

THE ROLE FOR A SCOTTISH DEVELOPMENT BANK IN A DEVOLVED SCOTLAND

David Bailey and Lisa De Propris

INTRODUCTION

Mention finance in the same sentence as devolution and most thoughts jump to the 'tartan tax' and the tax varying powers of the new Scottish Parliament. Yet as Jackson (1999) and McCarthy and Newlands (1999) note, this is something of a distraction to the real business of managing the Scottish economy, as the demands on public spending are so large that even the most that could be raised under these powers would not go very far. Whilst accepting the tight constraints on what the Scottish Parliament can do in economic terms - particularly in managing demand (Newlands 1997) - this paper argues that there is a key role for the new Scottish Executive in fostering economic development by improving the functioning of the Scottish financial system.

In particular, there is a need to improve the nature of the relationship between small and medium sized firms¹ and the financial sector in Scotland so that

Both authors are at the Research Centre for Industrial Strategy, University of Birmingham Business School, Ashley Building, Edgbaston, Birmingham B15 2TT, UK, e-mail:d.g.bailey@bham.ac.uk. This paper draws on earlier work with John Clancy. The authors would like to thank Chris Warhurst, Paul Thompson, Will Hutton and other participants at the Seminar on Financing Scottish Business organised by the Centre for Scottish Public Policy (held at The Merchants' House, Glasgow, 15 September 1999) for useful advice and critical comments on an earlier version of this paper, as well as anonymous referees for this journal.

¹ *The debate on the definition of small and medium-sized firms has drawn attention to various cut-off points. The European Union classification considers small and medium sized enterprises (SMEs) to have less than 250 employees; we also support a*

long-term, patient finance is both more acceptable to and more available to such firms, as well as to improve the functioning and co-ordination of development actors such as Scottish Enterprise, Highlands and Islands Enterprise, the Local Enterprise Companies and more broadly, the Scottish Enterprise Network. Taken together, this might put some strategic thinking back into economic development planning in Scotland, for example, in bringing together policy objectives, such as Scottish Enterprise's cluster-based approach, with the instruments to achieve them (e.g. long term, patient financing of projects in such clusters). The achievement of such goals would be facilitated, we argue, by the creation of a Scottish Development Bank, which we suggest should be properly networked with development actors, business support organisations and local authorities. Furthermore, in creating such a body, lessons can be learnt from the successes of 3i (the venture capital firm created by the Labour Government in 1945 as a public body) and Scottish Development Finance, the soon-to-be spun-off venture capital arm of Scottish Enterprise.

The paper proceeds as follows. Section two outlines the key problems in Scottish Finance, the relevance of the stakeholding concept and what role we envisage for a Scottish Development Bank. Section three looks at what lessons can be drawn from the experiences of 3i and Scottish Development Finance. There follows an exploration of the role for a Scottish Development Bank in plugging the finance gap for small and medium-sized firms (section four) and in spreading stakeholder values among medium-sized firms (section five). The desirability of a two-tier role for a Scottish Development Bank is discussed in sections six and seven. Some final thoughts conclude the paper.

2. SCOTTISH FINANCE AND STAKEHOLDING

Several commentators have stressed the particular distinctiveness of the Scottish financial system, which through its separate history and development has favoured independence from London and co-operation within the sector (Callaghan 1997) as well as a different ethos to its English counterpart 'fed by the social and cultural cohesion within the sector' (Bell and Dow 1995). In practical terms, for example, Clay and Cowling (1996) note that Scottish banks appear to be 'more responsible, knowledgeable and sympathetic towards their small firm customers than English banks'. Indeed,

more precise definition of small firms as having less than 50 employees (Lazerson 1990).

The Role for a Scottish Development Bank in a Devolved Scotland

it is this apparent distinctiveness which offers the opportunity to help develop an industrial development policy in Scotland. As Dow (1996) has argued:

the cohesiveness of the financial sector ... would allow for a corporatist approach to industrial policy (which would also involve other interest groups in society). This would be to the advantage of the Scottish banks in that credit worthiness is a function not only of individual projects but also of their macro setting.

Of particular significance for this paper, commentators have also argued that this alleged distinctiveness may prove advantageous in developing a stakeholder economy (Callaghan 1997; McCormick and Alexander 1996)

Why, however, is 'stakeholding' a relevant concept for Scotland? In answering this it has to be understood that even if the Scottish financial system does in some sense work 'better' than in England, there would still appear to be major shortcomings, especially with regard to the financing of small and medium sized firms. Indeed, Cowling et al (1991) described the relationship between such firms and the Scottish banking sector as 'sterile, uncommunicative and unimaginative' and say that 'firms put very little store by banks' local and industrial knowledge'. This was recently reinforced by a Federation of Small Businesses survey of its Scottish members, which found that 20% of small and medium firms felt that Scottish banks had a 'low or very low' understanding of their services. The survey also revealed a perceived lack of support from the Scottish Enterprise Network (**Financial Times** 12 November 1999) .

Problems for such firms in Scotland are exacerbated, as McKillop and Hutchinson (1990) find, by the segmentation of the corporate finance sector, with small firms dependent on local funding sources and large firms able to access external sources. But it is important to recognise that the finance-industry relationship is not just a problem on the banking side: small firms are often unwilling to seek external funding, with a strong desire to remain independent (Standing Commission on Scottish Economy 1989). In this sense, banks are just one part of a system of 'defensive financial behaviour' with weak credit demand as much a problem as supply constraints (Dow 1992). We need to avoid simply blaming the banks for this problem, as they are acting rationally given the systematic constraints within which they operate. Therefore, whilst banks have rationed credit to small firms for various reasons (risk-aversion, short-termism, asymmetric information), small firms have lost confidence in the lending system: the result is a vicious circle of defensive financial behaviour.

