A Historical Perspective on the Variaties of institutions, Finance and Entrepreneurship

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A Historical Perspective on the Varieties of institutions, Finance and Entrepreneurship

Abstract

A recent growing body of evidence using the Varieties of Capitalism approach shows that institutions are complementary and different institutional constellations support different forms of entrepreneurial activity. This line of research highlights the necessity of tailored reform strategies taking into account this complementarity. In this paper, after identifying the different types of constellations in the financial institutions of Europe and their challenges for entrepreneurial activity, we focus on the historical evolution of the banks and family lending as two alternative financing options that can help to overcome the lack of finance options for entrepreneurs. We argue that policies targeted at stimulating family lending can be a useful strategy particularly in the Mediterranean and the Eastern European countries given that family ties are historically strong and formal financial institutions remain limited to stimulate entrepreneurial activity. We rely on the evidence provided in the secondary literature to support our arguments, as historical data on financing options for entrepreneurs remain limited to make a comparison between different institutional contexts. Therefore, future research should prioritize historical data on finance to allow for a more systematic test of the historical origins of the divergent development patterns of financial institutions today.

Keywords and JEL-classification

Keywords: Entrepreneurship, bank, financial institutions, family

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Dear Dr. Dilli,

many thanks for submitting your paper. We will let you know soon after the deadline for submissions.

Best wishes,

Stefano Battilossi (Carlos III Madrid)
Rui Esteves (Oxford)
Editors
Financial History Review

2018-04-26 14:16 GMT+02:00 Dilli, S.D. (Selin) <S.Dilli@uu.nl>:

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STEFANO BATTILOSSI .
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Manuscript

1. Introduction

The availability of financing options is crucial in all stages and types of entrepreneurial activity: in seeing an opportunity to start a firm, growing business and engagement in innovation (Dilli et al. 2018). While both policy makers and academics identify the importance of increasing access to finance as a reform strategy to stimulate entrepreneurial activity in Europe (Sanders et al. 2018), the question on how to achieve this goal still remains debated. One of the major obstacles in achieving this goal is that the effectiveness of financial intermediaries in the allocation of resources to firms is limited by the informational opacity of new firms, which have uncertain returns and are costly to monitor. In many European countries large financial conglomerates have emerged that seem less suited to financing entrepreneurship. Bank credit and collective pension funds may be optimum for financing fixed, physical capital that may serve as collateral for debt, but more finance in the form of equity or private wealth may be needed to enable entrepreneurship (Sanders et al. 2015).

Furthermore, the importance and ease of access to finance for entrepreneurs both vary substantially across the European countries (European Commission 2018). According to a recent report by the European Commission (2018), which compares the 28 EU countries, limited access to finance and the lack of financial institutional arrangements are obstacles particularly in many of the Mediterranean countries (e.g., Italy, Greece, Cyprus) and the Eastern European countries (e.g., Romania, Hungary). In this paper, our aim is to help in identifying strategies to stimulate entrepreneur's access to finance by considering the complementarity between financial institutions. In particular, we will aim to answer to what extent two financial agencies, banks and family, can provide financial support for entrepreneurial activity in Europe given the diversity of institutional constellation and history of the region. To answer this question, we rely on the secondary literature due to the lack of the available historical data on financing entrepreneurs that is comparable across the wide range of European countries.

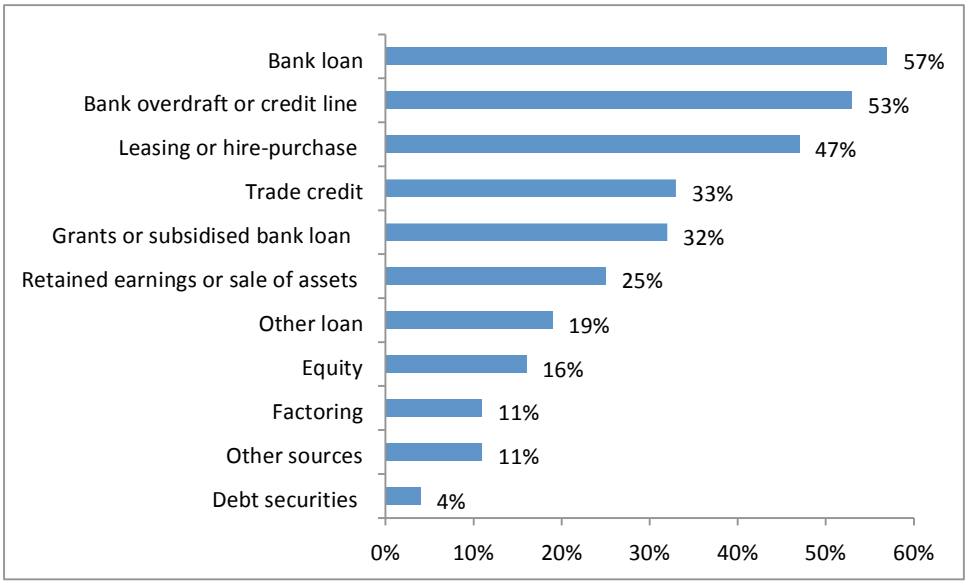
Before identifying the relevant financing options for entrepreneurs in Europe, it is important to clarify what we mean with entrepreneurship as the definitions and the forms of entrepreneurial activity differ widely in the literature (Acs et al. 2014; Dilli 2016). In a broad economic sense, entrepreneurship means owning and managing a business, or otherwise working on one's own account (Van Stel 2008). Here, entrepreneurship is defined in the broad economic sense, thus in terms of owning a

business.[1]

According to entrepreneurship literature, while banks are crucial sources of finance, alternative financial instruments such as venture capital, business angel investment, family, friends and foes (FFFs), asset-based finance instruments such as leasing and factoring, mezzanine finance, and crowd funding exist too (OECD 2015; European Commission 2018). Historically many alternatives to banks and markets have also been available in the form of retained earnings, family capital, investment from wealthy entrepreneurs, and short-term loans (Westerhuis 2016). Despite the different alternatives, however, Figure 1 shows the importance of bank loans and overdrafts for small and medium enterprises (SMEs) in the European Union (EU). Despite the different alternatives, banks remain as the largest financial intermediaries in all EU countries, although their relative importance varies significantly from one country to another. Figure 1 also shows that the share of the non-bank instruments in financing entrepreneurial activity remains relatively small in Europe, which is visible with the relatively low share of factoring, private equity and other sources. Moreover, while not visible from Figure 1, venture capital, a crucial source of financing new ventures in the US (OECD 2015: 18), also remains a limited source of funding in Europe. For instance, between 1995 and 2010, European venture capital investment has been, on average, approximately only one-third the size of investment in the US (OECD 2013) and offered finance solutions mostly for high-tech firms and in later stages of the business ventures.

[1] Moreover, it is important to acknowledge that the differences between countries' performances in terms of entrepreneurial activity are generated by the type (replicative vs. high−impact) and motivation (necessity vs. opportunity) of entrepreneurial activity (Stenholm et al. 2013). Firms, which provide the largest potential for new jobs, and enhance economic growth, are defined as high−impact firms (Acs 2008; Henrekson et al. 2010). Opportunity−based entrepreneurship refers to cases in which people mainly start a new business to exploit a perceived business opportunity. In the case of necessity−based entrepreneurship, individuals decide to start up a business out of necessity such as unemployment (Hechavarria and Reynolds 2009; Dilli 2016, p. 5). However, the historical evidence in the literature is too limited to provide a systematic study of the different forms of entrepreneurial activity historically.

