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Small Firm Finance and Public Policy

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ABSTRACT

This paper examines how a finance gap for small firms might be addressed by means of government policy to support informal financing initiatives. A review of both the finance and the government policy literature provides the basis for discussing and conceptualising the financing difficulties faced by small firms, the role of informal financing in alleviating certain of these difficulties and the areas where public policy is currently usefully employed in addressing such financing problems. A questionnaire survey is undertaken to collect data concerning small business awareness and use of informal finance and to identify issues concerning difficulties encountered in gaining access to finance. The results suggest that a debt finance gap may exist for a minority of firms, though an equity finance gap may represent a more significant issue for small firms. Four categories of policy action emerge from the study towards the achievement of economic and social policy objectives. These are legislation/regulation, information provision, direct funding and network provision.

MANAGERIAL AND POLICY IMPLICATIONS

- Over the decades, the presence and nature of a small firm finance gap has been an important preoccupation of policy-makers, the finance industry and of course the small firm manager. This gap may be filled by means of quasi-commercial, or QCOM, finance.
- It appears that only a minority of small business managers encounter a debt finance gap, though a more serious problem is presented by the presence of a significant and widespread equity finance gap.
- There exists a range of policy prescriptions to address the debt and equity financing gaps experienced by small firms. Those initiatives aiming to address the former are aligned to the government's more recent agenda concerning social inclusion and community

development whilst those aiming to address the latter are aligned to existing government economic policy objectives, particularly the continued emphasis on 'picking winners'.

- Policy action directed at addressing the small firm debt finance gap might include legislation to enable the growth of business credit unions; better information provision regarding sources of debt and appropriate support services; direct funding of agencies such as the Princes Trust; and network support for collectivist financing initiatives such as mutual guarantee societies and credit unions.
- Policy action directed at addressing the equity finance gap might include legislation and deregulation to further encourage private equity investment; information to promote informal venture capital opportunities; the establishment of government funds to extend informal equity investment; and enhanced support for new and existing venture capital networks.

KEYWORDS

Finance, public policy, finance gap, information asymmetry, informal finance

INTRODUCTION AND BACKGROUND

The aim of this paper is to examine how a finance gap for small firms might be addressed by means of government policy to support informal financing initiatives. This research constitutes part of a wider funded research project which seeks to investigate the use of various sources of informal finance by small firms. The issue is of particular importance given that 43.4 per cent of employment and 31.2 per cent of turnover in the UK is generated by small firms (Small Business Service, 2001a).

The paper will commence with a discussion of the broad policy context associated with informal financing. This will be followed by a conceptualisation of the nature of small firm financing problems and a review of specific informal finance instruments. The methodology will then be discussed, describing the survey approach employed. The results are then presented to enable examination of the extent of the small firm financing difficulties and to consider the role of policy instruments to deal with any such difficulties. Salient results are then drawn together in the conclusion which considers the current role of public policy and suggests ways in which that policy may be made more effective in addressing the small firm finance gap.

The broad policy context

The success of developing world 'micro-finance' initiatives in combating poverty by enabling the poor to enter the market mechanism as small business owners has renewed interest in informal financing approaches in the developed world. From the early 1990s, the United States embraced the micro-finance philosophy as a means of combating social exclusion caused through long-term structural unemployment (Hulme and Edwards, 1997). In the UK, the Labour government's emphasis upon tackling social exclusion mirrors developments in the United States. The aim of one of the Policy Action Teams within the Social Exclusion Unit (established in 1997) is to encourage enterprise in deprived communities. In their first report (Enterprise and Social Exclusion, November 1999), access to finance is identified as one of the key obstacles to the development of enterprise in poor communities. This socially-oriented enterprise support agenda appears to represent a limited move away from the dominant growth-oriented business support policies of the 1990s. The policy interest in business growth arose largely from evidence indicating that most employment growth within the small firm sector has come from business expansion rather

than the creation of new companies (ENSR, 1994). Furthermore, other research (Storey, 1994) suggests that the majority of employment growth is generated by a very small number of fast-growing firms. Therefore policy during much of the 1990s has emphasised the idea of ‘picking winners’ (Hutchinson *et al*., 1996; Lean *et al*., 1999). However, such a policy is clearly at odds with a socially-driven agenda of inclusion. Thus, a key policy question relates to the extent to which informal finance initiatives, which are typically targeted at very small firms that might have little growth potential, should be supported by government. This issue represents a particularly important challenge for the new Small Business Service as it attempts to create a better match between the needs of small businesses and the type of finance that they use (Small Business Service, 2001b). In order to consider the value of government support for informal financing initiatives, it is necessary first to conceptualise the finance gap problem for small firms in the UK and to explore the concept of informal finance and the role it plays in addressing small firm financing needs.

The Finance Gap and Information Asymmetry

Small firms have traditionally encountered problems when approaching providers of finance for funds to support fixed capital investment and to provide working capital for the firm’s operations. The presence and nature of a ‘finance gap’ for small firms has been debated for decades, ever since the Macmillan Report (1931) and more recently by Cruickshank (2000).