The stakeholding approach is particularly relevant here, for in considering the nature of finance-industry relationships it looks at the financial system as a whole (Hutton 1995). 'Short-termism' as a problem affecting Scotland (as a peripheral region) would be seen not just as emerging from a lack of long-term patient finance, but also related to the closed and defensive system of corporate governance that prevails within such a rugged capitalism, with entrepreneurs and management shunning outside involvement (including finance) in a desire to retain independence. Yet closing off other stakeholders, or potential stakeholders, from strategic decision-making brings problems in terms of foregone equity finance, constraining economic democracy and harming long-term economic performance.

Gamble and Kelly (1996) argue that the stakeholder approach can bring benefits by reducing the external costs imposed on stakeholders by a firm through handling such costs through internal negotiation. This avoids treating such costs as externalities, where the firm disclaims responsibility for them and faces possible conflict (e.g. strikes) or regulation as a result. Furthermore, they argue that it encourages a better transfer of information between various elements of the firm, thereby assisting competitiveness by enabling agreements to be reached between management and stakeholders (such as banks) which require information sharing and the generation of mutual commitment. This would seem particularly important in Scotland given the defensive, closed nature of the financial system. Of course, some are critical of the stakeholding approach (see Minford 1998) especially given its imprecision. We argue that it is indeed relevant to Scotland in that its essence concerns how decisions in a properly functioning Scottish economy and society should 'in some way incorporate the interests and ambitions of all those affected by those decisions - a fundamental democratic principle' (Cowling 2000, on the approach more generally).

In exploring the potential role for a Scottish Development Bank we will be looking at mechanisms already embedded in the venture capitalist 'free' market. We argue that the establishment of a Scottish Development Bank could provide a catalyst for change in the Scottish banking system towards longer-term lending and closer relationships with small and medium-sized firms, as well as the opportunity to take a strategic interest in encouraging firms to follow stakeholding principles. Taken together we hope that these will sustain the growth of a competitive small and medium-sized firm sector and reinforce the social settlement in Scotland. Such an approach does bring with it a particular concept of stakeholding, and we need to be clear as to what form we advocate. Like Hutton, as well as Gamble and Kelly, we do advocate reform of corporate governance structures for medium sized firms,

The Role for a Scottish Development Bank in a Devolved Scotland

in our view to promote greater openness and democracy as well as longer-term thinking and commitment. Indeed, the success of alternative regional economic systems such as Baden-Württemberg in Germany or the industrial districts of Northern Italy indicates that financial systems are more effective when they are embedded within a regional institutional framework. Within such contexts, by and large, the thicker the regional institutional capacity and the tighter the link between firms and banks, the more at ease banks are in offering long term credit. The successes of these regions result from the combined impact of government intervention - especially in the German case - and bottom-up development (Braczyk et al 1998).

Our proposal thus ties in with Gamble and Kelly's (1996) argument that in order to encourage stakeholding firms, government 'needs to take its enabling role seriously, considering if institutional or regulatory innovation would assist in facilitating change'. They point to the successful role played by 3i in providing venture capital, as a possible model 'which could pioneer new financial relationships between banks and small firms on a strictly commercial basis'. This was echoed by Stuart et al (1996) and Bailey and Clancy (1997). It is to this prospect that we turn next by looking at lessons from 3i and Scottish Development Finance. In fact, we envisage a two-tier set of Scottish Development Bank activities designed: a) to plug the finance/equity gap for small and medium-sized firms, and b) to inject stakeholding principles into medium sized firms. Such activities might include the Scottish Development Bank acting as a comprehensive dating agency for informal 'business angel' venture capital, the debt-financing of start-up and early stage firms, and creating and running a virtual (internet) Scottish stock market.

3. LESSONS FROM 3I?

3i is a provider of capital to small and (mainly) medium sized firms on a long-term, loan and equity basis. It is an example of the commitment missing from much of the Scottish - and British - banking sector which is dominated in the small and medium-sized firm sector especially by unreliable overdraft financing. The equity aspect is important in reducing the risk of customer firms going under through increased interest payments; through the shareholding, the interest rate on the loan can be kept at 'normal' levels as well as the investment being more secure (Coopey and Clarke 1995). The success of the firm itself determines the return to 3i; a successful firm may well pay back more than under a straight bank loan. Capital gets repaid as the

firm redeems shares over a certain timescale, and dividend payments represent the profit flow to 3i.

Of particular interest, 3i was established as a private-sector institution, but through government initiative, and with public bodies as shareholders for much of its history. The Industrial and Commercial Finance Corporation (ICFC) was set up in 1945 despite the clearing banks being reluctant shareholders, and from its inception had 'a distinct socialist aroma' (Coopey and Clarke 1995). The clearing banks were compelled to participate 'under threat of sterner action', and so the ICFC was set up with freedom from interference by its shareholders - including the Treasury and the Bank of England - paving the way for it to carve out its own role, later merging with Finance Corporation for Industry and eventually being floated as 3i (Investors In Industry). There is a clear message (and precedent) here, namely that the Scottish government has an enabling role in facilitating change in the banking sector, and that the institutions it creates can, if need be, go their own way as private or public-private organisations. In a similar vein, Scottish Enterprise has done much to stimulate small scale venture capital provision in Scotland, with its venture capital arm, Scottish Development Finance, now being spun off as a separate entity.

Furthermore, in taking a long-term shareholding in a firm, 3i both rewrites the articles of association (thus restructuring the constitution of the firm) to provide a legal framework for the protection of its investment, and may impose conditions such as appointing directors and observers to the firm, with the power for them to be made managing directors. 3i enters firms and in return for long-term finance lays down a set of warranties, contractual commitments, undertakings and objectives. These commitments are broad ranging, covering future financial transactions, investments, and divestments. 3i can also closely monitor company performance via a specified flow of information from the firm and any other financiers. This is where a Scottish Development Bank has much scope to spread stakeholding principles amongst those medium-sized firms borrowing from it, by learning from and extending 3i's approach to stakeholder performance objectives. Before considering such an approach, though, we first look at how a Scottish Development Bank could help finance small and medium-sized firms.