Figure 1. Relevance of financing types for SMEs, EU-28, ECB/EC SAFE survey, 2014 (% firms)



Source: OECD (2015: 32)

Despite the availability of different financing options, entrepreneurs face a number of challenges in access to finance for several reasons. Financiers face high risks when selecting amongst entrepreneurs because entrepreneurs may act opportunistically towards them and because entrepreneurs vary in their ability to identify and exploit opportunities (Shane and Cable 2002: 364). Transaction costs involve the cost of gathering information about potential clients to minimize the risk of default, and of monitoring to minimize the risk of moral hazard. In a perfect (capital) market all parties have equal access to capital and information. However, the market is not perfect due to information asymmetries, as borrowers possess more information about their own business than the possible lender. New businesses face liabilities of newness in attempting to attract finance from providers (Harrison et al. 2004). Information asymmetries in credit markets are especially large for new firms that lack a credit history and have limited cash flows, whereas formal equity finance tends to fund lower-risk later stage business ventures (OECD 2017). Similarly, for a bank it might be too costly to gather additional information in relation to the returns. Therefore, it is often assumed that large banks are reluctant to grant loans to the SME sector (Black and Strahan 2002).

Given the limitations of formal financial intermediaries, informal financing options can provide an important alternative for entrepreneurs to access capital (OECD 2013). These informal investors include private individuals/business angels, composed of a network of friends, family and foolhardy investors, who provide

financing directly to unquoted companies in which they have no family connection (Szerb et al. 2007). Economic explanations generally hold that allocation of contractual rights, the staging of capital, and risk shifting lead entrepreneurs to disclose information in ways that overcome this information asymmetry (Gompers and Lerner 2000). Organization scholars, on the other hand, have proposed that seed-stage informal investors rely on social relationships to select which ventures to fund and argued two different mechanisms —information transfer through social ties and social obligation- influence investors' decisions (Shane and Cable 2002: 364). While information transfers through social ties is a crucial determinant of informal investment by non-relatives, social obligation is a crucial explanation of why family members invest in new ventures. In this paper, we focus on the cross-national variations in family ties to identify the context(s) where stimulating family lending can provide an alternative strategy to bank lending.

This paper proceeds as follows: we first discuss the diversity in the financial institutions relevant for entrepreneurial activity today. In order to assess the financing options of entrepreneurs, it is crucial to know the regulations with regards to finance as a whole since these institutional arrangements determine the willingness of the financers to invest in businesses. Second, we focus on banks and their historical evolution to evaluate the variation in the importance of banks in financing entrepreneurs over time and across countries. Third, we focus on family lending as an alternative form of financing and then link it with the historical differences in family organization. In the last section, we draft our policy implications based on the historical evolution of these two financial intermediaries considering the complementarity of financial institutions and the diversity of the historical patterns in the informal institutions of Europe.

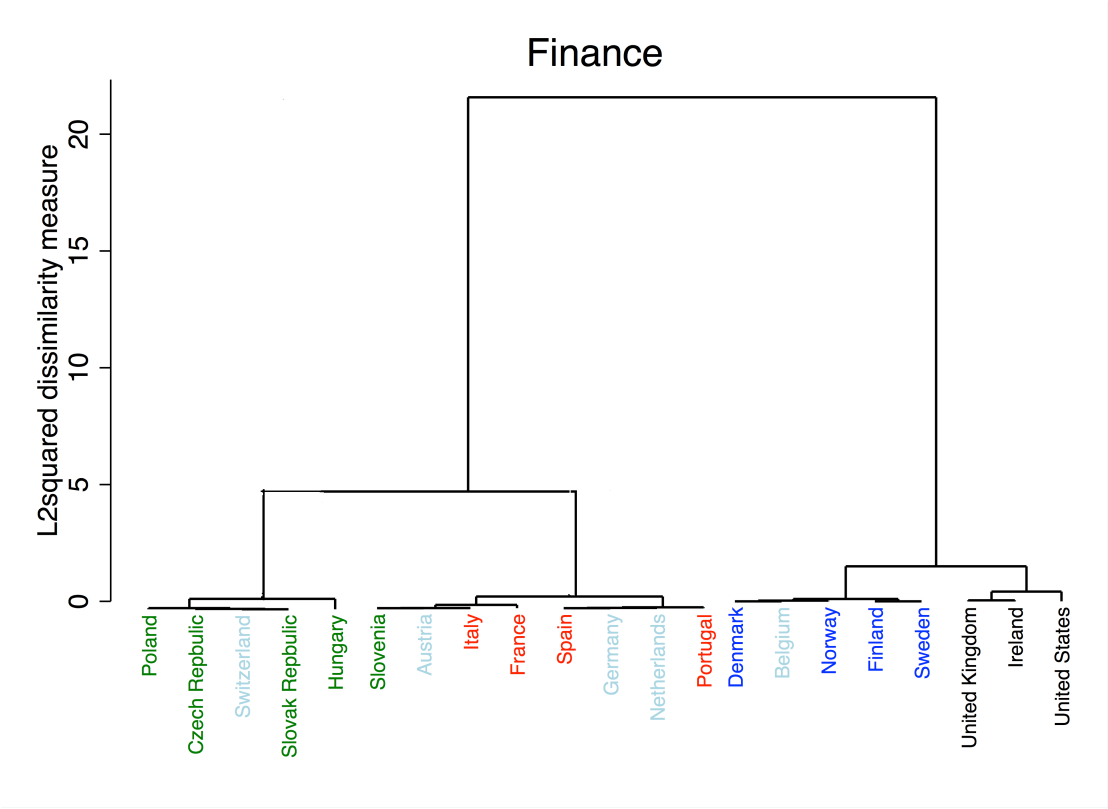
2. The Diversity of the Financial Institutions in Europe

In this section, based on the typology provided by Dilli et al. (2018), we provide an overview of the diversity of financial institutions relevant for entrepreneurial activity in Europe for two main reasons. First, it provides a holistic perspective on the diversity of the financial institutional structure in Europe that distinguishes between contexts where access to finance is a larger obstacle for entrepreneurship than others. Institutional arrangements are crucial in determining the level of transaction costs and risks attached to information asymmetries. As a result, institutions determine the availability of financial sources and the decision of formal and informal financial intermediaries in lending money (La Porta et al. 1997). Second, it helps in distinguishing between contexts where financial institutions reduce transaction costs and risks attached with information asymmetries and thus

stimulate formal financing lending such as through banks versus where informal financing options through family can be a viable strategy to limited formal lending options.

Using the Varieties of Capitalism (VoC) framework and entrepreneurship literature, Dilli et al. (2018: 4-5) identify the 'entrepreneurship relevant' financial institutions and their diversity in Europe by considering their complementarity. They identify four types of financial institutions to be particularly relevant for entrepreneurial activity: the corporate governance system that grants shareholders the right to elect their representatives onto a supervisory board, the protection of shareholder rights in case of venture failure, minimum capital requirements that founders need to place into their venture at its inception, and the availability of venture capital. First, shareholders need to be assured that their investment is used in the most efficient way by the corporate management. In coordinated market economies (henceforth CMEs), for instance, shareholders have a say and insight into how their funds are used and consequently, they often prefer projects that guarantee lower, but more stable and predictable returns over a longer period of time. Second, in case of failure, shareholders' possibilities to disinvest importantly depend on the rights of creditors to recover their investments that in turn, are determined by national institutions. The more easily creditors can recover the funds provided to entrepreneurial ventures, the more likely they would invest in entrepreneurial activity. Third, the lower the amount of capital required, the easier it would be to open a venture. Last, venture capital (VC) is one of the most crucial sources of entrepreneurial activity especially in the US, depicted as the most entrepreneurial society in the world (Dilli et al. 2018: 4-5). While venture capital is a source of finance rather than an institutional arrangement, this dimension is relevant to include, as to the best of our knowledge, there is no direct institutional measure on this form of financing.

