms are less often viewed as explicit ‘policies’, but they are a major focus of this book because they are often the most significant influences on entrepreneurs and small business. Moreover the aim of this book is to be internationally relevant so that understanding institutional frameworks is a key aspect of understanding differences between policies and places. The main instruments for entrepreneurship and small business policies are shown in Table 1.1. You should look at this table carefully. It will be referred to throughout the following chapters. You can follow up details of each instrument in further reading at the end of the chapter.

WHY IS SMALL BUSINESSES POLICY IMPORTANT?

Small business policy is a significant activity in most countries, and for many international institutions. The reasons for this policy attention are (also see Further Reading):

1 Small businesses are the vast majority of all businesses in all countries; even using narrow definitions they are at least 80 per cent of all businesses, accounting for around half of output; on wider definitions they are 99 per cent of all firms; hence, as the majority of firms, all policies need to take account of the managerial capacity of small firms.

2 There is some evidence that small firms have been growing more rapidly than large firms in capacity to create employment and reduce unemployment and state welfare benefits, and increase taxes and resources for social and other expenditures. They can also cushion economic shocks.

3 They provide potential efficiency benefits in an economy by increasing competition, increasing the rate of market entry and exit and helping to limit the adverse effects of
<table>
<thead>
<tr>
<th>Policy field</th>
<th>Policy instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Business enabling environment</strong></td>
<td>Start-up registration, Governance laws, Fiscal incentives (tax exemptions, subsidies, grants), Employment laws, Bankruptcy laws, Government administrative efficiency and professionalism, Anti-corruption procedures</td>
</tr>
<tr>
<td>1.1 Regulatory framework</td>
<td></td>
</tr>
<tr>
<td>1.2 Business infrastructure</td>
<td>Transport, Power, electricity, water, Communications networks, Land policy, industrial estates, incubators</td>
</tr>
<tr>
<td><strong>2. Entrepreneurial culture</strong></td>
<td>Education and training, Business incubators, Inclusion programmes (e.g. for youth, women, ethnic groups), Public awareness and support</td>
</tr>
<tr>
<td><strong>3. Finance</strong></td>
<td>Micro-finance, Commercial loans, Public credit guarantees, Credit rating and financial institutions, Corporate bond markets, Venture capital and business angels</td>
</tr>
<tr>
<td><strong>4. Business development services</strong></td>
<td>On laws, accountancy, finance, trade, technology, Support for advice from partner business associations and training bodies, Support to private professional services</td>
</tr>
<tr>
<td>(advice and information provision)</td>
<td></td>
</tr>
<tr>
<td><strong>5. Innovation and technology</strong></td>
<td>R&amp;D, Technology transfer, Incubators and commercialisation, Quality standards and certification, IPR laws, e- and m-commerce, Higher education policy and universities</td>
</tr>
<tr>
<td><strong>6. Market access</strong></td>
<td>Information on trade and investment opportunities, Trade fairs and exhibitions, Export promotion agency, Product quality improvement initiatives, Support for supply chains and clusters</td>
</tr>
</tbody>
</table>

Source: modified from UNESCAP, 2012: 8
monopolies and inefficient incumbents.

4 They can be significant sources of innovation and new products, with potential for new industries; even one new high-growth small firm like Apple in the USA or Alibaba in China can make a major impact on an economy.

5 They offer opportunities for personal independence and initiative, particularly for new entrants to self-employment and entrepreneurship, as an alternative to employee status in larger firms with greater personal satisfaction; often beneficial for specific groups such as young people, ethnic minorities or women; offering opportunities to diffuse development in developing countries.

6 They are efficient means to organise production for markets where the volume of sales is small, with low and/or very varied capital needs, and usually where entry costs are low; new technologies may be making these conditions more frequent; this is important for developing countries and transition economies.

7 They provide variety and hence wider consumer choice.

8 They can provide alternatives and variety to the supply chain, which can improve sales potential and may reduce costs through offering opportunities for outsourcing; they are complementary to large firms.

9 They may be able to respond more quickly and rapidly than large firms to new market conditions and opportunities; some argue that without the ‘heterogeneity and volatility’ provided by entrepreneurs and start-up firms ‘the economy eventually stagnates or even collapses’ – what Schumpeter called ‘creative destruction’ (Schumpeter, 1942; Carlsson, 1999: 109).