Binks and Ennew (1996) discuss the small business finance market within a *principal-agent* framework. Here, the small firm is the agent of the finance provider, and as such undertakes to generate returns from its investment projects on behalf of that provider. In a ‘perfect markets’ setting, with full information available to both parties in the contract, a finance gap would not occur. However, finance markets are characterised by a number of market

imperfections, not least of which is the problem of information asymmetry. To understand this problem more fully, it is necessary to examine the situation of the provider as principal and the recipient firm as agent in turn.

The finance provider

Finance providers for (small and medium sized enterprises) SMEs range from venture capitalists and High Street banks through to soft loan and grant providers. Before the role of informal financing in the market may be considered, it is useful to understand how that sector operates within the wider setting. This is best achieved by examining the way in which banks operate as finance providers, as they represent the main source of external finance for small firms (Binks and Ennew, 1996). In discussing information asymmetry in the principal-agent relationship, it is convenient, then, to consider the bank as the principal.

In a perfect markets setting, with perfect and costless information available to both parties, and no uncertainties regarding present and future trading conditions, the principal-agent relationship does not suffer from the market failure of information asymmetry. However, information in the real world is neither perfect nor costless, and additionally the small business finance market is characterised by risk and uncertainty regarding future conditions. Information is distributed asymmetrically between the bank and the firm. From the bank's perspective, it has incomplete information regarding the underlying quality of the project and the management of the small firm, giving rise to the problem of adverse selection (Stiglitz and Weiss, 1981). Furthermore, the management of the small firm may fail to perform to their full capabilities, giving rise to the problem of moral hazard. The latter arises because it is too costly for banks to effectively monitor small firm projects, thereby resulting in

equilibrium credit rationing and a shortfall in debt provision (Binks and Ennew, 1996; Bester, 1987; and Bester and Hellwig, 1989).

The information asymmetry problem may not only result in good lending prospects being rejected by providers, but also poor prospects being accepted by providers, as discussed by Altman (1968). Altman defined the latter as a Type I Error and the former as a Type II Error, as illustrated in Figure 1 below.

[Take in Figure 1]

In theory, the provider can reduce the risk of Type I/II errors by carefully screening firms at the outset and monitoring projects during the life of the loan. However, screening and monitoring are high cost activities associated with the lending proposition. If the lender is to recoup these costs then borrower interest rates may be increased, additional risk may be covered by demanding collateral or may be avoided altogether by rejecting the loan application. Of the Altman error categories, it is the Type II Error which is of most concern to the small business sector - that is, a good investment project which is incorrectly rejected by the lender. Common occurrence of this type of lending error would contribute significantly to a finance gap.

The problem of information asymmetry and the resulting adverse selection and moral hazard are further compounded by certain trends which are evident in the banking sector. Firstly, competition in the banking sector is leading to greater market concentration. This has an important impact on the market for small firm finance as there is evidence that larger/universal banks are less well placed to build close relationships with small business

customers than smaller/regionally-based banks (Bannock and Doran, 1991; Binks *et al.*, 1991). Secondly, a broad trend is that banks are further centralising business lending decisions and/or limiting branch manager discretion to lend outside of very strict policy guidelines. The ultimate lending decision maker has thus become even more remote to the small business borrower. Thirdly, although authors such as Binks and Ennew (1996) argue that the introduction of expert systems and other knowledge-based decision support systems to bank lending should reduce information costs whilst raising quality and consistency in lending decisions, such developments may actually lead to a greater unwillingness to lend to firms with non-standard projects, particularly in highly innovative or high-technology sectors. Fourthly, recent evidence reveals a decline in the use of bank overdraft facilities and a move towards term-loan lending among businesses (Binks and Ennew, 1996). The result might be more cautious lending by banks as such loans are not repayable on demand. Furthermore, there is likely to be a greater demand for collateral (business or private) to support loans with a longer maturity. Finally, it has been argued that short-termism continues to be a significant failure of the UK bank finance market (Edwards, 1987; Cruickshank, 2000).

To summarise, the general problem of information asymmetry can manifest itself in one of three ways: acceptance of the loan application but at a higher than risk-adjusted interest rate; acceptance but with strict collateral requirements; or outright rejection of the loan application. Acceptance but with higher than risk-adjusted interest rates can result specifically from the adverse selection problem or as a result of greater concentration in the market for finance. Acceptance but with more severe/strict collateral requirements is likely to result from moral hazard, compounded by the trend towards longer-term debt. Outright rejection of a loan application can result from moral hazard, market concentration, centralisation of lending decisions, and the increasing use of computer credit-scoring.