Figure 2. Financial Constellations in Europe and the US



Source: Dilli et al. (2018)

Using these four aspects of financial institutions, Dilli et al. (2018) identify four distinct institutional constellations in Europe and the US, which also corresponds well with the Varieties of Capitalism literature (Figure 2). The first one is composed of the liberal market economies (henceforth LME) (UK, Ireland, and the US), characterized by permissive finance-related institutions. In this constellation, corporate governance rights make managers accountable to shareholders, there are low minimum capital requirements, there is availability of venture capital, and institutions privilege shareholders in case of corporate failure. The second institutional group consists of Nordic CMEs and Belgium, and offers somewhat permissive finance-related institutions. This group mainly differs from LMEs in terms of a lower protection of minority investors and a higher minimum capital requirement, whereas their facilitation of venture capital and the recovery rate are similar to LMEs. A third cluster includes mostly Mediterranean market economies (henceforth MMEs) (Italy, France, Spain, Portugal) and some of the 'traditional' Continental CMEs (Germany, the Netherlands, Austria, as well as Slovenia). This cluster performs worse on all four finance-related institutions compared to Nordic CMEs in their extent of stimulating entrepreneurial activity, whereby this difference is least pronounced in terms of their minimum capital requirements. Finally, the fourth cluster includes mostly Eastern market economies (henceforth EMEs) (Poland,

Czech Republic, Slovak Republic, and Hungary, as well as Switzerland) and is characterized by little protection of minority investors, high minimum capital requirements, little facilitation of venture capital, and a recovery rate favoring creditors over shareholders (Dilli et al. 2018: 22).

Dilli et al. (2018) conclude that the financial institutions are least favorable in the MMEs and EMEs for entrepreneurial activity. This implies that financial intermediaries would be less likely to lend money in the MMEs and EMEs as the risks associated with lending money would be higher in these contexts. Below, we first look at whether these differences in the institutional structure are reflected in the cross-national differences in bank lending and the extent to which these cross national differences are historically rooted. We then argue for family lending as an alternative strategy to stimulate entrepreneurs' access to finance in the MMEs and EMEs given their historical difference from the CMEs and LMEs in terms of family organization.

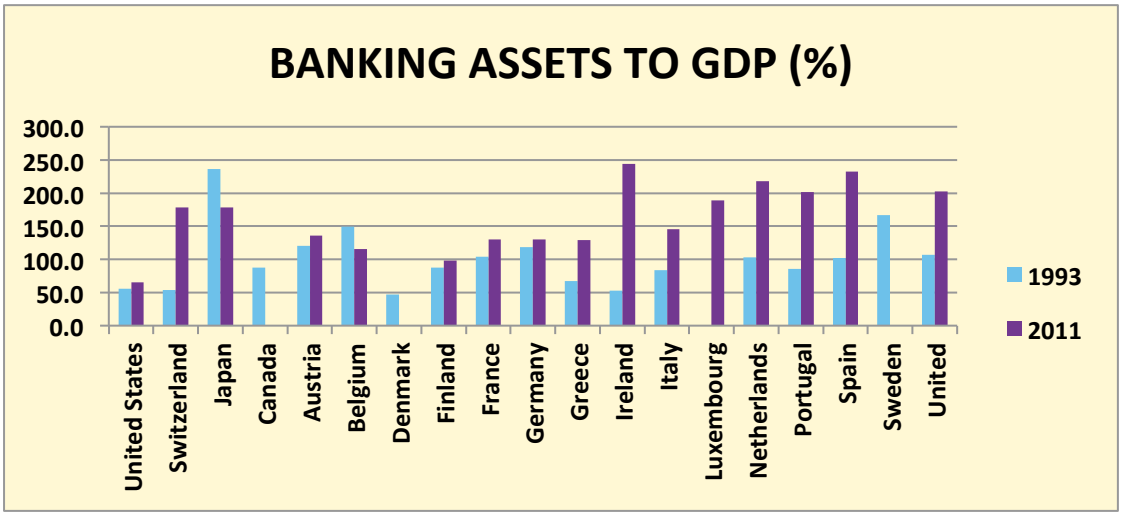
3. Increasing dominance of large financial conglomerates: Banks

In many European countries large financial conglomerates have emerged that are perceived as less willing to finance entrepreneurship. Bank credit and collective pension funds have been argued to be less favorable for enabling entrepreneurship due to transactions costs and information asymmetries. After the recent financial crisis, there is a broad concern about the credit constraints for the SME sector, as bank financing continues to be crucial for the SME sector (OECD 2015). This is not a recent concern. For example, after the oil crises in the 1970s and economic recession in the early 1980s, there were similar worries. However, given that banks continue to be the biggest lender of SMEs today (Figure 1 above), we first look at the cross national differences in the banking sector to understand whether this plays a role in entrepreneurs' access to finance and then study to what extent banks were historically important for entrepreneurial activity to understand the importance of banks for entrepreneurial activity from a long term perspective.

The size of the banks has been linked with the availability of bank credit for entrepreneurship. Small banks have traditionally been important lenders to small firms because small firms have their comparative advantage in relationship lending. According to this view, small banks are better than large banks at relationship lending that depends on "soft" information. Large banks, in contrast, specialize in transaction lending to more mature firms where less discretion is involved. (Black and Strahan 2002:2808). The varying importance and the size of the banking sector across European countries as well as over time (as illustrated in Figures 3 and 4) may be a relevant explanation for the differences in the importance of banks in funding

entrepreneurial activity (OECD 2015).

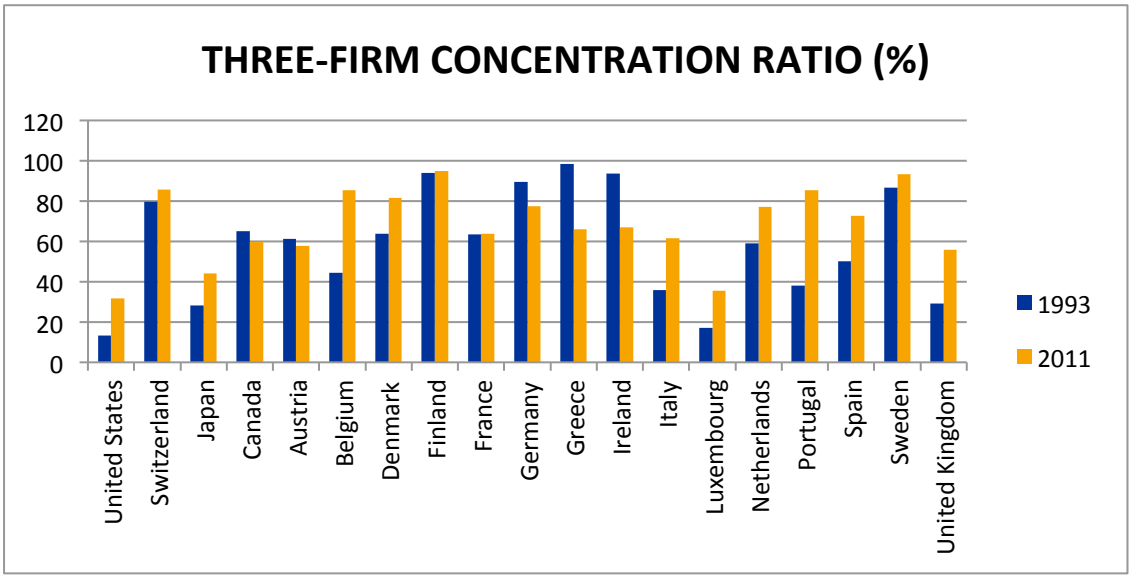
Figure 3. Banking assets to GDP



Source: World Bank (2013)

the large cross-national variation in banks and their increasing importance over time is illustrated in Figure 3. Banking assets to GDP is a measure of the relative economic importance of countries' banking industries. About half (seven) of the countries for which there is data in both time periods show roughly the same assets-to-GDP size in both time periods, an indication that banking industry growth was roughly in line with the growth of the economy. Six countries (Greece, Italy, Netherlands, Portugal, Spain and UK) show about a doubling in the banking assets- to-GDP ratio in 2011 compared to 1993. Two countries, Switzerland and Ireland, even show a ratio in 2011 multiple times that in 1993.