4. FINANCING SMALL AND MEDIUM SIZED FIRMS

The first role we advocate for the Scottish Development Bank is to provide patient finance to start-ups, small-and medium-sized firms. Indeed, it is

The Role for a Scottish Development Bank in a Devolved Scotland

possible to envisage for the bank a pro-active role not only in the provision of long term equity and loans so as to fill the finance/equity gap, but also in engaging in a range of activities, including acting as a dating agency for business angels and entrepreneurs, as well as networking with regional organisations (e.g. Local Enterprise Companies, Chambers of Commerce) to gather, filter and share information about the feasibility and profitability of possible business projects, and creating an investment-based stock market to access finance anywhere.

The existence of a 'finance gap' for small and medium sized firms in particular goes back to the report of the MacMillan Committee on Finance in 1931 and the Bolton Report of 1971, but has recently been given added attention by the identification of an 'equity gap' for such firms. This affects firms that have grown as far as they can through borrowed money, but are unable to find patient equity finance to grow any further: on the one hand venture capitalists appear unwilling to invest small amounts of money, on the other hand the low valuation the stock market puts on small listed companies means that they are also unable to invest via share issues, leaving them struggling for survival. This might explain the fact that 12% of Scottish plcs have disappeared over the last two years alone (**Financial Times** 23 September 1999).

The lack of small-scale capital and the low stock market valuation of small and medium sized firms represent a key supply-side gap in the market at the moment. The City and venture capital institutions do not like start-up and small-scale capital, being 'frightened of it because they have had bad experiences and [because] it is very expensive to maintain and to support with high overheads' (Stoddart 1996). At the moment even 3i, which has done so much, finds lending £200,000 and below difficult. Firms coming to it need a track record behind them. The DTI's Waterstone Committee concluded that the so-called equity gap is in part caused by venture capital being unable to assist firms in making the jump to the stock market because institutions are not interested in flotations valued at less than £500 million (**Financial Times** 23 August 1999). Whilst well developed by European standards, British venture capitalists have largely moved away from the bottom end of the market, driven by the success they have had in making larger investments, often in Management Buy-Out activity (DTI 1999).

Simultaneous to this supply-side shortage of small-scale, long-term equity funding, there is unsatisfied demand amongst small and medium-sized firms. Around 30% of such British firms have the desire and orientation to grow (Cowling et al in DTI 1999), but just 10% secure external equity (ESRC in

DTI 1999). As the DTI recognises, there may be a vicious circle taking place. Funds aimed at the equity gap do not demonstrate the same level of returns as funds making larger investments, because of the costs of learning and economies of scale, which makes establishing new funds more difficult. This in turn means that those which are raised are then too small to generate the returns needed to attract new investment.

Scotland has been more advanced than much of the rest of Britain in tackling these problems, thanks to the entrepreneurial attitude of Scottish Enterprise. Scottish Development Finance already provides some investment for emerging growth firms and facilitates improved access to finance for new and growing firms. In doing so, it manages two funds.¹ The first is the 'Scottish Equity Partnership', a £25 million public/private venture capital fund. This is structured as a limited partnership and includes £12.5 million from Scottish Enterprise and another £12.5 million of matching funding from 15 corporate, institutional and individual private investors, backed by a guarantee from the European Investment Bank. This has been running for two years and has made around 20 investments (DTI 1999). It usually invests between £100,000 to £750,000, with follow-ups of as much as £1.5 million. It has also been successful in securing significant private sector co-investment. The second is a 'virtual' fund operated jointly by Scottish Development Finance and 3i ('virtual' in the sense that investments are made by them on a 50:50 basis directly into firms) called the Scottish Technology Fund. This provides seed capital to pre start-up hi-tech firms, usually making investments of £100,000 or less. This has only been running for a year and has made 8 investments totaling just £1 million. More recently, in April 1999, the Business Growth Fund was set up to provide loan (not equity) finance of £20,000 to £100,000 to new firms that satisfy criteria relating to size, commercial viability and growth prospects. In doing so, funds are accessed via Local Enterprise Companies, and will meet a maximum of 50% of firms' funding requirements (BGF 1999).

Thus Scotland already has a highly successful recent history of public/private partnership and innovation in venture capital provision which has begun to tackle the equity gap problem. These funds only scratch the surface, however. The scale of investments, at £26 million in total (excluding the

¹ *Between 1991 and 1996, Scottish Development Finance invested using HM Treasury finance, and made around 400 investments in 'more traditional' Scottish firms which later floated, including firms such as Stagecoach, PPL Therapeutics, Creos, Calluna and Core (Scottish Development Finance 1999).*

The Role for a Scottish Development Bank in a Devolved Scotland

Business Growth Fund), are useful but hardly tackle the size of the problem – witness the 12% decline in the number of small Scottish plcs in the last two years. In particular, there is still little in the way of investment funding at the lower end, notably less than £100,000. It is also doubtful whether commercial banks would be prompted into small scale investments through further extension of the Loan Guarantee Scheme, as they would probably take the benefit without necessarily expanding their portfolio to include riskier investments (3i anticipated this and lobbied vigorously against the introduction of the Loan Guarantee Scheme in the early 1980s (Coopey and Clarke 1995)). Whilst the Scheme has brought benefits in stimulating firm formation and growth beyond that possible in its absence, its operation in Scotland has been disappointing: Cowling (1995) cites evidence to suggest that Northern English regions have been net beneficiaries of the scheme, at the expense of Scotland and Northern Ireland.

Hence whilst recognising the remarkable successes of 3i and Scottish Enterprise, much more needs to be done in promoting industrial development in Scotland. As Coopey and Clarke (1995) note, 3i's

economic impact has been limited by comparison with its continental and Japanese equivalents. This is a cause for regret because 3i's uniquely successful experience as a capital market substitute could have been the basis for a much more significant national strategy of encouraging and funding stable industrial growth.