The small firm recipient of finance

Now that the problems faced by the provider of finance have been discussed and the principal-agent relationship is better understood, it is useful to examine the problems faced by small firms when attempting to raise finance. The nature of the information asymmetry problem on the firm's side is that it cannot prove the quality of its investment projects to the provider of finance (usually the bank). Small firm managers often suffer from a lack of financial sophistication as they are often product or service specialists, not specialists in the area of finance. Thus, the information asymmetry problem is partly one relating to difficulties in the spheres of communication and credibility. This is compounded by the fact that new or recent start-up businesses may be unable to provide evidence of a good financial performance track record. Banks in particular rely on past financial performance as an indicator of the future profitability of projects. A closer relationship between the bank and the firm should reduce the information asymmetry regarding the firm's understanding of the lending constraints faced by bank managers (Watson, 1986).

Other small firm financing problems relate to the characteristics of the firm itself and the attitude and objectives of the owner-manager. Such characteristics include their diversity, their higher risk, their inability to provide strong collateral, and stage of development effects. Binks and Ennew (1996) note that there is no such thing as a typical small firm. This heterogeneity presents lenders with great difficulty in determining the risk associated with the firm's projects. Due to the lack of business experience of many small owner-managers in the early years of the business, business risk may be more significant than for larger firms. Small firms generally have smaller financial reserves to draw upon in times of crisis and are also relatively highly geared compared to larger firms due to the difficulty and expense of attracting new equity finance. Thus, such firms are characterised not only by higher business

risk but also higher financial distress risk. Banks tend to respond to this risk by adopting a capital gearing rather than an income gearing approach to lending. Thus, rather than focusing their attention on evaluating the income streams flowing from an investment project, they may focus more upon the value of collateral available in the event of financial distress. This creates a problem for small firms in that they often do not have significant fixed assets to secure upon in their early years of establishment. The stage of development, then, may be an important determinant of, and constraint upon, the type and amount of external finance raised. Small firm financing, then, will typically be heavily secured debt, with few incidences of external risk capital contribution (Cruickshank, 2000).

The attitude and objectives of the owner-manager can exert an important impact on the firm's ability to secure external finance. Such managers are often unwilling to provide personal assets as collateral. Furthermore, many small businesses have objectives other than growth as a priority (e.g. 'lifestyle businesses'). However, Binks and Ennew (1996) argue that many small firms will be forced to provide yield expansion to protect their limited liability status (which would otherwise be eroded by the provision of personal assets as loan collateral). A primary motive for starting a small business is to exert greater control over the work environment and to internalise the benefits of personal effort and risk-taking. In this regard, then, it is understandable that many small business managers would not countenance any dilution of this control through the introduction of outside equity from venture capitalists or business angels. Thus, the attitudes of managers may sometimes constitute an important constraint upon the range of external financing sources available to the firm.

Provider-recipient interaction in the presence of information asymmetry

Figure 2 presents a model of principal (provider) and agent (small firm) interaction, noting that the former focuses upon High Street bank financing. Information asymmetry and related problems such as adverse selection and moral hazard are central to the problems encountered by providers and, in turn, by small firms. Industry trends such as centralisation of the lending decision and greater reliance on computer credit scoring compound these problems for small firms. The ultimate effect on the small firm is acceptance but at higher interest rates, acceptance but with stricter collateral requirements, or rejection of the application for funds. It is the overall incidence and impact of all three which might give rise to a finance gap in the UK.

[Take in Figure 2]

Exploring the nature of informal finance

In exploring the nature of informal finance, it is necessary to consider the range of mechanisms or models that might fall into this general category. One important model, originating from the developing world, is that of micro-finance. Interestingly, the term micro-finance is often used as a label for any type of non-bank finance provided to small (especially micro) firms. However, it is useful to consider how micro-finance might be more clearly defined. Malcolm Lynch, a UK contributor to an International Labour Organisation seminar on the topic, defined micro-finance as:-

1. A business loan of less than 10,000 ECU;
2. Made to a person or group of persons to undertake or finance a business or community enterprise start-up;

3. Financial support for the training of the unemployed for self-employment so as to enable them to more effectively use micro-finance and/or;
4. Mentoring schemes for the new entrepreneur. (International Labour Organisation, 1998)

Therefore, micro-finance, using this definition, is a particular type of informal finance that takes the form of a small loan to individuals (or a group of individuals) who are in some way 'socially excluded' to enable them to become self-employed or start a business. Assistance in the form of training or mentoring may also accompany the loan. Some writers include small grants under their definition of micro-finance. A good UK example is the Prince's Youth Business Trust.

However, this definition leaves us without a satisfactory means of conceptualising the many other forms of non-conventional finance that exist. Other forms of non-conventional finance include:

1. **Social banks** who only lend to businesses with clear social and environmental objectives;
2. Organisations who only lend to **co-operative** or **community based** enterprises
3. **Business credit unions** who only lend to their own member businesses;
4. **Mutual guarantee societies**;
5. **'Business angels'** (informal venture capitalists);

These lenders, unlike conventional banks, appear willing to accept the greater screening and monitoring costs involved in over-coming information asymmetry as there is a likelihood of an additional *non-commercial* payback in the form of **psychic income** (the satisfying of

personal/individual wants (Wetzel, 1984)), and/or **public policy** (the satisfying of public/social wants).