Figure 4. The percentage of all banking system assets by the biggest three banks in a country



Source: World Bank (2013)

The (three) firm concentration ratio provides a measure of the size of the banking industry in a given country, which is the percentage of all banking system assets accounted for by the biggest three banks in a country. The cross-national variation in the size of the banking industry is reflected in Figure 4. For the majority of CME countries, in both time periods, the three-firm concentration ratio is above 50 percent (e.g., Switzerland, Austria, Germany, Netherlands). This also goes for the Nordic CME countries Denmark, Finland and, Sweden. In LME countries such as the US this is not the case. In the US the ratio increases but only from 13 to 32 percent. The UK banking system is already rather concentrated in 1993 with a percentage of 29 percent, even increasing to 56 percent in 2003. The MME countries show mixed results. Some, such as Portugal, Italy and Spain, show a clear increase in the ratio between 1993 and 2003, whereas Greece shows a decrease. Overall, in most countries, including the clear majority of the 19 EU countries where the banking industry has a large role in the overall economy, the largest banks dominated the banking industry 20 years ago, and continue to do so now. This hints to the fact that historical patterns seem to be reflected in the current day banking structure. In the next section, we provide a more in depth discussion of the historical patterns in the banking sector for a selected number of countries.

3.1. Why have some countries a more diverse banking sector than others? Back to historical roots

In many European counties the banking landscape was much more diverse than it is nowadays. Small credit institutions played an important role in many industrializing

countries by extending financial services to the general public, introducing innovations and providing financing to firms and sectors that were overlooked by the larger financial institutions (Wadhwani 2016: 192). In some countries (e.g. Netherlands, UK) they have almost vanished by now, whereas in others (e.g. Germany) they still play an important role in the financial system.

At the end of the 19th century differences between banking systems across European countries started to emerge. In particular, with the Second Industrial Revolution and the emergence of large-scale firms the increased demand for capital led to the creation of large commercial banks (Westerhuis 2016). In many countries, big banks emerged replacing relationship banking with impersonal transaction banking. In the UK many local banks disappeared as a result. During the interwar period UK banking became more concentrated and less competitive. The emerged banking cartel became even more risk averse. Reasons for this process of concentration in 1919 include the almost complete absence of opposition. The British central bank even encouraged the concentration process, because it could exercise influence over a smaller number of larger banks. Stability of the banking sector occurred at the expense of the small firms. Provincial banks were taken over by large London based banks, which preferred higher liquidity ratios. This reduced the supply of funds for the industrial clients, in particular smaller provincial ones. There were no other financial institutions to replace them. However, recent research has shown that other sources of external finance have been important in the UK too. For instance, specialist markets and institutions such as stockbrokers, private investors, and dealers, were relatively well developed and historically have been an important source of finance in the UK (see e.g., Ross 1996). This pattern corresponds well with the LME's institutional structure, which stimulates market-oriented solutions (Hall and Soskice 2001).

In contrast, in Germany, Italy and France, the banking system remained fragmented and the state intervened by creating public and semipublic lending institutions. These public, semi-public and regional banks specialized in segments of the market, reducing information asymmetries, because lending to the same type of client lowered the risk assessment costs. It also led to the development of long-term relationships with their clients, in particular for banks that were deeply embedded in local economies (Carnavali 2005). This type of banking structure thus lowered assessment and monitoring costs due to long term relations between lenders and borrowers. The banking structure based on the long term relationship and the governmental intervention also corresponds with the type of institutional structure of the CMEs identified in the VoC literature that stimulates coordination between different agents of the economy. The disadvantage was that these banks were less

capable in spreading risks. However, next to banks, there were alternative financial intermediaries present (Carnavali 2005).

Savings banks are an example of these alternative financial intermediaries that emerged with the development of formal financial systems. The first ones were established in Germany in the late 18th century in order to provide possibilities for working and poor people to save for periods of need due to illness, unemployment or retirement. A similar financial institution was created in the UK in the 1810s. In the mid-19th century savings banks had been established in many European countries (Mura 1996). At the end of the 19th century divergence of the role and model of saving banks came in. In countries with a strong state and large public debt, the state became a competitor for these local saving banks by establishing postal savings systems (e.g. UK, Italy, France, the Netherlands). They often crowded out smaller institutions (Wadhwani 2011). In countries such as Germany with a weaker central state and a federalist political structure, the introduction of such postal savings systems met with fierce resistance resulting in delay and provisions constraining the ability to compete with existing financial institutions. As a result, the role they play nowadays is very different from country to country. In Germany and Italy, savings banks still play a significant role as financial institutions holding a large share in the total assets held by financial institutions. In other countries, such as the UK and the Netherlands, their number has decreased significantly by merger and acquisitions and their activities are largely the same as those of the large commercial banks (Wadhwani 2016).

Cooperatives are another form of financial intermediaries that are owned and controlled by its members and grants loans to its members who might lack access to credit at the large financial institutions. As such cooperatives have information and monitoring advantages. Informal cooperatives date back centuries, whereas the formal credit cooperatives emerged like savings banks as an integral part of the emergence of modern financial systems. In Germany, cooperatives emerged in the 19th century in response to the failure of existing lenders to lend credit to small retailers and rural populations (Wadhwani 2016). Around the First World War credit cooperatives together with commercial banks and savings banks formed the core of the German banking system (Deeg 1999). Like the savings banks the cooperative model has spread across Europe since the second half of the 19th century. In Italy, they became a very important part of the financial system as well (Carnevali 2005). In contrast, in the UK and US, typical LME economies, the credit cooperatives were established relatively late and met with obstacles. In these contexts, commercial and saving banks were already providing financial services to the working and rural people.

The reason why these smaller credit institutions, such as savings banks and credit cooperatives, emerged is often explained by economic theories of asymmetric information. Smaller financial institutions might benefit from information and monitoring advantages compared to large ones. For example they can use information due to social relationships. Apart from local embeddedness the organizational form might also play a role. For example savings banks, often in the mutual and trustee form, did not have shareholders and managers were often prohibited from taking profits. However, it is not only the economic theories that explain the emergence of these smaller financial institutions. As said in some countries the banking landscape remained diverse, whereas in others these smaller financials disappeared in the 20th century. An important explanation for this divergence is the socio-political environment and importance of small firms (Carnevali 2005).

In France, Italy and Germany, small firms have been historically considered as being very important for the economy and cultural identity of these three countries. As a result, politicians could not exclude them from their plan as small firms were seen as "preservers of social stability and as a valuable pool f votes". On the other hand, in the UK the government started to deal with SMEs only since the late 1970s and it did so by removing or compensating for market imperfections in line with the free market regime. For example, minimizing taxation to provide for finance and information (Carnevali 2005).

In Germany, cooperatives and savings banks historically developed close links with local SME business. Although in the extended literature the focus is often on the big banks from Berlin, we know that with the emergence of these banks, in the Interbellum many SMEs still depended on local and regional banks. The SME, also known as the *Mittelstand*, consisted of among others artisans, shopkeepers, and small business owners. Moreover, they were considered a social class (Carnevali 2005: 46). They met with fierce opposition from the commercial bank and it was this conflict that "shaped the state's response towards competition between different types of banks, ensuring the permanence of segmentation" (Carnevali 2005: 196). Thus, in Germany the state played an important role in mediating between different types of banks. It was an active political choice to protect the SMEs and their local economies. In contrast, savings banks in the UK for example were not allowed to lend for commercial purposes as it was forbidden by law. In the 1950s and 1960s long term finance of the *Mittelstand* was made available via savings and cooperative banks, ensured by strong competition and state regulation. Regulation provided incentives for the saving and cooperative banks to grant SMEs long-term credits. The banks operated in a limited market and their success depended on the economic welfare of the region. In their charters it was stated that pursuing profits was

important but only as a means to other goals. Savings banks were mandated with the promotion of the local economy and cooperative banks had to serve interests of their members (Carnevali 2005).

