



Government financing for innovative enterprises - policy mix and changes over time

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Main reasons why government financing is needed

During the worst recession since World War II, Finland at the beginning of the 1990s was at the edge of bankruptcy similar to how Greece is today. What did the government do then to save the country? The most important decision had to do with cutting down radically on capital gains taxation as well as investing strongly in R&D.

Many similarities can be found with today's situation in terms of the policy measures that have been adopted. In the current difficult economic circumstances, at the same time that the government was obliged to severely cut the budget and increase taxation, it decided to cut corporate taxes and give tax exemptions for business angels' investments in start-ups and to allow for SMEs to make tax deductions from their R&D expenses. Later, the government decided to launch a EUR 1 billion venture capital fund programme.

During difficult economic times, government financing is needed which focuses, for example, on young innovative companies that have difficulties obtaining financing from private sources.

The experience of Finland

For two decades, the government policy in risk financing has been restricted to only increasing the supply of capital by channelling taxpayer money to the market. In recent years, this policy has been widened to encompass at least three dimensions.

First, since the government has increased the supply of venture capital only occasionally and only in the short term, it recently decided on a ten-year programme to increase the supply of capital. This removes insecurity from the market and gives a strong signal for the best talents to choose entrepreneurial careers and also a good sign for investors to invest in them.

Second, regardless of the government's long-lasting principle of taking a neutral stance in relation to taxation, it recently began to use, in addition to the direct provision of capital, tax incentives for investors and SMEs.

Third, the provision of capital alone, whether it comes from private or public sources, does not necessarily contribute to the growth of young companies. Even more than capital, those often innovative enterprises with a high growth potential need to be provided with a better means to grow. With this in mind, the government's priority, besides the supply of capital, turned slightly in the direction of strengthening the demand side, i.e. encouraging and incentivizing the most experienced business people to coach start-ups along their growth path. Tailored for this purpose, the [Vigo Venture Accelerator](#) programme (cf. below) was the response of the government to the continuous argument made by market players that while there is enough capital in the market, there are not enough good enterprises.

There is no right or wrong way or single decision or policy measure regarding how a government should act when financing innovative enterprises. Instead, governments should adopt a mixed policy that changes over time depending on the circumstances in a country at a given time.

What has been learned?

Although the long-term government policy to invest in R&D has been successful, recent studies have revealed that this method is not sufficient when done in the form of a grant. The grant instrument often means “loose” money for enterprises. As a result, the government has steadily started to turn grants into equity.

Similarly, direct equity investment in a company does not seem to be the best form of government intervention. Consequently, the government has decided to move in the future from direct investments to investing in privately managed funds, thus avoiding the need to intervene in company-level decisions.

So far, the government money has been invested according to *pari passu* principles, which means that if private investors do not want to invest in risky innovative start-ups with a high growth potential, then neither will the government do so. As a result, private investors, and accordingly, venture teams have disappeared from the market. To break this deadlock, the government has begun using an asymmetric profit-sharing model. When investing in a fund, the government is satisfied with only a low interest rate return, with the rest of the profits going to private investors.

Regional venture funds in a small country like Finland cannot survive. A deal flow that is restricted to a region has proven to be too small, and thus investments are rare. Good exits are non-existent. The size of the typical regional fund has been too small to be able to attract professional managers. Hence, institutional investors have left regional funds. The government has followed.

In addition to the above-mentioned decisions made by the government, other supportive decisions have been made as well. The government has streamlined seed- and early-stage financing by putting seed and early stage financing into one place. For start-ups, this means having access to one single address regardless of whether it is a question of grant, lending or equity investment. For years, the government has supported the business angels’ network, but during the current year this practice will be assumed by the private association called FiBAN – Finnish Business Angels Network.

One important lesson to learn has been to continuously assess the results of each policy measure and reject those measures that do not seem to work and to come up with new approaches or adopt new policies that seem to work elsewhere, while tailoring them to match local circumstances.

How the approach has been adapted in light of these lessons

A new policy initiative called the [Vigo Venture Accelerator](#) programme seems to be successful. The selected Vigo accelerator teams must commit themselves to working for the growth of the target companies that they have selected. Increasingly, government financing for start-ups is being channelled via the accelerator programme controlled by the Vigo accelerator teams. Over a three year period, the Vigo manager teams have succeeded in attracting EUR 200 million to their target enterprises, two-thirds of which has come from abroad, mostly from US venture capitalists and business angels. One successful example from the program is a company called Supercell, which was non-existent only two years ago. Now it makes one and a half million euros profit per day. Government financing for innovative start-ups controlled by professional teams seems to be much more effective than the direct financing of start-ups.

However, the most important issue for a well-functioning ecosystem of start-ups is an innovative entrepreneurial spirit, one which wants to change the world. The government can only support and encourage this spirit and phenomenon. Previously, all the best talents wanted to build their careers in famous corporations, whereas now they have a dream of creating a start-up and conquering the world with their idea.