10 They may offer scope for experiment with high risk investments.

The high multi-purpose expectations have been summarised by UNESCAP:

SMEs are a key source of economic growth and dynamism in all economies. Adaptability, resilience and the ability to manufacture goods and to provide services with a high degree of flexibility and cost effectiveness are hallmarks...Small businesses are particularly important for bringing innovative products and/or services to the market ... SMEs are an ‘nursery’ for nurturing entrepreneurial talent, in addition to creating employment and fostering industrial development in an economy. SMEs are alleviating poverty around the world as well as increasing the social and economic participation of women, youth and minorities. Some SMEs also have the potential to grow into large enterprises. (2012: 5)

These claimed benefits have led to great enthusiasm for policies, but this is recent. In most countries before the 1950s–1970s the dominant view was that small businesses
were backward, and support should be focused on large businesses, large state enterprises and maintaining industrial oligarchies or monopolies in ‘strategic’ industries. In socialist economies small firms and entrepreneurs were suppressed as ‘parasitic’. This was often cultural or ideological, or to maintain existing elites. But in many cases it also reflected the economics: in the conditions of the early twentieth century large firms often provided greater employment, lower costs and greater market efficiencies in many industries. Only with recent technological changes have small firms been able to offer greater competitive opportunities.

The policy rebalancing towards entrepreneurs is important. But there is also a reality check. Not all entrepreneurs and small businesses are dynamic, efficient or valuable. Large firms remain the dominant producers in most sectors in most countries and are likely to remain so in many cases. Not all small businesses are ideal places to work: some have domineering and repressive owners; some are essentially vehicles for survival and ‘self-exploitation’, encouraging people to accept incomes or working hours and conditions that are poorer than they might receive in employment, or that have poorer health and safety records. GEM distinguishes ‘necessity entrepreneurship’ for survival, from ‘opportunity entrepreneurship’ aiming at high growth (see, e.g. GEM, 2012; www.gemconsortium.org).

Also, most new start-ups yield no more than a ‘churn’ to the market: most survive for a short time only to die, or they replace even weaker incumbents whilst adding little to net income generation; i.e. only redistributing existing activity to new owners. The evidence of innovative contribution is mixed, with most data suggesting that larger firms remain the major investors in R&D and innovation in most economies, whilst many entrepreneurs are good at commercialisation but are often not innovative. Hence, in this book, as in reading all the small business literature, you should bear in mind that small businesses are very varied and do not present a simple or uniform object for policy, any more than they present uniformly reliable benefits for potential entrepreneurs, investors or customers.

**WHAT ARE SMALL BUSINESSES?**

Small businesses as defined in this book fall into three groups, each with different potential policies.

**Entrepreneurs**

Entrepreneur is a term often used imprecisely: to cover all self-employed and small firm owners. Here entrepreneurship is restricted to those that are innovating by designing new projects, taking the risks involved (financial and non-financial) and making irreversible commitments that are expected to create new profits. They are breaking out of the mould of existing practices. The most successful will have used
ability and judgement to identify opportunities that produce greater than normal returns in the product or market concerned. They win significant rents in return for identifying and exploiting these opportunities and thus have the potential to gain high rewards for themselves, but also contribute to general economic welfare by improving overall resources allocation and economic growth. However, successful innovation may not achieve high returns, but merely ensure the business survives. They are the target for entrepreneurship policies. These policies focus on individuals rather than businesses; e.g. education and culture that encourage individual initiative, risk-taking and judgement, and tax policies supporting risk taking, research and rewards, as well as more traditional policies such as providing advice and financial support. Schumpeter, one of the earliest writers, stated:

Entrepreneurs ... reform or revolutionise the pattern of production by exploiting and invention ... and untried technological possibility ... [This] is difficult and constitutes a distinct economic function, first because they lie outside of the routine tasks which everybody understands, and secondly, because the environment resists in many ways.  
(Schumpeter, 1942: 13)

It is notable that Schumpeter included institutional resistance as a factor negatively influencing entrepreneurship. A modern statement by the OECD (Ahmad and Hoffman, 2007: 4) sees entrepreneurs as 'those persons who seek to generate value, through the creation or expansion of economic activity, by identifying and exploiting new products, processes or markets'. Emphasis on entrepreneurs also redresses some definitional confusion: for most policy purposes it is not small businesses that are important, but innovative, risk-taking individuals, who often have the best opportunities in small firms. However, entrepreneurs do not act entirely alone, and the majority are usually supported by family structures. Also most entrepreneurs do not start out of the blue: many have started businesses before (serial entrepreneurs) or already operate other businesses as portfolio entrepreneurs.