Thus, local financial institutions were able to support the competitiveness of SMEs and the development of local industrial districts (see also Vitols 1995 and Deeg 1999). Zeitlin (2007) for example stresses the importance of understanding local industries and knowledge about regional economies, which the larger financial institutions failed to do. Carnevali (2005) stresses comparative advantages of these regional banks in Italy, France and Germany after the Second World War compared to the much more consolidated banking system in the UK. However, while the banks differed across these countries, the limited historical evidence shows that the number of firms that could take advantage of the banks' combination of investment commercial banking services in Germany was quite small (Cull et al. 2006).

Italy, a typical example of a MME in the VoC literature, had a fragmented political structure until the political unification in the mid-19th century. The country also started relatively late with the industrialization process compared to its neighboring countries and there were large differences in terms of wealth, agricultural development, and industrial specialization between the various regions of Italy. The Italian case shows that banks were necessary for economic growth but it also required an "adequate sociopolitical matrix of law, regulation, and custom in which they operated and appropriate government policies" (5leberger 2006: 151). Government seems to have lacked the right tools to seize opportunities. As a result, "when banking and business opportunities presented themselves, they were seized for the most part by foreigners". (Kindleberger 2005: 146). By the interwar period, Italy had moved more in the direction of industrialization by the development of large scale capital intensive firms. After the Second World War, the economic structure did not change much: it consisted of SMEs grouped in segmented industrial sectors combined with a group of very large firms with economic and political power over the economy. This group of large firms existed mainly of state-owned firms in steel, chemicals and energy. Like in Germany, small firms were seen as essential preservers of social stability both in the countryside and cities. Policies for small firms included exemptions from income tax, subsidized loans, and regional development policies.

After the Second World War, the banking system was restructured by creating a decentralized system to strengthen local banks. Government wanted to create local financial channels (decentralized capitalism) to act as a counterbalance to the power of the large private business groups. While decentralization and a segmented banking system were seen as elements that would increase stability, a concentrated

banking system was perceived as a factor that would hinder economic growth (Carnevali 2005: 177; see also Spadavecchia 2005). The role of the state thus has been very important in the Italian case. Also when the Bank Law was updated in 1946, the central bank believed that growth could only be accomplished if firms could access the credit market. The diverse financial landscape of the 1930s with various types and size of financial intermediaries had to be defended as a guarantee for the diffusion of credit. As a result, regulations were reshaped in order to restrain banking competition and protect the small and medium sized banks from the larger national ones (Carnevali 2005: 178). Thus, the banking system after the Second World War was highly regulated based on the Banking Law of 1936. The awareness of policy makers that SMEs had disadvantages in access to market finance, contributed to the introduction of financial subsidies as part of national industrial policy (Spadavecchia 2005). From the mid-1970s however, the decentralized banking system was increasingly being questioned. As a result, many territorial restrictions were abolished as well as controls over interest rates, even leading to the mergers of banks in the 1990s.

However, the banking system of Italy has been criticized heavily because it has not developed into an efficient banking system. Italy has not been able to reform the public administration, which had led to corruption and rent seeking (Carnevali 2005). Moreover, the historical divide between the North and the South of Italy still, in particular with the slow economic growth in the south, continued to remain an issue. Of the various countries discussed here, the Italian banking system has been the most regulated and subsidized with the aim to promote the development of small firms. However, in Italy while the overall number of business ownership is large both historically and today, a large majority is composed of necessity entrepreneurs (van Stel 2005).

In contrast to Germany, industrialization in France occurred in a political context of a unified nation state, with strong central government. Although large French firms established themselves between 1918-1930, SMEs remained a very important part of the economy. Lescure (1999) shows that in the 1920s, the SME sector played a central role in the process of economic growth. He also mentions credit availability problems in this period, because commercial banks limited credit to this sector. As illustrated in the VoC literature, and being a CME, France's institutional environment was very different from the UK, because the state had a much more active role in France resulting in a more diverse banking sector. The state pursued policies that were aimed at avoiding overproduction. Small firms were seen as better for the economy than big ones. Due to agreements to fix prices and quotas there were hardly incentives for firms to merge into bigger conglomerates (Carnevali 2005).

During the Great Depression of the 1930s many local and regional banks had to close, and after the Second World War a process of concentration dominated the banking sector in which the regional and local banks merged with the national ones. Four large deposit banks were nationalized after 1945; they had national branch networks. Two other large deposit banks were not nationalized but also had branch networks across the country. In 1957, 22 regional banks and 158 local banks were left. The local banks had a strong hold over the local market. They had special knowledge of the locality and were willing to grant credits to local business. For this reason, one of the two non-nationalized banks, the CIC, worked closely together with these banks instead of acquiring them. The greater role of the state after the Second World War was also reflected in the role of public and semi-public banks in stimulating investments. The popular banks became important in that sense and granted credit to the middle classes and to SMEs (Carnevali 2005)

A process of liberalization and increased supervision leading eventually to the monetary union in 1992 led to increased concentration, also in the continental countries. In the 1990s, the German banks for example started merging, involving private banks but also saving and cooperative banks. However, even today the number of saving and cooperative banks is still relatively high and still embedded in local markets (see for this consolidation process also Westerhuis 2016). Despite the consolidation process, the banking sectors in Germany, France and Italy still remain diverse reflected in their size, geographical spread and specialization.

However, the extent to which these differences in the banking structure are relevant for explaining entrepreneurial activity is not clear. Both based on our comparison of the historical cases and according to the study of Cull et al. (2006), who has studied the resources available to SMEs during the 19th and early 20th centuries, we can conclude that historical differences in banking structure were present. However, these differences in banks were of marginal significance to SMEs in the past. Instead SMEs mostly relied on local intermediaries, which ranged from notaries in France who were arranging the loans to the cooperative movement in Germany. According to Cull et al. (2006), SMEs solved their finance problems through private initiatives and setting up institutions, which were demand driven. Cull et al (2006: 3028), for example, show that in nineteenth century France, textile manufacturers in different parts of the country raised funds in strikingly different ways. In Alsace and in the Seine River Valley between Paris and Rouen, they raised capital by selling equity, and relying on family and business connections to reduce the information problems involved in securing outside infusions of funds. Around Lille, on the other hand, family borrowing made up an important source of financing. In the next section, we evaluate the role private initiatives, in particular family lending, can play in providing an alternative form of financing for entrepreneurs in the institutional contexts where

the transaction costs and risks associated with lending due to the information problems remain high.

4. Informal Funders and Family as an Alternative Source of Finance

Sections 2 and 3 illustrate that the availability of formal financing options through banks and the financial institutions that support formal finance options remains limited especially in the Eastern and the Mediterranean Market Economies. In this section, we evaluate whether informal funding options can provide an alternative to the challenges related to the formal finance intermediaries and formal institutions in these economies. According to Stel et al. (2011), a country's level of entrepreneurial activity increased with the supply of informal investors. Here, we put forward the idea that family lending can provide an alternative in the Eastern and the Mediterranean Market Economies where family ties have been historically stronger than in the North Western Europe. This is because family members may be willing to invest in the business out of 'love' or social obligations even when the risk is high due to lack of supportive financial institutions. Family has been historically a crucial source of finance for businesses and remains important today (Cull et al. 2006). Moreover, studies that looked at the role of informal institutions in shaping formal institutions highlight that norms and values define what is preferable in social relations, and as a result, they decrease the costs for developing, justifying and sustaining the formal institutions underpinning a regime (Licht et al. 2007; Nee 2005; Dilli 2016). Moreover, institutional reforms can prove counterproductive if they destroy the existing benefits of such informal institutions (Ebner 2009).

To evaluate the feasibility of this idea, we first look at both the supply and demand side of family lending by discussing the current day cross-national differences in business angels' choice in investing family members (supply) and individual's choice of borrowing from family members (demand). We then evaluate whether these cross-national patterns in family lending correspond with historically embedded norms and values with regards to family organization. We conclude this section by presenting suggestions on in which contexts and how family lending in entrepreneurial activity can be stimulated in Europe.