Without being able to quantify its size (see Dow 1992), it would appear that a finance/equity gap still remains in Scotland, albeit slimmer than in much of England, and the Scottish Development Bank could help fill this gap, a role 3i was not able to develop, through a lack of resources relative to its overseas equivalents. For instance, the United States government intervenes extensively to provide venture capital for small firms. Lerner (1999) notes that the US Small Business Investment Company programme provided over \$3 billion to young US firms between 1958 and 1969, over three times the level of private venture capital provision. More recently, in 1995 US public small business financing programmes provided or guaranteed \$2.4 billion of equity finance, representing over 60% of the amount dispersed by traditional venture capital funds. The Scottish Development Bank's provision of finance need not be single-handed, but could be coupled with informal venture

capital through business angel funding.¹ Business angels are able to offer 'no strings capital' which suits small firms and start-ups, being quick, inexpensive, flexible, and often coming with a wider package of advice and assistance from the investor (Lonsdale 1997). Indeed, Mason and Harrison (1997) argue that informal venture capital is already a 'major source of equity finance for the small and medium enterprise sector'. The internet might be harnessed to link Scottish firms with informal venture capitalists wherever they are located.

Whatever the source, the provision of finance to small firms and especially to start-ups has to overcome one major problem: the asymmetry of information between lender and borrower. A vast literature has dealt with this, but it is important to stress here that although the asymmetric information argument has been used to explain the finance or equity gap, less attention has been paid to how to tackle it. One of the key roles that we suggest the Scottish Development Bank should take is to promote information channels which would help in assessing investment risk. The development of a thick network of relationships between the banking sector, regional organisations and venture capital funds would enable lenders to collect information about possible borrowers in order to assess the profitability of projects. The existence of an information network would also assist the Scottish Development Bank in encouraging the matching of business angels and entrepreneurs. Words like network, partnership and cooperation are not new in Scotland; Scottish Enterprise has encouraged the creation of business networking on the basis of already-existing social networking (MacLeod 1996; Ashcroft 1998). More broadly, the thickness of the institutional framework has been shown to be a key factor underpinning regional development (Braczyk et al. 1998 and Dei Ottati 1994).

A complementary role for the Scottish Development Bank might be in creating and running a virtual (internet-based) Scottish stock market. This might help in gearing the infrastructure of the capital markets more towards the needs of Scottish firms, which at present suffer (like firms in the rest of Britain) from the equity gap problem. Although the City now has the

¹ See Mason and Harrison (1995) on closing regional equity gaps via the promotion of informal venture capital. This may require further tax changes to make this possible: a KPMG (1992) study of the informal venture capital market in Scotland cited in Mason and Harrison (1995) found that virgin angels were not active mainly because of unacceptable risks and a lack of tax benefits. Although a number of measures have since been introduced such as the Enterprise Initiative Scheme, as Mason and Harrison (1999) note, such schemes have significant limitations.

The Role for a Scottish Development Bank in a Devolved Scotland

Alternative Investment Market, Schenk (1999) notes the problem that this and other European small-capital markets concentrate on chasing fund managers rather than retail investors, and calls for establishing independent internet-based alternative markets at the regional level. The appeal to investors is that they would be able to spread their risks whilst only requiring relatively small initial investments. At the same time the key problem of the lack of liquidity for a regional market could be overcome by expanding the system across the UK as a whole or internationally via the internet. Schenk (1999) outlines the development of such a market in The Netherlands by the Gelderland Development Authority, which involves the creation of regional counters designed to assess candidates for quotations, and to provide guidance and information services to firms and investors. These regional counters keep the market close to the firms it is designed to help. In Scotland such locally-based counters might help link the Scottish Development Bank with Local Enterprise Companies and local authorities and might tie in with the recently launched 'E Kiosk' network created by Scottish Enterprise. A Scottish Development Bank-created, internet-based market in Scotland might complement the role of the Alternative Investment Market in London, and might offer a number of advantages in terms of reducing the volatility of initial public offerings by allowing smaller investors in on a first-come first-served basis, and in providing an exit mechanism for founding investors without the need to sell out to large (often foreign) firms. In other words, the Scottish Development Bank could have a number of roles to play in plugging the finance/equity gap.

5. INJECTING STAKEHOLDING IN MEDIUM-SIZED FIRMS

Venture capitalists force firms to comply with a structure and a system which protects their investments: they intervene in the market place and change the way firms work. Thus, in rewriting articles of association there is the potential to redefine the corporate governance arrangements within medium sized Scottish firms¹, for example by giving workers real stakes in the form of shareholdings, as well as retaining power for the bank over key financing decisions. This can be taken further through the conditions placed on loans; in return for the provision of patient, long-term finance, firms might have to commit themselves to certain stakeholder principles. The exact form of such commitments is an issue to be examined elsewhere; here it is the mechanism for establishing such commitments which we highlight. However,

¹ According to our definition, established firms with 50-250 employees.

stakeholder goals for well-established medium sized Scottish firms might include such commitments as:

- ∑ *Adherence to a minimum wage.* Whilst now a legal requirement, it is difficult to monitor. Breaking such a commitment would not only mean the firm breaking current law, but would bring the added danger of breaching the contract with the Scottish Development Bank. We might look for a minimum wage plus a mark-up reflecting labour skills and qualifications. This may act as a driver to efficiency gains in such firms; if firms have to pay their workforces more they will have to give greater attention to improving productivity.
- ∑ *Minimum levels of training and education* perhaps arranged in conjunction with revamped, democratically accountable Scottish training bodies.
- ∑ *An employee share in the profits of the firm*, through worker shareholdings.
- ∑ *Worker representation on the board of directors*, or other forms of worker involvement and consultation.
- ∑ *Enhanced trade union rights.* For example, a streamlined recognition process avoiding complex ballot procedures, perhaps with the quid pro quo that workers agree to a dispute settlement procedure.
- ∑ *Minimum levels of investment in Research and Development.* The exact figure may vary by sector, but it is crucial that such investment is raised generally. Whilst Gordon Brown has introduced a £150 million tax credit for R&D investment by small firms (**Financial Times** 10 March 1999), we feel this needs to be taken further by the Scottish Development Bank. If this commitment formalises the R&D spend in small firms then they may also benefit from the credit.