Generally, ‘non-commercial’ criteria do not feature in the lending process of conventional banks who typically adopt a CAMPARI-type framework (Banking Liaison Group, 2002). However, other criteria, of a non-commercial nature, might be important to certain less-conventional lending bodies. Examples include the environmental, social or community impact of projects receiving finance, ethical considerations and psychic income generated.

Any lending body that employs CAMPARI-type criteria plus at least one of the above non-commercial criteria might be termed a *'quasi-commercial lender'* and thus the provision of resources following the satisfaction of these extended criteria could be termed 'quasi-commercial' or QCOM finance. In this regard, then, lending bodies exist on a continuum whereby their lending criteria can be gauged anywhere from purely non-commercial through to purely commercial. At the commercial extreme exist conventional banks and the capital markets whereas towards the non-commercial extreme exist governments and charities providing grants and soft loans.

QCOM finance as a potential solution to the finance gap

QCOM enables the conceptualisation of a range of informal financing options available to small firms in the UK. This section describes how the finance gap might be closed by the employment of QCOM sources. Where appropriate the role of public policy is highlighted.

Specialist lenders

Small firm finance risk can potentially be better understood and dealt with by lenders who specialise in small firms, lending to certain sectors, lending within certain limits, or lending to firms with specific (e.g. social or environmental) objectives. Social banks currently undertake such a specialist role, relating to some of these sub-markets. Additionally, social banks are often able to borrow from their investors relatively cheaply by promising compensating returns in the form of psychic income. This increased rate spread can be at least partly used to cover the higher screening and monitoring costs associated with small firm finance.

Matching agreements

Matching agreements occur where one lender will match the funds of other lenders providing that at least one of those other lenders has undertaken rigorous screening/investigation of the loan candidate (and incurs the costs of so doing). Social banks can play an important role here, absorbing screening costs through higher spreads or even lower overheads. Alternatively, charities and quasi-governmental organisations may be willing to undertake screening activities on behalf of other matched lenders. Micro-finance providers such as the Prince's Youth Business Trust are often prepared to incur screening costs and play the pivotal 'first to commit' role in the matching process and even help to co-ordinate other parties in that agreement. Matching agreements, then, whilst not addressing the intrinsic risk of the individual small firm project, can reduce total screening costs across providers and also provide further diversification of that risk.

Mutual support groupings

The provision of finance or the reduction in risk to an institutional provider can both be achieved by a collectivist approach to small firm borrowing. Businesses can join credit unions for the provision of lower-than-market-rate finance to members. This directly circumvents problems of the principal-agent relationship with respect to institutional providers by effectively rendering all member firms both principal and agent. Risk is thus internalised to the small firm sector. Businesses of like nature or philosophy can also engage in mutual guarantee agreements, these having the effect of minimising the risk to the provider and enabling relatively cheap borrowing from providers such as banks. Mutual guarantees reduce the need, then, for more rigorous investigation and are conducive with lower screening and monitoring costs.

Micro-finance initiatives

Micro-finance initiatives involve the provision of small-scale finance through grants or soft-loans, to small firms often as part of a package of other services (e.g. training or mentoring). The provision of a grant may not necessitate high screening costs, relying more on simple eligibility criteria. The criteria for soft-loans will be more stringent, though are likely to rely more heavily on softer (QCOM) criteria than would be the case for banks. Again, screening costs can be relatively low and are borne by micro-finance providers as they are compensated by psychic income or are incurred as a matter of public policy.

Provision of risk capital

The principal-agent relationship discussed previously relates mainly to debt finance, consistent with the dominance of debt in the small firm market for external finance. However, the provision of risk capital (external equity investment) by informal venture capitalists

(business angels) can address each of the problems associated with the finance gap. The business angel will only make an equity investment in a firm once it has fully screened the business proposal and is allowed participation in the management of the firm. The provider thus becomes both principal and agent and the information asymmetry may disappear, depending on the extent of participation. However, an important problem remains for the provider of risk capital i.e. how to identify small firms which are worth investing in. There is an implicit understanding here that small firms are risky, but that the higher returns from identifying and investing in an entrepreneurial firm will compensate for this. The information asymmetry problem thus re-emerges in a different guise, that is, the absence of a clearly defined market for *entrepreneurial* small firm finance. The solution is the creation of a network of business angels to facilitate a greater flow of information to and from potential providers, the costs of which might reasonably be borne by Government as a constituent of small business policy.

It is common for many of the above QCOM sources to use mentoring (or similar publicly funded advisory services) as a support mechanism. Both small firm business risk and screening/monitoring costs may be reduced with the appointment of an expert mentor. Part or all of the rewards to mentors come in the form of psychic income derived from aiding a small business within the mentor's community. Mentors can be engaged to improve the screening process by helping the owner-manager to develop a more robust business plan, by helping to 'translate' the quality of the investment project to the provider of finance, and by providing continued monitoring. A number of QCOM sources, then, employ the use of mentors in order to reduce lending risk. Further, the association of a mentor with a particular business may also facilitate access to further external sources of funding by reducing the screening and monitoring costs of providers (e.g. banks).