**Owner-managers, partners and the self-employed**

Small businesses in the narrow sense of sole or independent entrepreneurs/traders are owned and managed either by an individual, or by a small group of individuals acting as risk-sharing business partners who are owner-managers, often drawn from family links. These have the advantage of integration under an individual or small collective group of partners: the owners’ eye is on everything, there is no divided responsibility or gaps in understanding between departments, management is aligned, with little scope for shirking by the workforce so that principal-agent problems can hardly arise, and there is less bureaucracy for checking and less need for messaging. On the other hand, they have the disadvantages that the owner is frequently overstretched between strategic tasks and ones that are mundane, there is less specialisation and expertise
available for those tasks for which the owner is less skilled, all of which can induce efficiencies. The scope to respond to increased demand through existing routines is also limited so that up-scaling and growth may be held back. Policies to help such business have often focused on stimulating selfemployment. But this is confusing because many self-employed people perform functions for larger firms, sub-contracted or outsourced. This is an increasingly modern phenomenon, but was also historically important; e.g. in Europe through ‘putting out’ production to operatives in their homes, or in nineteenth-century Japan (Tonya system). These people are self-employed, but business strategy and marketing/exporting are managed by external entrepreneurs or larger scale businesses. As a result, policies often target sub-categories of business rather than the self-employed as a whole.

**Small and medium sized enterprises (SMEs)**

This is the most common policy term. These include business in the first and second categories, but also those that have progressed to a level of subdivision and managerial specialisation, where the ownership and management of the business are becoming, or have become, separated. They are usually established businesses. Many will have moved to shareholder ownership, with a high level of subdivision, and are operated essentially by managers rather than owners. Some are beyond the focus of this book but the demarcations are fuzzy. The literature is also confused; it is frequently dominated by assertions of the characteristics of the pure owner managed business for SMEs that are relatively large business organisations. Some are occasionally referred to as mid-corporates, an even fuzzier term. All these definitions are relatively extensive: they allow inclusion of a wide range from the self-employed and owner-manager up to large and complex organisations. This vagueness results in SME being the most widely adopted way of defining small business for policy purposes. It has been attractive because a diverse group can be the subject of a wide range of different (and often conflicting) policy objectives that can satisfy a wide range of different policy makers and political interests. However, the vagueness undermines effectiveness, leading to confused policies aiding larger rather than smaller businesses.

**Other differences between small businesses and entrepreneurs**

Small firms may also differ in legal form from large firms, by less often being incorporated and many may be ‘informal’. Incorporation of itself is of little relevance to policy since its primary advantage – protection from creditors through limited liability – is rarely available in practice because small business owners usually have to risk personal assets (including their homes) as collateral for loans. Incorporation usually gives different tax treatment (corporation tax instead of income tax) and perhaps accountancy and regulatory differences. However, in other respects incorporated small businesses differ little from unincorporated ones. Hence, in most of this book legal form
is given limited attention.

*Family firms* are often treated as a distinct category. These are special forms of partnerships or registered companies where family members act as the controlling directors. They account for 60–90 per cent of all companies in most countries, and 35–65 per cent of GDP (Colli *et al.*, 2013). However, efforts to distinguish family businesses from others are multi-dimensional and complex making them difficult targets for policy (Westhead and Howorth, 2007). It is most useful, therefore, to remember that many SMEs and small firms are underpinned by family structures of management, labour and capital (Hoy and Sharma, 2010), and many are serial and portfolio entrepreneurs (Carter and Ram, 2003), but in other ways they are like other networked firms.

*Informal businesses* are not formally registered, but formed through informal understandings and the use of 'common law' procedures such as partnerships and contracts between individuals. Many are critical parts of the economies of lower-income countries, but have no legal position: doing business and occupying land outside formal legal regulations. Avoidance of regulations occurs in all countries; it characterises large businesses as well as small ones.

The differences between firms for policy purposes is not just about size and organisation; it is also about their potential economic contribution and hence their value as the objects of policy. For example, the self-employed or owner-managers will include entrepreneurs, but many are no different from the managers or operatives of a larger business. They are undertaking tasks for themselves, but the tasks may be the same as in a larger firm in the same sector. Thus a window cleaner working for themselves will be doing essentially the same job as one employed by a cleaning company. From a policy point of view there may be an argument for encouraging one form of organisation rather than another if it improves the overall efficiency of window cleaning, releasing resources to deploy elsewhere, thus increasing overall economic growth. But it is more likely that either organisation can provide similar returns and efficiencies. Firm size is therefore not a simple guide to policy.