A recent growing body of evidence in economics and economic history literature shows that the differences in informal institutions shaped by historical setting have set in motion divergent evolutionary paths, leading to the long term cross-country differences in development outcomes today (Nunn 2009; Dilli 2017). Recently, historically rooted family ties have been shown to matter for economic, institutional, social and political outcomes of societies. For instance, Duranton et al. (2011) find

that regions with weak family ties perform better in terms of economic growth, adopt better to sectoral shift and have a higher educational attainment. Similarly, Alesina et al. (2013), comparing the different migrant populations in the United States, show that individuals who inherit stronger family ties are less mobile, have lower wages, are less often employed and support more stringent labor market regulations. While evidence in the literature hints to the fact that regions with weak family ties are performing better in economic outcomes, strong family ties can provide advantages especially when it comes to informal lending.

In entrepreneurship literature, family ties have received some attention (Aldrich and Cliff 2003; see Arregle et al. 2015 for a review). Family members are often assumed to be important providers of financial resources (so called ''love money'') (Bygrave et al. 2003). This is because financial capital from family members has important advantages such as lower transaction costs (Au and Kwan 2009), favorable interest and payback requirements (Steier and Greenwood 2000), and availability when other sources are not available (Steier 2003). Especially when the firm requires more time to provide returns, family may provide a better lending possibility to the entrepreneur than formal financing options (Arregle et al. 2015). Consequently, the literature tends to assume implicitly that the more money the family has available, the more likely there are to be entrepreneurial intentions (Sieger and Minola 2017).

Despite their advantages, however, findings in the literature show that entrepreneurs often prefer to access business resources from non-family partners, such as venture capitalists or business associates (Au and Kwan 2009). These non-family partners can bring not only financial resources to new ventures but also broad experience in new venture development (e.g., De Clercq and Sapienza, 2001). In addition, out of loyalty to the family and considering the high failure rate of new ventures, many entrepreneurs may prefer to avoid placing family assets at risk in a new venture because if that venture performs badly or fails, the family will suffer (Arregle et al. 2015:333).

Moreover, the share of family financing in new business ventures differs widely across countries, regions and over time (Szerb et al. 2007; Bygrave and Hunt 2008; Chua et al. 2011). Studies which paid attention to the cross-national differences in informal venture capital show that individual explanations (e.g. know an entrepreneur, see good opportunities, have entrepreneurial skills, fear of failure) are generally far more important determinants of informal investment than country's economic development, pro-enterprise government programmes, new business costs, or high levels of entrepreneurship education (Szerb et al. 2007). However, less attention has been paid to the role of historically rooted informal institutions as an explanatory factor. As mentioned earlier, organizational studies highlight the

importance of social relations in acquiring finance through informal channels. However, while the importance of social relationships in lending behavior of business angels is acknowledged, less attention has been paid to the historical origins of these cross national differences in the strength of the social relations. A better understanding of these historical conditions is crucial as informal institutions change very slowly over time and through their impact on shaping informal and formal institutions, historical family institutions are likely to influence lender's and borrower's choice today.

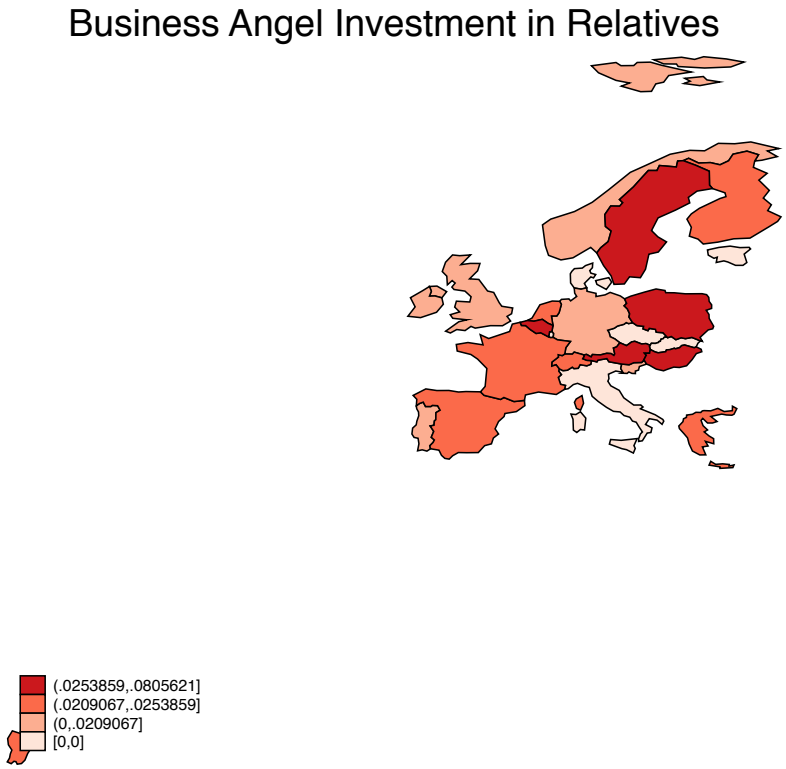
Previous studies have argued that the level of social obligations individuals feel towards their family members shape the willingness of the borrower to lend money to the family member (supply side) and the willingness of the lender to borrow from a family member (demand side). For instance, Bygrave and Reynolds (2005) argue that the ratio of altruism to the self-interest decreases as the relationship between an investor and an entrepreneur increases. The altruistic way of investment is most commonly seen in investment in family members. Therefore, in contexts where family ties are stronger, business angels can be more likely to lend money to their family members out of social obligation/out of love. Therefore, we formulate the hypothesis that the share of family financing is expected to be higher in areas where traditionally the family has priority over the individual (strong family ties).

A bulk of literature has illustrated that there is a large variation in Europe in terms of the strength of the family ties. Demographers Reher (1998) and Todd (1985), using census data, have shown that strong family ties characterize the Mediterranean countries whereas weak family ties (the individual have priority over family) characterize the North Western European countries (Reher 1998; Todd 1985). More recently, Alesina and Giuliano (2010), using the World Values Survey data, constructed a more direct measure of family ties based on three items, namely individual's responsibility towards to parents and children, respect towards parents, and importance of the family. They show that while on average the Mediterranean countries have the strongest family ties, the Eastern European countries have moderately strong family ties and the North Western European countries have weak family ties. Similarly, Rijpma and Carmichael (2013), using ethnographic data, reach to similar conclusions on the difference between the North Western Europe, Eastern Europe and the Mediterranean countries in terms of family structure.

Based on the Global Entrepreneurship Monitor (GEM) (2011) database, Figure 5 illustrates the cross-national differences in terms of the investment of business angels in close family and relatives to see whether business angels are more likely to invest in family members in regions with strong family ties. Figure 5 shows that Investment of business angels in family members is high particularly in the Eastern

European countries, which has moderately strong family ties in Alesina and Giuliano (2010)'s typology. While the share of the business angels who invest in family members is also relatively high in the Mediterranean countries, Portugal seems to have a low share of business angels who support family members in their business ventures. This is contrary to our expectation given that Portugal is characterized with relatively strong family ties. Moreover, contrary to our expectation, Sweden and Belgium, depicted as having weak family ties, are outperforming the rest of the European countries in terms of their share of business angel investment in family businesses. An explanation for these contradictory cases can be due to the overall supply of business angels due to the favorable institutional context (Au and Ding 2011). According to the GEM data (2011), while Belgium and Sweden have the highest share of business angels among the European countries with respectively 15 % and 8 % of the respondents reported being a business angel, in Portugal this share was only 2 %. Another factor can be the level of entrepreneurial activity, which can influence the availability of financing options. Thus, the direction of causality is an issue here, which requires further investigation; however, this is beyond the scope of the current study.

Figure 5. Business Angels investment in Close Family Members and Relatives.