What is clear from considering the problems constituting the finance gap, high screening and monitoring costs and the higher risk associated with small firms, is that the six solution mechanisms discussed above suggest greater provision of QCOM finance. Put another way, QCOM finance can, in theory, be argued to provide practical solutions to the financing problems faced by small firms, potentially leading to closure of the finance gap. The role of public policy currently extends to the following categories of policy action: producing legislation to facilitate support agencies (for example, the relaxation of regulations concerning credit unions, leading to their expansion over recent years); the provision of financing information and advice services such as those provided by the Small Business Service and Business Link; direct funding of agencies and organisations such as the Princes Trust which provide soft loans, grants and mentoring advice; and increasingly, support for informal venture capital networks for smaller firms.

THE RESEARCH METHODOLOGY

To establish the potential role of government policy to support informal financing initiatives, it is necessary to determine the use and awareness of the range of financing sources available to the small firm and to identify the issues associated with small firm financing. To achieve this aim, then, a questionnaire survey was implemented based upon a sample of 1,000 small UK firms drawn from the Yellow Pages Business Database.

The firms were selected to conform to certain criteria - they should have less than 10 employees, a sales turnover of less than £2.5 million, and should be drawn from all industrial sectors. A draft questionnaire was piloted among a small sub-sample of local businesses. This was particularly important given the often sensitive nature of questions. The survey was

released in early November 1999. Data from responses was entered into an ‘SPSS’ database application for analysis.

RESULTS

The response rate from the survey of 1,000 small firms was disappointing though perhaps unsurprising: 103 firms returned usable responses. This response rate can largely be attributed to the sensitivity of the financial matters addressed by the survey. The results showed that 66 per cent of the respondents were first time businesses, most of which were private limited companies. The respondents were predominantly micro businesses, with 67.6 per cent employing five people or less and with the mean number of employees being six. For this sample, 70.5 per cent were businesses with a turnover of £500,000 or less, and 85 per cent had total assets of £250,000 or less. There was a relatively small proportion of start-ups within the sample of respondents, with only 16.2 per cent of firms in existence for less than five years. As the survey reflects both the current and past experience of small firms in the market for external finance, this was not felt to be a significant limitation. In terms of the demographic characteristics of the owners of the firms sampled, the great majority were found to be mature (76.6 per cent over 40 years old), white (94.7 per cent) and male (90.8 per cent).

Use and awareness of QCOM finance

Table I illustrates the awareness amongst respondent firms of a range of QCOM financing options. The majority of firms are unaware of non-bank sources of finance. They are, however, more aware of both formal and informal venture capital opportunities than the other options. This may reflect the advanced stage of development of many of the sample companies. Given their length of establishment and the marketing efforts of quasi-

governmental providers such as Business Link and Enterprise Agencies, the lack of awareness amongst the respondents of these providers is quite surprising. It may reflect that the role of these organisations is perceived to be more that of intermediary than provider. Very few firms were aware of the existence of mutual support group providers such as business credit unions and mutual guarantee societies, awareness of social banks was particularly low, and few firms were able to articulate other sources of external finance.

[Take in Table I]

The lack of awareness of non-bank sources may result from a lack of need by most small businesses to know about alternative sources. Indeed, they may be entirely happy with the range of sources available from the commercial sector.

Table II illustrates a relatively high dependence on the bank overdraft facility as the main source of external finance, with a surprisingly low proportion of firms raising finance through bank term loans or other sources. The reliance on bank overdrafts might suggest that small firms place great importance on the flexibility offered by short-term debt as opposed to longer term debt with structured repayments. Alternatively, it may simply reflect the fact that the sample contains a high proportion of well established firms which are cash generative and thus have a lower requirement for external finance.

[Take in Table II]

The dominance of bank sources of finance contrasts starkly with the low use of most QCOM sources, the only exception being finance provided by family and friends which could be

considered a form of QCOM finance. The latter represents a proportionately small but nevertheless important source for a significant minority of businesses.

It is interesting to note the significant minority of firms which have made use of the Small Firms Loan Guarantee Scheme (SFLGS). The use of this scheme by firms may be one reason why a wider range of financing options, such as that provided by mutual guarantee societies, are not used. Indeed, Cruickshank (2000) proposes that the government should switch its financial support away from the SFLGS and towards an enlarged venture capital fund programme. If this were to occur, this might provide an impetus for growth for mutual guarantee societies and other QCOM providers.

Issues in raising small firm finance

Table III illustrates that most firms regard High Street bank financing and family/friends finance as easy to acquire, which again suggests that for most firms a debt finance gap does *not* exist. What the survey did not address was whether the scale of finance and other specific term details agreed were satisfactory to the recipient. However, only 24.8 per cent of firms regarded the provision of external finance as either inadequate or very inadequate. Indeed, a surprisingly high 31.4 per cent of firms do not make any attempt to raise any form of external finance, suggesting that many firms are financed adequately from private sources or from internal finance generation.