Even the characteristics of entrepreneurship are not unique to small businesses. The identification of new business opportunities, ability to win rents and achieve above average profits is a goal that large businesses also pursue. 'Intrapreneurship', and 'competence enhancement' are terms often applied to a large business that becomes more entrepreneurial. 'Corporate venturing' is used by large businesses to set up subsidiaries (or buy start-up firms) to provide entrepreneurial feeds, spinout innovative elements, or speculate: e.g. by Microsoft and many other firms during technology bubbles in the 1990s and since. Entrepreneurship has even been applied to the ability of public sector or governmental functions to be innovative and risktaking. Clearly
entrepreneurship can be applied to all walks of life. Moreover, not all entrepreneurial start-ups start small. Some are able to access large scale investors and start as large companies (e.g. through corporate venturing).

Nor does small size itself guarantee entrepreneurship: it does not distinguish firms that pursue innovation from those that do not. A small firm can be run as a routine operation undertaking standard tasks that have been using the same processes and equipment for years, just as a large firm can. Whilst preforming useful and perhaps essential functions, many self-employed and SME businesses will not be innovative or growing. Indeed some are often termed ‘life-style’ businesses or ‘trundlers’ (Storey, 1994; ADB, 2009). It is important not to be dismissive of these businesses: they are contributing to the economy and employment; whilst survival and maintaining a successful business is itself challenging. However, most lifestyle and micro-businesses offer little scope for growth. It is important that policies targeting them do not destabilise perfectly acceptable businesses.

From this discussion two key things should be clear. One is that defining the subject of this book – ‘entrepreneurship and small businesses’ – is fuzzy. Second, developing sensible and appropriate policies is likely to be difficult. These difficulties create all sorts of uncertainties for how a policy maker should proceed, and also indicate that interventions may have significant limitations.

DEFINITIONS IN PRACTICE: SMALL FIRMS AS POLICY OBJECTS

The functional definition used here (independent enterprises directly managed by their owners) is not so easily defined for policy purposes and definitions vary between countries. UNESCAP (2012: 13) quotes 60 definitions used across 65 countries, with employee numbers most common, followed by sales volume. For example, the EU uses under 250 employees, under €40m turnover and/or a balance-sheet valuation below €27m. Japan uses fewer than 300 employees in manufacturing, fewer than 100 in wholesale distribution and fewer than 50 in retail and other services. The USA for different industries has ranges up to 1500 average employment, and $35.5m average annual receipts (SBA, 2012). China also uses ranges of employees up to 1000 and operating revenue up to Rmb2m.

Using these definitions, SMEs are 90–99 per cent of all businesses in most countries, generally accounting for nearly 40–60 per cent of GNP and over 50–70 per cent of employees (Ayyagari et al., 2005; EC, 2008; World Bank, 2011). However, these shares vary considerably between countries, and between formal and informal sectors. As shown in Table 1.2, whilst large companies account for 31–37 per cent of GDP in almost all types of economy, the balance between formal and informal businesses varies greatly. Informal businesses account for one third to one half of GDP in low and
middle income countries. Export orientation of small businesses and entrepreneurs also varies: from 16–40 per cent in low-income countries, to 40–55 per cent in high- and middle-income countries, with an exceptional 69 per cent share of SMEs in exports in China (UNESCAP, 2012: 21).

Some measure of the overall entrepreneurship of a country can be gained by calculating the ratio of number of businesses and the self-employed to the total population (or total working-age population). Although Bannock (2005) warns of the difficulties of statistical comparability between countries, the calculation yields some startling results. For purely formal concerns, small businesses per 1000 population range from 62 in developed countries, to 30 in middle-income and 15 in low-income countries (UNESCAP, 2012).

As well as definitions that are applied to specific small business policies, all countries also use other definitions for other fields of policy. Thus in the USA the federal and state tax codes define a small firm or entrepreneur in different ways for different taxes and regulations, which all tend to differ from SBA definitions (Guenther, 2005). The same differences occur in all countries, with disconnects between one field of policy (or one agency) and another. This leads to situations where a small business is supported by some policies but penalised by others. It also gives politicians and policy makers almost limitless scope to manipulate eligibility, which makes policies complex and costly for firms and administrators and undermines policy credibility. The definitions have also had major influence on academic research by distorting attention away from functional definitions of small businesses and entrepreneurs proper, as followed in this book.

<table>
<thead>
<tr>
<th>Table 1.2</th>
<th>Contribution to GDP by firm size and type (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Businesses</strong></td>
<td><strong>High-income countries</strong></td>
</tr>
<tr>
<td>Large companies, public enterprises and para-state agencies</td>
<td>36</td>
</tr>
<tr>
<td>SMEs</td>
<td>51</td>
</tr>
<tr>
<td>Informal businesses</td>
<td>13</td>
</tr>
</tbody>
</table>

**Source:** Enste and Schneider, 1998; Ayyagari et al., 2005

**CONTEXTS FOR SMALL BUSINESS POLICY**

Policy is not implemented in an empty or theoretical space, but in real places and countries with governments, history and culture that differ from each other. There is no ‘ideal’ policy, only one that meets the needs of the specific context and is implemented
effectively. A major purpose of this book is to help you understand the importance of contexts that underpin different ‘business enabling environments’, ‘institutional inhibitors’ and ‘tipping points’.