The Role for a Scottish Development Bank in a Devolved Scotland

- ∑ *Networking with other firms* in appropriate and systematic joint R&D, marketing and export initiatives. Evidence suggests that firms can benefit from developing a thick network of relationships with other firms, first and foremost with those locally. Such relationships may be production-based (for firms producing along the same supply chain) or involve cooperation on areas such as innovation (Camagni 1991) or training programmes. Such collective ventures have proved crucial in helping medium-sized firms both to reduce costs and to gain access to highly specialised complementary production. Examples of successful networks of firms can be found in North-East Italy, Germany, France, Sweden and Spain (Braczyk et al 1998; Nelson 1993). There is a clear role for public policy here. For example, in investigating the work of the Welsh Development Agency, Izushi (1999) concludes that through a carefully designed programme a 'government agency can facilitate collective learning among local firms which would otherwise not have taken place'.
- ∑ *Networking with business support organisations*. Medium sized firms can benefit greatly from the advice and support of regional and local service providers, such as Local Enterprise Companies, science parks, chambers of commerce and so on. Whilst the services offered by such organisations need to be made truly accessible to firms, the latter also have to be encouraged to be outward looking in order to find external means of overcoming internal barriers to growth.
- ∑ *Sourcing*. Commitments could be made concerning minimum Scottish or European sourcing, especially important if loans are made to incoming firms from outside the region, as well as paying debts within a specified period.
- ∑ *Sustainable development*. Reflecting the significance attached to this by the new Scottish Executive, commitments on environmental performance could be made. Indeed stakeholding has been closely linked with Agenda 21, which aims to bring together local authorities, communities and businesses to develop sustainable development strategies (Imrie and Wilks-Heeg 1996).
- ∑ *Equal opportunities*. The Scottish Development Bank could seek compliance on equal opportunities regarding gender, ethnicity and disability.

These are only illustrations of how the Scottish Development Bank could promote stakeholder values. Many medium-sized firms would claim that they

would do 'all these things' if they did not have to struggle daily to balance the books. In other words, commitments included in the lending agreement become the means to encourage or support the adoption of best practice in established firms. We expect medium-sized firms operating along such principles to be more successful in the long run than firms operating along more 'traditional' lines, as the commitments would trigger off a 'high road' of development involving long-term, patient investment, productivity growth and innovation. The long-term equity stake held by the Scottish Development Bank would itself offer the firm a degree of protection from take-over, allowing it to concentrate on planning and investment for the long-term. This is one illustration of why compliance with the agreed commitments needs to be monitored and failure to comply with the stakeholder commitments would be a fundamental breach of contract. It needs to be stressed that medium-sized firms would not be forced to take on such stakeholder commitments, but that if they wish to borrow from the Scottish Development Bank the quid pro quo is agreeing to them. They can of course decide not to do so and to go elsewhere for financial assistance.

6. WHY A SCOTTISH DEVELOPMENT BANK?

We need to look overseas to see what is missing in Scotland's system of finance-industry relations and then to devise effective organisations that fit within and extend the Scottish system. For example, Hutton (1995) notes that 'continental Europe and Japan have in general equipped themselves with *long-term development* banks upon which any sustained investment effort depends' (our emphasis). Even now, with Japan adopting wholesale deregulation, it remains committed to sustaining the small firm sector via the provision of long-term finance. But in recognising the nature of the problem, we then have to look for solutions that are embedded in the Scottish economic system. We cannot simply invite in bodies from elsewhere to do this job as the Scottish Development Bank needs to be endogenous, to be linked with a network of local actors in order to build in information channels and thus overcome information asymmetry problems. Establishing a Scottish Development Bank could act as a catalyst to trigger change that reflects the needs of the local actors. As other banks may be forced to respond, by becoming more local and more long-term, it seems feasible that in Scotland the process of devolution allows for a link between decentralised political and financial power as Lee (1996) highlights. Of course, too much should not be claimed for this measure alone. There is no quick fix for the short-termism inherent in the British (and Scottish) system. A package of measures needs to be implemented, including the introduction of development banks, reform of

The Role for a Scottish Development Bank in a Devolved Scotland

insolvency laws and the tax system, changes in take-over rules and so on, in order to foster a longer-term perspective. Given that the financial system is itself becoming increasingly transnational, measures will also be needed at the global level to reform and regulate the system, but here our concern is with measures at the Scottish level. It is important to foster such a debate in Scotland, for as Thompson (1999) has noted, the Blair government 'has been notably reluctant to challenge and change the short-termist ways that financial institutions and firms operate in many areas'.

The earlier sections of this article have outlined a role for the Scottish Development Bank with respect to both small and medium-sized firms, but we do not claim that this two-tier model is optimal. Rather, we argue that it has the potential to promote competition, in two senses. Firstly, what we term 'econo-diversity' would be encouraged, i.e. the fostering of a greater variety of corporate organisational forms. Medium-sized firms reorganising according to the stakeholding principles (which might be called 'stakeholder limited companies' or SLiCs) would have to compete with conventional Limited Liability firms, partnerships, cooperatives and quoted companies. This is in itself desirable, for example in terms of democracy in benefiting workers by giving them greater choice over which type of organisation to work for. As Gamble and Kelly (1996) note, new forms of corporate governance need to show that they are superior to the old in economic performance, but at the moment we do not have the knowledge to say they are. We feel that SLiCs will succeed, but we recognise that this is uncertain at this stage. Inter-organisational competition can only be healthy in this respect; over time the relative performance of different forms will become clear. Rather than regulating for a certain organisational form, why not instead encourage organisational diversity and see which come out best? Not to be underestimated is the importance of new firm creation that the action of the Scottish Development Bank could generate. As such firms grow and mature, they might re-finance through the Scottish Development Bank and take on stakeholder dimensions. This would allow more consideration to be given to the social dimension of economic development, a key criticism of the Scottish development agencies at present (McCarthy and Newlands 1999).