[Take in Table III]

Given the information asymmetry that exists regarding the quality of the small firm's investment projects, lenders may demand security for advances or only lend as part of a

matched funding agreement. This is borne out by the survey findings which show that for those firms using High Street bank term loans 81.8 per cent had to provide security against the advance, as did 72.1 per cent of firms arranging an overdraft facility. At present there is little evidence of matched funding arrangements being pivotal to the lending process, although qualitative findings, reported in Lean and Tucker (2000) suggest that this is a requirement of growing importance.

Table IV shows how respondents rank the difficulties faced when raising external finance. For most of the financing difficulties listed in the table, only a minority agreed that they were significant. The most common difficulty (for 50 per cent of respondents) appeared to be a lack of knowledge by finance providers about the nature of the respondent's business. Interestingly, 42.7 per cent of respondents also admitted that their lack of knowledge about lending criteria used by providers represented a significant difficulty whilst 42.4 per cent of firms identified difficulties in accessing information about available finance. These three difficulties demonstrate the centrality of information asymmetry in provider-recipient small business finance market interaction.

[Take in Table IV]

A significant proportion (48.4 per cent of respondents) regarded a lack of securable firm assets as an important problem in the finance raising process. This contrasts with the relatively small proportion of firms that view a lack of financial track record to be a significant difficulty (22.5 per cent of respondents). For businesses that are more recent start-ups, one would expect the lack of financial track record to be a more important problem.

DISCUSSION AND IMPLICATIONS FOR PUBLIC POLICY

The aim of this paper was to examine how a finance gap for small firms might be addressed by means of government policy to support informal financing initiatives. The results of the study reveal that both awareness and use of QCOM finance are extremely limited. Indeed, the survey found that where firms do use external finance, this is most likely to come from conventional sources, and in particular from High Street banks. Surprisingly, a significant minority of firms use no external finance at all.

The survey indicated that only a small minority of firms regarded the provision of external debt finance as inadequate. However, whilst for the great majority of firms there appears to be no debt finance gap, the very nature of social exclusion is that it affects only the minority. Therefore it is impossible to rule out the potential for financial exclusion of certain groups of owner-managers and their firms. Furthermore, sampling constraints associated with the identification of new and very small micro businesses in this study may mean that the financing difficulties encountered by such firms have been underestimated by this research.

Although for the average firm there may not be a significant debt finance problem, other recent research (Cruickshank, 2000; Tucker and Lean, 2001) recognises a significant problem concerning the provision of informal equity finance for growth potential small firms. Policy prescriptions, then, need to consider both debt finance and its role in achieving social policy objectives and equity finance and its role in promoting the development of growth-oriented businesses. Figure 3 provides a model of the role of public policy in supporting both debt and equity QCOM finance initiatives.

[Take in Figure 3]

The Figure examines policy prescriptions concerning debt and equity finance provision and relates these to the four categories of policy action identified earlier in the paper.

With regard to debt finance, policy action might include: legislation to enable the growth of business credit unions; better information provision regarding sources of debt finance and appropriate support services; direct funding of agencies, such as the Princes Trust; and network support for collectivist financing initiatives, such as mutual guarantee societies and credit unions. These types of initiatives are most clearly aligned to the government's more recent agenda concerning social inclusion and community development.

With regard to equity finance, policy action might include: legislation and deregulation to further encourage private equity investment; information to promote informal venture capital opportunities; the establishment of government funds to extend informal equity investment; and enhanced support for new and existing informal venture capital (business angel) networks. These types of initiatives are most clearly aligned to existing government economic policy objectives, particularly the continued emphasis placed upon 'picking winners'. However, it is important to note that the social and economic policy objectives are inter-linked in that the attainment of one set of objectives should impact positively upon the other. The further integration of these objectives through fully co-ordinated initiatives would be one way of furthering the government's aspirations towards "joined-up government".

A particularly important category of policy action appears to be that related to information provision. As shown in Table 4, a number of the most important financing difficulties reported by businesses relate to information asymmetry and general issues of awareness. These difficulties are encountered by both the provider and the small firm recipient of

finance. For the small firm recipient, this problem is also apparent in the low levels of awareness of the various forms of QCOM finance shown in Table 1.

In summary, there exists a finance gap for a minority of firms seeking debt finance. However, a more significant problem concerns the adequacy of equity finance provision for small firms. Therefore, the finance gap problem must be tackled on two fronts: one oriented towards economic policy objectives and the other towards social policy objectives. Recent policy pronouncements indicate a movement towards this two-pronged approach, whilst retaining primary emphasis upon the economic objective of supporting growth-oriented businesses. This paper has identified a number of specific action areas for proactive public policy, focusing in particular upon the importance of high quality information provision to all parties in the market for small business finance.