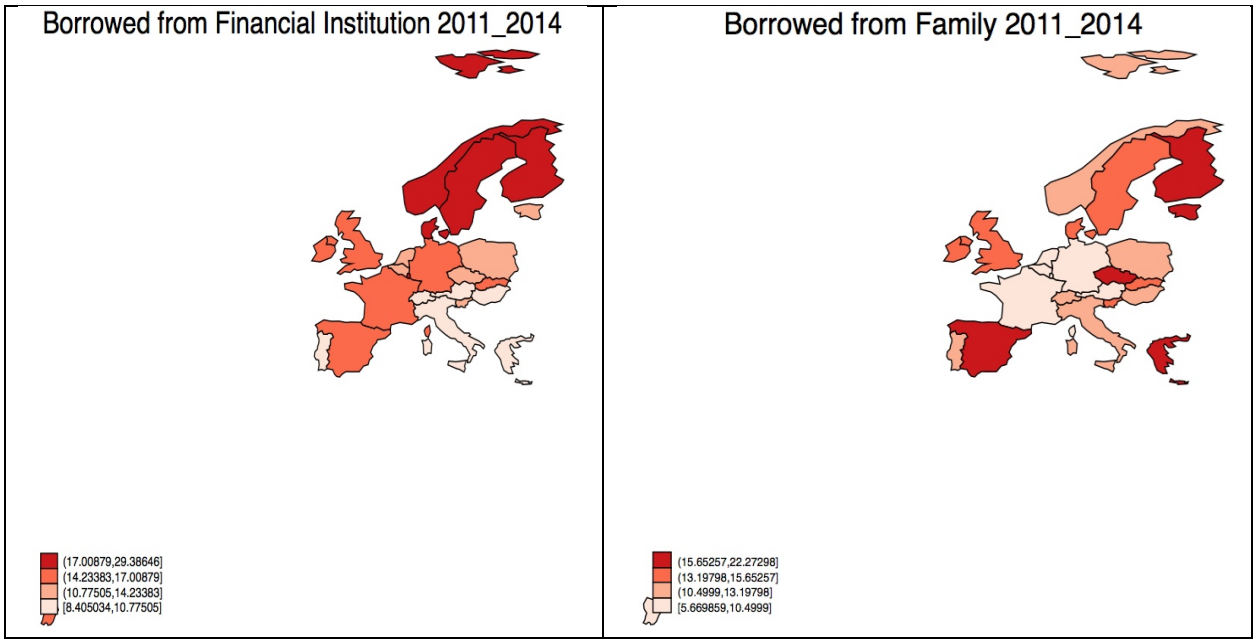


Source: Global Entrepreneurship Monitor (2011)

Furthermore, family ties can be relevant not only for the supply side but also for the demand side of finance by shaping entrepreneur's decision to borrow money from a

family member. While we lack data on entrepreneur's lending behavior from family members, based on the World Bank (2011) Findex Database, Figure 6 illustrates the unweighted average of borrowing behavior of individuals in the last 12 months from banks or any other financial institution (Figure 6.1) and from family, relatives, or friends (Figure 6.2). A divide between the Southern/Eastern and the continental European countries in terms of the individuals' borrowing behavior is clear from Figure 6. According to Figure 6.2, borrowing money from a family member is a commonly used source of finance in the Southern European countries, followed by the Eastern European countries, both of which are characterized with strong family ties. On the other hand, the formal financial institutions and particularly banks seem to be a common source of finance in the Scandinavian and the continental European countries (see Figure 6.1) both of which are characterized with weak family ties.

Figure 6. Borrowed Money from Financial versus Family Institutions



Source: World Bank Global Findex Database (2014)

Overall, the patterns presented in Figures 5 and 6 show that family lending occurs under two conditions. First, in the Eastern European and the Mediterranean countries, except Portugal, business angels seem to invest in the family members despite the unfavorable financial institutional environment identified in section 2. In the Northern European countries, on the other hand, where such a social obligation is lower due to weak family ties, the investment of business angels and borrowing behavior from the family remain limited. Given that these two regions have strong family ties and borrowing from family members is commonly done, creating incentives for business angels to invest in the family members in the two contexts can be a strategy to stimulate financing options for entrepreneurs.

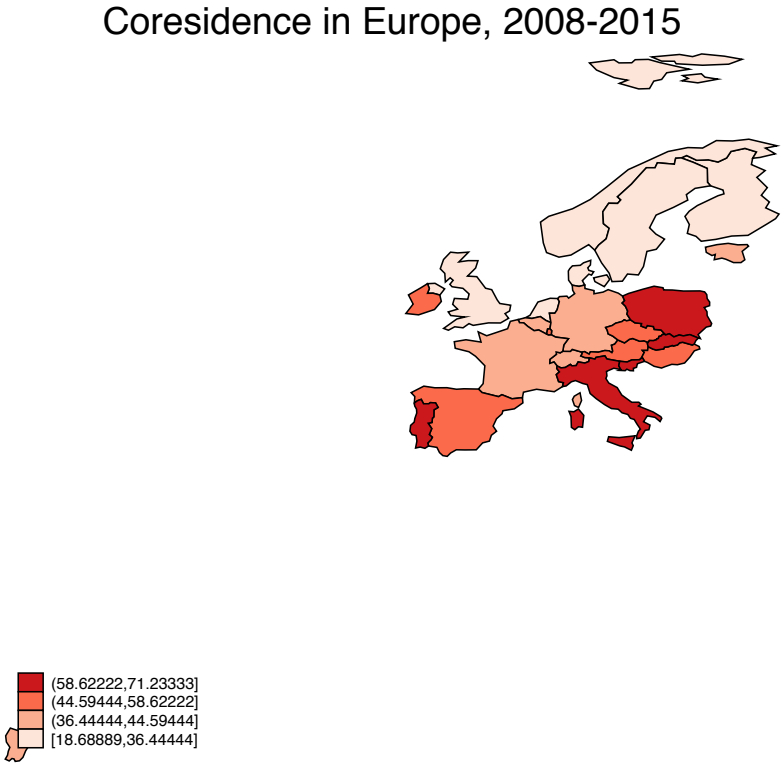
Alternatively, the cases of Belgium and Sweden show that business angels can still invest in their family members in contexts where family ties are relatively weak but the quality of financial institutions are high. Dilli et al. (2018) show that the Nordic CMEs and Belgium have the second most favorable financial institutional environment for entrepreneurial activity after the LMEs. This favorable formal institutional environment can be useful to understand why family borrowing is high in the UK and Finland. Moreover, policies targeted at stimulating family lending seem to be reflected in the investment of business angels to family members. Recently, Belgium introduced a *win-win-scheme*, whereby anyone who lends a loan to a business as a friend, family, or acquaintance receives a tax reduction in return (OECD 2015). We argue that similar policies to Belgium should be prioritized in the Eastern and the Mediterranean countries to stimulate family lending which also have the supportive informal institutional structure. To explain further why this is the case, in the next section, we discuss the persistence in family ties and divergent patterns of family lending in Europe from a historical perspective.

4.1. The Historical Roots of Family Ties and Family Lending

The previous section focused on the link between family ties as an informal institution and family funding. In this section, we discuss the historical family organization as a reason behind the cross-national variations in family ties to argue why family funding can provide a feasible alternative to formal financing options particularly in the Mediterranean and the Eastern European countries.

One of the core explanations as to why North Western European countries have much weaker family ties compared to the Eastern and Southern European countries has been attributed to the differences in the living arrangements of family members. Figure 7 below shows that the share of the population residing with parents until a later age is much higher in the Mediterranean and the Eastern European countries compared to the North Western Europe. Typically young populations continue to live with their parents until finding a job or marriage and in some cases after marriage in the Mediterranean countries whereas in the North Western European countries, they would typically live until around the age of 20 (Reher 1998). Scholars have argued that these differences in living arrangements resulted in varying patterns in social obligations with regards to individual's duties towards family members (see Alesina and Giuliano 2010 for a review). The argument is that in societies where individuals continued living with their parents longer, they developed stronger feeling of social obligations towards family members (strong family ties). In societies where individuals left their parents' home earlier, on the other hand, this feeling of social obligation is lower (weak family ties).