Secondly, competition in banking could be improved. At the moment there is only limited competition between banks for small and medium-sized firm customers, with Scottish Development Finance tackling part of the equity finance gap in Scotland. The banks, as well as 3i itself, may have to respond to the added competition from the Scottish Development Bank by cutting loan rates and by forcing them to get closer to customers. This could force

the whole banking system to operate more locally and over a longer time frame. The greater involvement of the banks with small and medium-sized firms hinges on the elimination of the information asymmetry between lenders and borrowers, which in turn depends of the availability of information in the system. We are suggesting that once banks and venture capital funds become part of a thick institutional system which is capable of collecting and spreading information, lending to small firms, medium firms and start-ups will be easier.

The Scottish Development Bank could thus provide advantages in terms of lower information costs, accelerated bank learning of conditions and prospects in client firms' industries after recessions, the avoidance of high collateral demands, and in assisting the development of clusters or webs of local firms (see Kelly et al 1995 more generally). It is envisaged that the Scottish Development Bank itself would have a number of stakeholders, perhaps including chambers of commerce, local authorities, Scottish Enterprise, Local Enterprise Companies, the Scottish government, and the European Commission or European Investment Bank if funding comes from a European source. Being part of such a network of agents appears to help banks in overcoming information asymmetries within loan contracts, thus reducing screening, monitoring and enforcement costs. In other words, they have a richer resource base to draw on, with a wider set of recipes: see, for example, Carnevali (1996) on regional banks in Italy, and Deeg (1998) and Vitols (1998) on Germany.

There might also be a positive feedback from the Scottish Development Bank, in contributing to the 'organisational capacity' of the Scottish economy; that is the ability of a region or nation, including all its key institutions, to work together in coping with rapid economic change. This is a capacity in which British regions in particular have been weak given the centralised system of Westminster government (Mawson 1996), but which now represents a real opportunity for a more autonomous Scotland. This institutional weakness has been exacerbated in Scotland with the exodus of the headquarters and treasury departments of Scottish based companies to London, as noted by Hutchinson and McKillop (1991), a process which has continued apace during the 1990s, culminating with the recent take-over of Scottish Widows. There may even be a negative feedback for small firms: Hutchinson and McKillop hypothesised that there was a policy of risk-subsidisation by Scottish banks to the advantage of the local large firm sector - and to the disadvantage of the local small firm sector - in an attempt to retain 'relatively large well capitalised companies within the regional lending market'.

7. ACCOUNTABILITY AND FINANCE

Given our criticisms of the current financial system, the Scottish Development Bank will need to be different from the clearing banks in particular, both in its objectives and its relationships with client firms. These differences could be formally established in the Charter creating the Scottish Development Bank (see Kelly 1995 on regional development banks more generally). This would set out the Scottish Development Bank's scope of activities, its operating guidelines, stakeholder commitments, membership of its Board, as well as performance targets, timescale and assessment criteria. The charter could also establish accountability, whether to the Scottish Executive directly or via Scottish Enterprise. Accountability could also be enshrined via the membership of the Scottish Development Bank Board which should reflect the differing expertise and interests of Scotland's community. The Board's role would be to monitor investment performance and the lending criteria used by the Scottish Development Bank. The Scottish Development Bank itself could be part of Scottish Enterprise or free-standing but networked with different actors. The spun-off Scottish Development Finance could be one stakeholder in the Scottish Development Bank, so as to ensure co-ordination between its activities and those of the Scottish Development Bank. Within any framework of accountability, the Scottish Parliament should have a role in monitoring the work of the Scottish Development Bank, perhaps through public hearings or in having a say in the appointment of the Board.

On financing, the Scottish government could begin by redirecting money going into Regional Selective Assistance via the Scottish Development Bank. This would channel assistance to local start-up and small and medium sized firms, on a longer-term basis and with better scrutiny of investments - something Britain has had problems with (see Bachtler 1990). Secondly, the Scottish Development Bank should be able to issue bonds, with the proceeds channeled into Scottish firms. Thirdly, the Scottish Development Bank might also be able to attract institutional and private funds, something Scottish Enterprise has achieved with its Scottish Development Finance Fund. Indeed when tighter government control deprived the Enterprise Boards created in the 1980s of local authority funding, the Boards began to act as venture capital agents, using money from pension funds and elsewhere, thereby stimulating the development of private-sector regional venture capital funds (Brunskill and Minns 1989). Whilst the level of investment involved was modest, it does suggest that the Boards were successful in identifying a funding gap, and that investment opportunities can be created by pro-active funding bodies armed with new forms of finance, support and strategy

(Eisenschitz and Gough 1993). A pro-active Scottish Development Bank could feasibly create such opportunities and similarly attract institutional funding, building on and complementing the work of Scottish Enterprise.

Furthermore, resources might become available from Europe. A recent example is the European Commission's intervention to help create the Merseyside Special Investment Fund (MSIF) to lend amounts of £3,000 to £800,000 on a long-term basis to viable small firms in Merseyside.¹ This suggests that the Commission is sympathetic to novel ideas such as a Scottish Development Bank and may be willing to channel assistance via it. There are precedents for this; 3i's predecessor, the Industrial and Commercial Finance Corporation, administered loans under an agreement with the European Investment Bank, and 3i has itself used finance from the European Coal and Steel Community. The latter involved over £46 million being lent between 1977 and 1982 alone, creating 9,000 jobs (Coopey and Clarke 1995). More recently, the European Investment Bank has guaranteed private sector investment in the Scottish Development Finance Fund in Scotland, and this year the European Regional Development Fund has backed the new £7 million Strathclyde Investment Fund.