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Figure 1 - Altman's (1968) risk categories

		PROVIDER	**THINKS**
		Good prospect	Bad prospect
FIRM	Good prospect	√	Type 2 × Error
KNOWS	Bad prospect	Type I × Error	√

Figure 2 - Information asymmetry in small firm lending

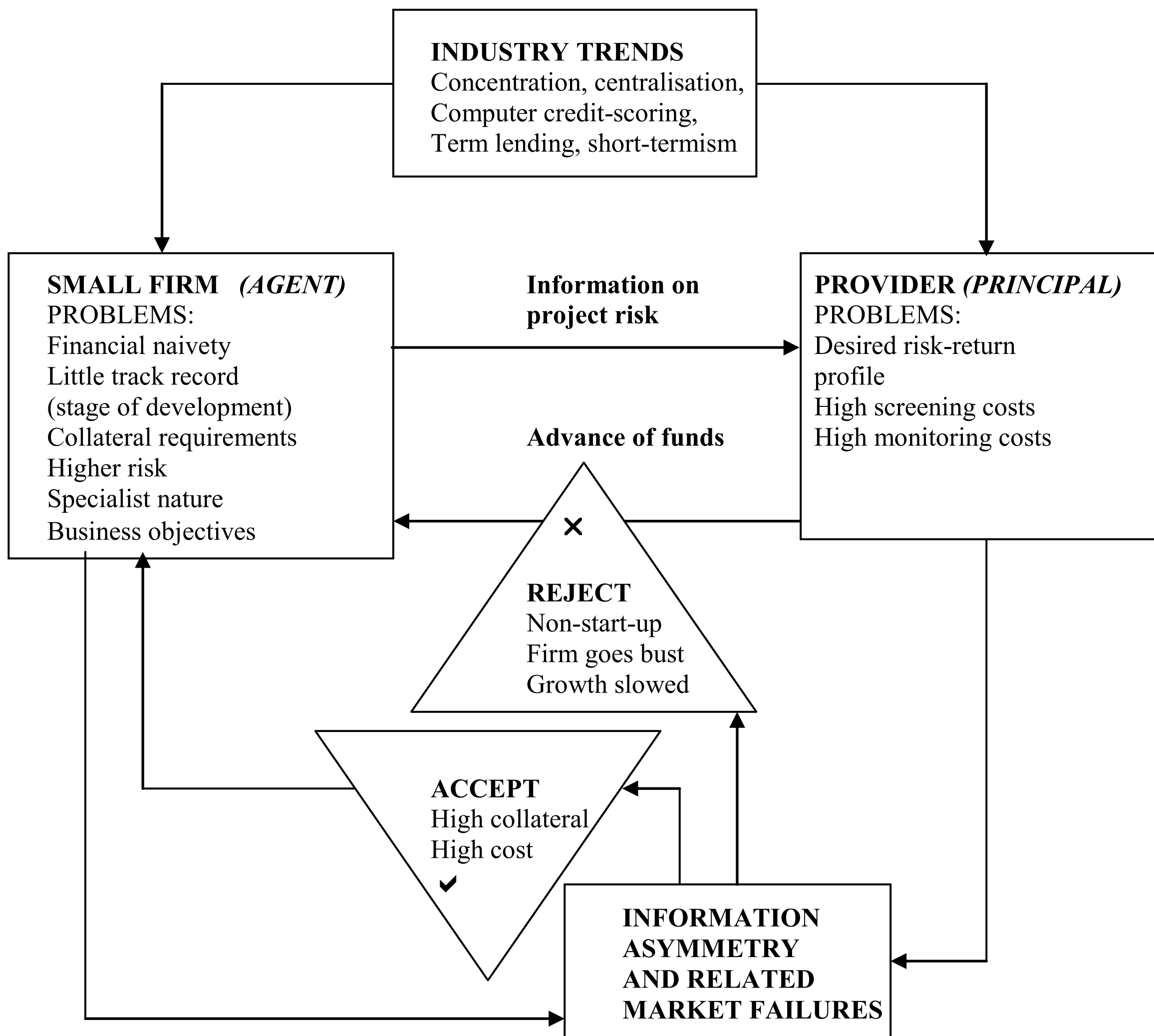

Figure 3 - Policy prescriptions and QCOM finance

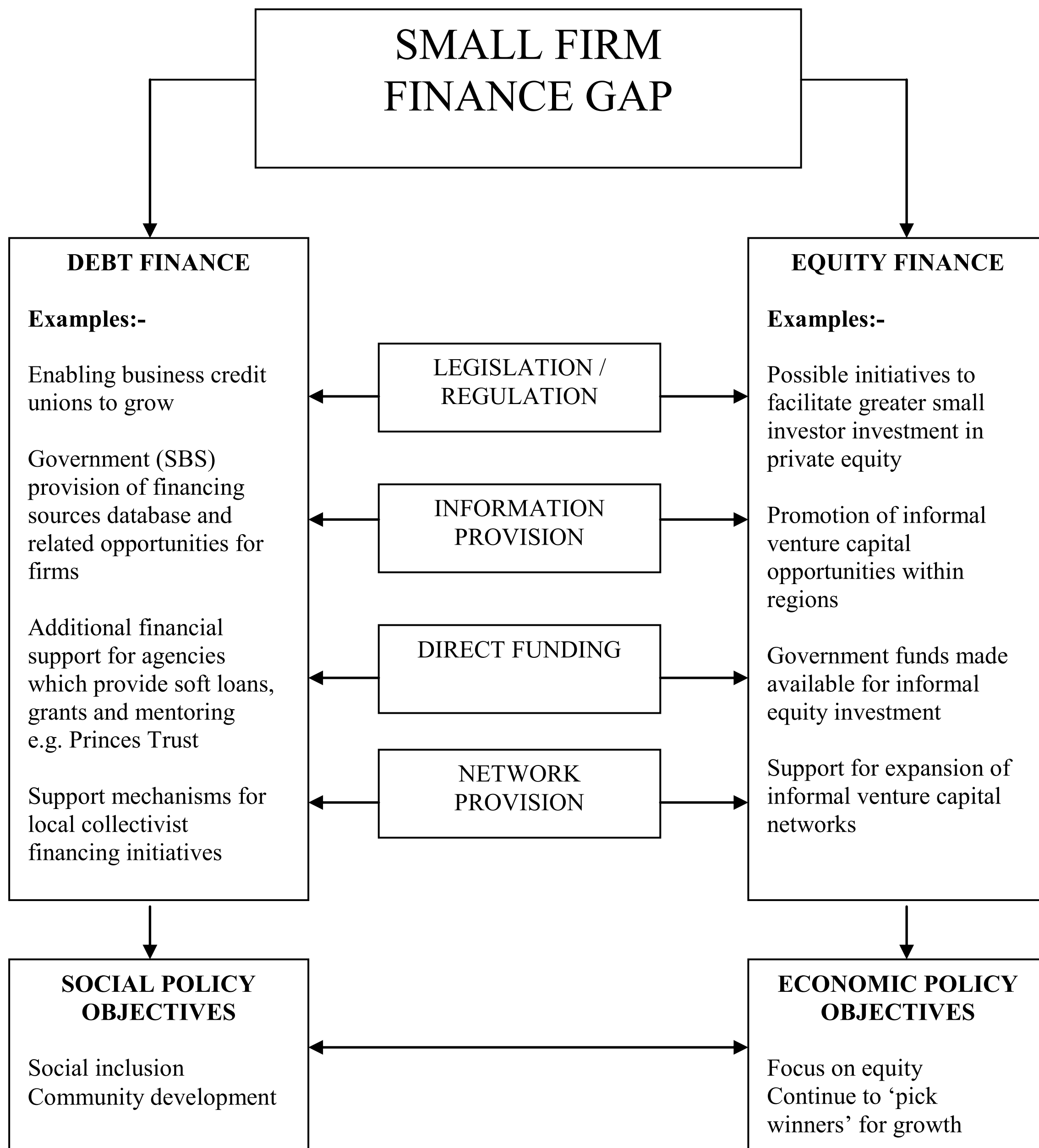

Table I - Awareness of various forms of QCOM finance

Form of finance	Awareness of form %
Formal venture capital	49.5
Informal equity capital (business angels)	33.3
Business Link grant/loan	21.9
Prince's Youth Business Trust grant/loan	21.0
Enterprise Agency grant/loan	17.1
Loan obtained through membership of a business credit union	7.6
Loan obtained through membership of a mutual guarantee society	7.6
Other source of external funding	4.8
Social bank loan	1.9

Table II - Use of various forms of QCOM finance

Form of finance	Successful in obtaining %
High Street bank overdraft facility	64.8
High Street bank term loan	21.0
High Street bank term loan (guaranteed by SFLGS)	10.5
Family and/or friends	17.1
Other source of external funding	2.9
Informal equity capital (business angels)	1.0
Formal venture capital organisation	1.0
Business Link grant/loan	1.0
Enterprise Agency grant/loan	1.0
Social bank loan	-
Loan obtained through membership of a business credit union	-
Prince's Youth Business Trust grant/loan	-
Loan obtained through membership of a mutual guarantee society	-

Table III - Perception of ease of acquisition of various forms of finance

Form of finance	Perception that acquisition is easy %
Family and/or friends	88.9
High Street bank term loan	86.3
High Street bank term loan (guaranteed by SFLGS)	81.8
High Street bank overdraft facility	79.1

Table IV - Financing difficulties encountered by the business

Difficulty	%
Lack of knowledge by finance providers about my (small) business(es)	50.0
Lack of securable assets	48.4
Lack of knowledge by my (small) business(es) about lending criteria used by providers	42.7
Difficulty in finding out about available finance	42.4
Lack of financial performance track record	22.5