

Financing Regional Endogenous Development: the Role of Proximity Capital in the Age of Globalization

OLIVIER CREVOISIER

ABSTRACT Today, financial activities become more and more integrated at a global scale. Nevertheless, SMEs have no access to these circuits. Consequently, one can ask how do they find their equity capital? This paper presents the concept of 'proximity capital' which articulates informal capital and proximity relations between demander and supplier of capital. A typology of spatial forms of financial circuits of industrial activities is built by contrasting proximity capital and financial cores which link the largest firms and banks together.

1. Introduction

This paper sets out to identify the form of economic structures in the financing of industrial activities. Special emphasis will be placed on the regional or international aspect of financial channels. We will focus on the *equity capital* of industrial companies and will only touch on the problem of capital from outside sources.

The thesis we uphold here is that there is a duality of channels for financing industrial activities. On the one hand, the large companies are organized into groups, holding companies, etc. and exchange shareholdings with each other, either directly or through financial players. The financial relations of these companies are thus characterized by an integration logic. On the other hand, to the extent that small and medium-sized enterprises (SMEs) are unable to finance themselves, they find the bulk of their equity capital in their regional environment. This is what we shall term 'proximity capital'.

After an introduction about globalization of financial flows, we will describe two spatial logics for the structuring of financial channels: an autonomy logic, based on proximity, and an integration logic, relying heavily on financial relations or networks on a much broader geographical scale. We will then construct a typology describing the changes undergone by regional financial channels.

The main source of the empirical data used is a survey conducted in the Swiss Jura Arc in 1995 the object of which was to understand the role of proximity capital in the development of regional SMEs (Crevoisier *et al.*, 1996). This paper is a reinterpretation of those data and aims to place them in the more general context of industrial activity financing channels. Given

the limited number of case studies and the lack of quantitative data on proximity capital, this paper remains mainly exploratory in nature and aims to provide avenues for reflection.

2. Globalization of Goods, Services and Financial Flows

For several decades it has been possible to detect a number of changes in the financing modalities of industrial companies, changes that are due partly to the globalization of operations. Let us look first at the general changes in the real sphere and then at those in the financial sphere.

2.1 Real Sphere and Changing Financing Requirements

The current opening-up of markets for goods and services implies an acceleration of international trade and, as a result, an increase in competition, rendering companies' operations ever more uncertain. The flow of information and technologies and the significant reduction of transport costs are calling into question the stability of industrial operations. Technological change is thus becoming ever faster, making the products and innovations in place on the markets obsolete at an ever earlier stage in their life-cycle (Julien, 1994).

This instability of industrial activities is inducing a change in conventional financing modalities. Thus the bank loan is no longer by any means the sole source of corporate financing. On the contrary, we are witnessing a general trend towards financial disintermediation. Owing to a greater instability of technologies and markets, to the growing difficulty of evaluating industrial risks and to the shortening product life-cycle, companies are continually being compelled to increase their equity capital.

2.2 Financial Sphere

At the same time, a whole range of products in the financial sphere has been developed and made available to companies. They allow a better matching between the needs of industrial firms and the way to finance them. Thanks to derivatives, it is possible to get reliable protection against fluctuations of currencies or commodities, leasing allows an interesting alternative to finance equipments, and there are numerous possibilities to manage pensions funds of firms: we could also add all the services related to mergers and acquisitions.

The development of these instruments is linked to internationalization of financial markets and to their integration (Das, 1993). The innovations and breakneck progress made by information and telecommunication technologies have made this integration much tighter than the one of goods and services markets.

The financial sphere and the real sphere are obviously not independent of each other: however, the former's autonomy has increased considerably in the last 10 years. Indeed, not only have capital movements increased several dozen-fold over this period but purely financial transactions, without any real counter-performance, account for nearly 95% of these flows! In view of these figures, it would be tempting to think that, in the field of capital flows, distance is now immaterial, borders have been abolished and we are therefore witnessing the 'end of geography' (O'Brien, 1992). However, we maintain exactly the opposite idea, at any rate as far as the financing of industrial activities is concerned.

3. SMEs and Large Companies: Two Different Types of Financing

This internationalization of the financing of industrial activities is taking place in very different ways and at very different speeds. Moreover, it would be a mistake to think that it directly

affects *all* companies. On the contrary, some very broad areas of industrial activities are still far removed from these trends. Now they are not sectors that are lagging behind but ones with a different operating logic that has its own modes of financing and accumulating capital and its own networks.

In the context of this paper we shall be focusing mainly on the difference between companies that are participating in a trend towards reorganization of their ownership and control relations at a supra-national level and which are generally listed on the stock exchange or which would have the option to be listed, and those that are disconnected from these processes and that consequently have to find their own equity capital by different channels. The former are mainly large companies and the latter SMEs. It should be noted that the concept of SME varies greatly from one country to another. In the Swiss context, a large company is one with more than 500 employees. Smaller companies, however, account for the overwhelming majority of Swiss industrial companies. It is these orders of magnitude that are used in this paper.

3.1 Large Companies' Financing Logic: Integration and Formation of 'Financial Cores'

About 10 years ago the major industrial companies began to engage in large-scale merger/acquisition operations. It is not only industrial groups that are involved in this trend but also banking and financial institutions, that are playing an increasingly important role in the reorganization of control relations among industrial groups. But these restructuring operations are not carried out in the same way regardless of the country of location.