8. CONCLUSION: PROMOTING SCOTTISH STAKEHOLDER ENTERPRISE.

If stakeholding is to mean anything to ordinary Scottish people, it has to impact at the level of their lives: in the communities they live in, through the welfare system that supports them, and at the places where they work. Recognising that stakeholding principles need to be actively fostered in such firms, linking this with the need to plug the gap in the provision of long-term finance for small and medium sized firms, and learning from 3i's and Scottish Enterprise's experience, we identify a constructive role for a Scottish Development Bank under the Scottish government. Such a Scottish Development Bank would have a number of key roles: (i) assisting small and medium-sized firms with packages of debt and equity finance, 'dating' them with business angels and creating an internet-based stock market; (ii) in spreading stakeholder values in medium-sized firms. Competition might be

¹ *The MSIF also helps build organisational capacity in Merseyside, by regularly bringing together key players in regeneration, including 26 public and private sector actors, as well as the Liverpool Chamber of Commerce and the Bank of England (DTI 1999).*

The Role for a Scottish Development Bank in a Devolved Scotland

intensified, both between banks and between different corporate organisational forms. Such greater 'econo-diversity' is itself desirable. In addition, it might inject a dynamic element into corporate evolution. If we do not know whether new forms of corporate governance are superior to old ones, let us encourage such econo-diversity and see which ones win out.

Such an approach, using Scottish-based institutions to overcome market failures and to accelerate industrial development, should be seen as just one example of a proactive industrial strategy, one which is responsive, enabling and supportive, and one which should be based at a Scottish level to complement those at British and EU levels. We see this proposal as part of a wider package of measures that are needed in order to form a coherent industrial strategy for Scotland. This should be a balanced strategy based on: targeting investment (foreign investment and involvement where appropriate); indigenous firms; inter-firm cooperation; support for technology and innovation; training; and the building of appropriate new public-private institutions. The creation of the Scottish Parliament offers a range of opportunities in this respect;¹ opportunities that need to be grasped so as to build on the successes of Scottish Enterprise in fostering a vibrant small firm economy in Scotland based on stakeholder principles.

This may in turn contribute towards Scotland building its own 'Third Way', a way coming out of Scotland's own experiences and history, and one based (we advocate) on democracy, diversity and a stakeholder economy. As Blair (1996) himself has argued (our emphasis):

We cannot by legislation guarantee that a company will behave in a way conducive to trust and long-term commitment, but it is surely time to assess *how* we shift the emphasis in corporate ethos from the company being a mere vehicle for the capital market - to be traded, bought and sold as a commodity - towards *a vision of the company as a community or partnership in which each employee has a stake, and where the company's responsibilities are more clearly defined.*

The current review of corporate law seems likely to back minimal change through an 'enlightened shareholder' view rather than a progressive stakeholder approach. With the exceptions of the minimum wage, the social chapter and limited trade union rights, little has been achieved in giving

¹ See McCarthy and Newlands (1999) and McCarthy (1999) on wider opportunities with regard to urban regeneration under the Scottish Parliament.

employees stakes or defining corporate responsibility more clearly as Blair advocated. Why are we still waiting?

REFERENCES

- Bachtler, J (1990) 'Grants for Inward Investors: Giving Away Money?', **National Westminster Bank Quarterly Review**, May, 15-24.
- Bailey, D and J Clancy (1997) Stakeholder Capitalism Via Venture Socialism: A Role for Regional Development Banks under Labour? **Renewal**, Vol.5, No.2, 49-60.
- BGF (Business Growth Fund) (1999) <http://www.scotent.co.uk/sb/bgf.htm>
- Blair, T (1996) **New Britain. My Vision of a Young Country**. London: Fourth Estate.
- Braczyk, H, P Cooke and M Heidenreich (1998) **Regional Innovation Systems. The Role of Governances in a Globalized World**. London: UCL Press.
- Brunskill, I and R Minns (1989) 'Local Financial Markets', **Local Economy**, 3, 295-305.
- Callaghan, G (1997) Stakeholding and a Scottish Parliament, **Renewal**, Vol 5, No 3/4, 59 - 65.
- Carnevali, F (1996) 'Between Markets and Networks: Regional Banks in Italy', **Business History**, July, 84-100.
- Clay, N and M Cowling (1996) Small Firms and Bank Relations: A Study of Cultural Differences Between English and Scottish Banks. **Omega**, Vol.24, Issue 1, 115-120.
- Coopey, R and D Clarke (1995) **3i. Fifty Years of Investing in Industry**. Oxford: OUP.
- Cowling, K (2000) Review of P.Minford's 'Markets not Stakes' (1998) and W.Hutton's 'The Stakeholding Society' (1998), **The Economic Journal**, Vol. 110, No, 461, F197-199.
- Cowling, M (1998) 'Regional Determinants of Small Firm Loans Under the U.K. Loan Guarantee Scheme', **Small Business Economics**, Vol.11, No.2, 155-167.
- Cowling, M, R Sugden and J Samuels (1991) 'Small Firms and Scottish Clearing Banks', **Fraser of Allender Institute Quarterly Economic Commentary**, Vol.17, No.2, 64-69.
- Degg, R (1998) 'What Makes German Banks Different?' **Small Business Economics**, Vol.10, No.1, 93-101.
- Dow, S C (1992) The Regional Financial Sector: A Scottish Case Study, **Regional Studies** Vol. 26, No.7, 618-631.