Figure 7. Coresidence Patterns in 2013



Source: Eurostat (2013)

Economic and demographic historians argued that these coresidence patterns have been present in Europe at least since the late Middle Ages and hardly changed over time. According to the historical demographers, the line (known as Hajnal's St. Petersburg-Trieste line), which separates the central and northern Europe territories (Scandinavia, the UK, the Low Countries, much of Germany and Austria) from the Eastern and the Mediterranean in terms of coresidence practices, has been present for centuries (Reher 1998). The study of Reher (1998) shows that from at least the late Middle Ages until the second half of the nineteenth century, it was common in rural England and in the Low Countries for young adults to leave their parental households at a young age to work as agricultural servants in other households. On the other hand, in the Southern European societies even though there were servants in both rural and urban settings, it affected only a small part of the young population in rural areas (Table 1).

Recent empirical evidence also supports the view on the persistence of the coresidence practices and norms and values regarding family life (Duranton et al. 2009). For instance, on a global level, Rijpma and Carmichael (2013) show that there is a strong correlation between family practices around the 1920s, the recent family norms and values from the World Values Survey database (1985-2015) and Social Institutions related to Gender Equality (SIGI) (2009). This persistence has been

attributed to the intergenerational transmission of these values from parents to children (Kok 2009; Alesina and Giuliano, 2010) and the formation of formal institutions, which in return perpetuate the dominant family traits over time (Galasso and Profeta 2010).

Table 1. The Historical Co-residence Patterns

Northern and Central European countries				**Southern European countries**			
Country	year	%servant	region/place	Country	year	%servant	region/ sample
Denmark	1787/1801	17.6	Three perishes	Italy	1610-1839	0.7-1.5	Kingdom of Naples
Iceland	1729	17.1	Three counties		1654	4.0-6.0	Parma
Norway	1801	8.9	Three areas		1656-1740	9.5	Pisa
Belgium	1814	14.2	Nine Flemmish villages		1853	5.0-7.0	Bologna
Austria	17th-19th cen.	13	19 listings	Portugal	1740-1900	3.6	Minho
Holland	1622-1795	11.7	Four localities		1796	4.6	Tras-os-Montes
Germany	1795	10.7	Grossenmeer		1788,1789	6	Santarem
France	1778	12.6	Longuenesse		1801	2.5	Colmbra
France	1644-97	6.4	Two southern villages	Spain	1753,1788	3.8	Valencia
					1786	7.3	Navarre
					1752	3.0-4.0	Santander
					1752	2.6-3.5	Galicia
					1766,1877	5.3	Basque Country
					1750-1850	3.6-5.0	Cuenca
					1719-1829	1.3	Murcia-Alicante
					1787	2.4	Andalusia

Source: Reher (1998)

The historical differences in the family structure have been shown to matter for societies' long-term (institutional) development. According to Reher (1998: 209), for instance, traditionally in Mediterranean societies much of the aid given to vulnerable members of the society came from the family, while in northern societies charity was largely organized through the public (e.g., English Poor Laws) and private institutions. He makes a similar argument to explain why public elderly care is better developed in North Western Europe as opposed to the South. According to Greif and Tabellini (2010), while the nuclear family type in Western Europe has led to the emergence of institutions such as guilds and universities in late Medieval Europe, the extended family structure of China, where children continue residing with the parents during their adulthood, resulted in the emergence of social institutions based on kinship relations (also in Greif 2006). More recently, Dilli (2016) shows countries characterized by a nuclear household structure in the past also tend to have more sustainable and higher levels of democracy in the long run.

These historical family arrangements are possibly linked with the long-term development of financing options. The scarce historical evidence from the late Middle Ages and Early Modern Europe shows that in this period, private lending was already formalized in the Low Countries. Van Zanden et al. (2012) demonstrate that in the fifteenth and sixteenth centuries, properties were used as collateral on a large scale and that interest rates on both small and large loans were relatively low (about 6 percent). As a result, many households owned financial assets and/or debts, and the degree of financial sophistication was relatively high. Similarly, Gelderblom and Jonker (2004) show that deposits and bonds were common among businessmen and entrepreneurs to borrow from family members in the 16th century Netherlands. Thus, formal institutions stimulated lending both from family and non- family members in this period. On the other hand, while financial historians show that Italian city-states were crucial financial centers in the fifteenth and sixteenth centuries too, it was mainly concentrated in the hands of a small group of merchants. The presence of weak family ties might have created the necessity to regulate the lending behavior more formally in the North, which resulted in access to credit by a larger share of the population compared to the South. However, the lack of historical data does not allow us to provide a formal test of this hypothesis.

5. Discussion and Policy Implications

This paper provided an overview of the diversity in the financial institutions characterizing Europe to identify the contexts where access to finance remains as a challenge for entrepreneurs. In particular, the finance related institutional structure

remains least favorable to support entrepreneurial activity in the Mediterranean and the Eastern European economies today. We then studied the historical evolution of two financial intermediaries, banks and family and the financial institutions related to these two intermediaries to identify possible solutions. A historical perspective on the banking structure in Europe shows that banks were more diversified in the past than today and provided different possibilities for entrepreneurs to have access to money. Moreover, rather than large banks, the challenges in accessing finance were solved in many cases through local and private initiatives.

Therefore, instead of focusing on solutions related to the formal financial institutions, we evaluated whether family lending can provide an alternative in the Mediterranean and the Eastern European economies. We argued that the way family has been organized in the past forms further implications for the organization of society today. We argued that in societies where the family is more central than the individual (strong family ties), family would be an attractive financial source for business ventures. While strong family ties have been argued to play a role in the development of less effective formal institutions (e.g., Reher 1999), they can provide an advantage in lending through family. Therefore, introduction of policy tools that would encourage family lending can provide a viable solution for financing for new ventures in the Mediterranean and the Eastern European countries. The Belgium example provides an example of how to achieve this. For instance, in Belgium, anyone who grants a loan to an entrepreneur as a friend, acquaintance or family member receives an annual tax discount of 2.5% of the value of the loan. If the enterprise is unable to repay the loan, the lender gets 30% of the amount owed back via a one-off tax credit in the context of the “win win-lending” scheme (OECD 2015). This change in the policy seems to have helped with increasing the availability of finance to entrepreneurs in Belgium.

Our investigation also showed that in a number of countries where family ties are weak (Sweden and Belgium), the supply of business angels are high which is reflected in the high levels of investment in the new ventures including family. This is likely to be the result of formal financial institutions that stimulate the overall level of business angels and entrepreneurial activity. In the continental European countries, where the formal financial institutions are less favorable to stimulate entrepreneurial activity and are also characterized with weak family ties, following a similar model to the Scandinavian countries and Belgium can help improve the financing options. Moreover, family lending can provide advantages over bank lending such as fewer requirements such as collateral in lending process and more flexible arrangements in returning the loans. However, an important implication of weak family systems in the continental European countries is that, policies should prioritize targeting improvement of the formal financial institutions rather than

family lending. This is because policymakers may need to deal with institutional barriers that are related to inherited family structures and cultures particularly resistant to change (Duranton et al. 2009).

However, our suggestions should be taken with caution and further investigation is required to reach for more conclusive evidence. The lack of long-term historical financial data that is comparable across different institutional contexts of Europe means that our analysis on the role of historical family structure for financial institutions remains descriptive and we cannot eliminate the role alternative explanations that influence financial institutions today. Moreover, reverse causality is an issue as regions where entrepreneurial activity is higher, investors would also be more likely to invest in businesses and develop formal institutions more favorable for entrepreneurial activity. Given the slow changing nature of institutions and their historical origins, the direction of causality is likely to run from financial institutions to entrepreneurship. Moreover, the type of entrepreneurial activity influences the demand for different forms of financing options. To gain insight on these issues, future research should prioritize collection of systematic data on entrepreneur's access to finance broken down by different forms of entrepreneurial activity both across time and across countries to allow for a more formal test of these issues. This remains as an ambition for future studies to investigate.

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