Before the changes in 1989–90 that saw the removal of the Berlin Wall and the withdrawal of Soviet troops from Central Europe and Central Asia, texts split the global economic system into two blocs: planned/socialist economies and market economies. Small businesses were entirely ignored or supressed in the former and often given low policy priority in the latter. One outcome of the end of communism is that there is ‘only one game in town’, that of capitalist market economies. However, this has made evident the variety within market economies and their different policy contexts for entrepreneurship. Global capitalism is a series of nested models – a system of economic systems, each with different policy needs.

As a result, recent policy interventions have recognised the importance of the ‘business enabling environment’. This is particularly important for entrepreneurs and small business because it is not something they can do much about; they are externalities. Large businesses can compensate for some poor externalities by doing more themselves in-house (e.g. on-the-job training new recruits from poor education systems): called ‘internalising externalities’. Generally small firms can do less of this. Hence, policies attempting to improve business environments are important for small firms as they try to improve the externalities of ‘endogenous growth capacity’ of different places.

There is no natural tendency for policy changes to make improvements; policies can make matters worse. There will be institutional inhibitors as well as supports from different policy regimes: as observed by Schumpeter quoted earlier. However, there may come a time when misallocations become so obvious, the incompetence or corruption of elites so difficult to hide and the inefficiencies of firms so complete that all or part of the system fails. The collapse of communism in 1989–92 was a systemic ‘tipping point’ in former Soviet states. The rapid failure of major US and European firms was a tipping point in the 1970s and 1980s leading to increased SME start-ups and self-employment. The finance crisis of 1996–2000 in Asia was a significant tipping point to give greater support to SMEs in many countries. The financial slump of 2008–11 is a tipping point for banking, financial market regulation and financial supports for SMEs.

Tipping points open opportunities for institutional reform; but they do not guarantee it takes place, or result in improvements. The role of different contexts is examined in Chapter 4 and the following chapters. The shift to e-commerce, and now m-commerce (through mobile devices), is a technological tipping point for businesses that is facilitating small firms across the world. A tipping point of policies to favour small
firms and entrepreneurs to match this technological shift underpins the subtitle of this book – ‘evolution and revolution’ – investigated in Chapter 10.

SUMMARY OF KEY POINTS

This chapter allows you to understand the basics of entrepreneurship and small business policies, and why they are important. The discussion of definitions demonstrates how difficult it is to grasp the object at which policies are directed. The policy definitions used in practice, although supposedly focusing on small business and entrepreneurs, embrace firms up to businesses of 1,000 or 1,500 employees. Chapters 2 and 3 take these arguments forward by investigating the case for policies and its constraints. Chapter 4 introduces institutions and metainstitutions as the underlying elements of the ‘business enabling environment’. The rest of the book then investigates different policy dimensions and contexts.

- The USA: Chapter 5
- The characteristics of ‘the leading entrepreneurial economy’
- Targeted small business policies through a dedicated agency – the SBA
- Britain: Chapter 6
- Lessons from the development of ‘the first industrial economy’
- Experiences from varied small business advice services
- East and Southeast Asia: Chapter 7
- Government-led economies and SMEs, chiefly using Japan and South Korea
- China: Chapter 8
- The characteristics of ‘a socialist market economy’
- The links of the state to entrepreneurship and small business development
- Developing and transition economies: Chapter 9
- Challenges for transition from ‘informal’ to ‘formal’ businesses
- Challenges of change in oligarchic economies
- Evolution and Revolution: Chapter 10: policy to meet new technological challenges.

DISCUSSION QUESTIONS AND FURTHER READING

You probably intend on specialising in the policy of one region or country as a case study or dissertation topic. At this stage you should start to assemble material on the policies being followed, especially using web-based resources to access the most recent initiatives. International guidance can be found in the most relevant of: ADB

Discussion questions can involve:

1 How is entrepreneurship and small business policy defined in your case study country? How does this differ from the case studies of other students in your peer group? What are the consequences of these varied definitions?

2 What have been the chief policy targets in your case study countries: entrepreneurs, small firms or SMEs?

3 What are the relative expenditures on each policy initiative in your chosen case study area? Does this reflect economic rationality or political choices?