The Role for a Scottish Development Bank in a Devolved Scotland

- Dow, S C (1996) Scottish Devolution and the Financial Sector. Paper presented at the Regional Studies Conference, Edinburgh.
- DTI (Department of Trade and Industry) (1999) **DT Consultation Paper: Addressing the SME Equity Gap**.
<http://www.dti.gov.gov.uk/sbs/ef/eqintro.htm>
- Eizenschitz, A and J Gough (1993) **The Politics of Local Economic Policy**. Basingstoke: Macmillan.
- Ennew, C and M Binks (1996) 'Banks and Small Businesses: An Anglo-Scottish Comparison', in M W Danson, Ed, **Small Firm Formation and Regional Economic Development**. London: Routledge.
- Financial Times** (1999) Science Funding Gets a Shot in the Arm, 10/3/99, 2.
- Financial Times** (1999) Government Moves to Help Smaller Companies, 23/9/99, 1.
- Financial Times** (2000) Scottish Agency to Boost Technology Funding, 17/2/00, 3.
- Gamble, A and G Kelly (1996) 'Stakeholder Capitalism and One Nation Socialism', **Renewal**, Vol.4, No.1, 23-32.
- Gouge, E (1996) 'Local and Regional Development' in David Coates, ed, **Industrial Policy in Britain**. Basingstoke: Macmillan.
- Hutchinson, R W and D G McKillop (1992) 'Banks and Small to Medium Sized Business Financing in the United Kingdom: Some General Issues', **National Westminster Bank Quarterly Review**, February 1992, 84-95.
- Hutton, W (1995) **The State We're In**, London, Jonathan Cape.
- Imrie, R and S Wilks-Heeg (1996) Stakeholding and the Local Economy, **Local Economy**, Vol.11, No.1, 2-6.
- Izushi, H (1999) 'Can a Development Agency Foster Co-operation Among Local Firms? The Case of the Welsh Development Agency's Supplier Association Programme', **Regional Studies**, Vol.33, No.8, 739-750.
- Jackson, A (1999) 'Tax Varying Powers: The Watchdog that Will not Bark' in McCarthy, J and Newlands, D (eds) **Governing Scotland: Problems and Prospects - The Economic Impact of the Scottish Parliament**. Ashgrove: Aldershot.
- Kelly, G et al (1995) 'Banking on the Regions', **New Economy**, Vol.2, Iss.4.
- Lazerson, M H (1990) Subcontracting in Modena Knitwear Industry, in Pyke, F et al, eds, **Industrial Districts and Inter-firm Co-operation in Italy**. Geneva: International Institute for Labour Studies.
- Lee, Simon (1996) 'Finance for Industry' in J Michie and J G Smith, eds, **Creating Industrial Capacity. Towards Full Employment**. Oxford: OUP.
- Lerner, J (1999) "'Public Venture Capital': Rationales and Evaluation'. Paper presented at the International Conference on Funding Gap Controversies, University of Warwick, April 1999.

- Mason, C M and R T Harrison (1995) 'Closing the Regional Equity Capital Gap: The Role of Informal Venture Capital', **Small Business Economics**, Vol.7, No.2, 153-172.
- Mason, C M and R T Harrison (1999) 'Public Policy and the Development of the Informal Venture Capital Market', in K Cowling, ed, **Industrial Policy in Europe. Theoretical Perspectives and Practical Proposals**. London: Routledge.
- McCarthy, J (1999) 'Urban Regeneration in Scotland: An Agenda for the Scottish Parliament', **Regional Studies**, Vol.33, No.6, 559-566.
- McCarthy, J and D Newlands (1999), eds, **Governing Scotland: Problems and Prospects. The Economic Impact of the Scottish Parliament**. Aldershot: Ashgate.
- McCarthy, J and D Newlands (1999) An Economic and Spatial Policy Agenda for the Scottish Parliament, **Regional Studies**, Vol 33, No. 9, 891-895.
- McCormick, J and W Alexander (1996) Firm Foundations: Securing the Scottish Parliament, in Tinsdale, S. (ed) **The State and the Nations. The Politics of Devolution**. London: IPPR.
- McKillop, DG and RW Hutchinson (1990) **Regional Financial Sectors in the British Isles**. Aldershot: Avebury.
- Minford, P (1998) **Markets not Stakes: The Triumph of Capitalism and the Stakeholder Fallacy**. London: Orion.
- Nelson, R (1993) **National Innovation Systems: A Comparative Analysis**. Oxford: OUP.
- Newlands, D (1997) The Economic Powers and Potential of a Devolved Scottish Parliament, in M.Dawson (ed), **Regional Governance and Economic Development**. London: Pion.
- Schenk, H (1999) 'Industrial Policy Implications of Competition Policy Failure in Mergers', in K Cowling, ed, **Industrial Policy in Europe. Theoretical Perspectives and Practical Proposals**. London: Routledge.
- Scottish Development Finance (Scottish Development Finance) (1999) <http://www.scotent.co.uk/sdf.htm>
- Standing Commission on Scottish Economy (1989) **Final Report**. Glasgow: SCSE.
- Stoddart, M (1996) 'A Venture Capitalist's View' in S. Milner, ed., **Could Finance Do More for British Business?** London: IPPR.
- Stuart, G, D Bailey and R Sugden (1996) 'Industrial Economic Policy Under Labour: What Is To Be Done?', **Renewal**, Vol.4, No.4 19-27.
- Sugden, Roger (1997) Economias multinacionales y la ley del desarrollo sin equidad (Multinational economies and the law of uneven development), **FACES: Revista de la Facultad de Ciencias Economicas y Sociales, Universidad Nacional de Mar del Plata**, Vol.3, No.4, 87-116.

The Role for a Scottish Development Bank in a Devolved Scotland

Thompson, P (1999). Stuck in the Middle with Whom? Modernisation and its Dilemmas, **Renewal**, Vol. 7, No. 4, 1-8.

Vitols, S (1998) 'Are German Banks Different?', **Small Business Economics**, Vol.10, No.1, 79-91.

March 2000