First of all, and even if today we are witnessing an expansion of most companies' area of operations, it is important to remember that the 'global' firm does not exist and is probably a utopian idea. Thus, Ruigrok and Van Tulder (1995) have compared the percentage of assets held abroad with the sales made abroad for the world's 100 largest companies. It is true that globalization takes the form, above all, of sales of goods and services abroad, and 40 of these large companies generated more than half their sales abroad in 1993, but only 18 of them held most of their assets outside their country of origin; and even then the latter usually originated in small countries such as Switzerland, Sweden or the Netherlands!

The concept of 'financial core' covers alliance relations between groups, relations that are embodied in stable cross-shareholdings (Morin & Dupuy, 1993). When studying the formation of a 'European financial core', Morin and Dupuy establish that even today the relations still mainly reveal national units (France, the UK, Germany, Belgium, Italy). On the other hand, they note a clear-cut tendency for the relations between these national 'financial cores' to multiply, a development that foreshadows a genuine 'European financial core'.

While there can be no doubt about the national reality of financial cores, the practical modalities by which these operations take place can take two very different forms. Firstly, these restructuring operations can be carried out through the stockmarkets. Such operations are conducted largely in the English-speaking countries, where shares circulate mainly through this channel. Secondly, these closer inter-company links can be established through the agency of banking and financial institutions. This accounts for by far the largest number of cases on the European continent.

Whatever the modality by which ownership relations between these groups is restructured, it remains true that as a result these large companies have two options for finding equity capital. Firstly, by funds provided by their shareholders—who are often major groups or banks—which means they are able to find sufficient funds. Secondly, on the stock exchange, each of these companies being listed on the stockmarkets, which today

are known to be closely interconnected worldwide. They are thus able to raise funds in different financial centres, depending on their requirements and their geographical locations.

Furthermore, a large industrial company frequently has centralized financial management of the financing resources of the companies it controls. It is therefore able to reallocate the profits from one activity to another in line with its industrial strategy and financial strength. When it makes an investment in a country or region in which it is not yet established, its financial base at the group level enables it easily secure bank loans locally. Thus, a large company has the ability to make equity capital and outside capital circulate between its various subsidiaries.

The subsidiary of a large company located in a region will therefore generally be cut off from local channels as far as its equity capital requirements are concerned. Regarding outside capital, local loans will be granted easily on the basis of the group's financial standing (Crevoisier *et al.*, 1996). On the other hand, it is *integrated* into a financial logic on a supra-regional and, increasingly often international, geographical scale, and indirectly on international stockmarkets.

The existence of 'financial cores' is essential if one is to understand the restructuring of the productive system and the way it is financed. Morin and Dupuy (1993, pp. 89–90) note, however, that a financial core must, at the very least, be national:

One cannot uphold the idea according to which there might be infra-national cores linked, for example, to local productive systems. For if this were the case, one would have to admit the existence of independent financial sub-systems, without having any dependency links or any connection with the central financial system [*note: in particular with monetary policy*], which appears to be totally illusory. On the other hand, nothing rules out the possibility of an international financial core emerging tomorrow, at the same speed as the international monetary and financial system is being reshaped in depth.

3.2 SMEs' Financing Logic: Proximity Capital

In view of this, one may ask oneself: how do SMEs, which, we should bear in mind, make up the overwhelming majority of industrial enterprises, find their equity capital? They are not connected to the 'financial cores' and have access to the stock exchange only in exceptional cases.

There are many different reasons why they cannot be listed on the stock exchange. In particular, listing requires a company to make an effort to inform its shareholders and to provide extensive administrative follow-up. For small businesses it is estimated that this task represents one full-time employee. A minimum size therefore has to be reached. Next, admission to the stock exchange is worthwhile only if a sufficient number of shares is traded to form a price. Now this is a gamble, because either a large number of SMEs are family businesses or else their capital is concentrated in the hands of only a few shareholders. The number of transactions is therefore generally extremely low. The result is that it is not easy to estimate the price of a share; it has to be done by a company audit whose cost is often prohibitive compared with the amount of the transaction.

In other words, the stock exchange is not a suitable financial instrument for small-sized enterprises. Should it be concluded from this that SMEs do not finance their own equity capital? Quite the contrary, and that is why we shall expand on the notion of 'proximity capital'.

3.3 Definition of Proximity Capital

By 'proximity capital', we mean funds that are invested in a company in the form of equity capital or quasi-equity capital and which derive from persons, companies or institutions that maintain—directly or, more rarely, indirectly—sustained relations with the receiving company or with persons inside that company, whereby these relations do not concern only the financial aspects.

The main feature of this definition is the relationship between the company and the economic players who provide its equity capital: it is thus the relationship between partners that becomes the central element. The SME cannot escape this 'personalization' of the financial relationship, whereas when capital is raised on the stock exchange, the 'technical' aspects of a financing bid generally gain the upper hand. Moreover, many investors—institutional investors or private individuals—are generally interested only in the profitability of the share. Thus, while it is possible to invest in a listed share on the basis of an analysis of documents published by the company, it is indispensable to go through a personal connection in the case of SMEs.

Furthermore, in SMEs there is a close relationship between the holding of shares on the one hand and decision-making power in the firm on the other. Indeed, reorganizations of financial cores are operations that concern both industrial restructuring and financial relations. However, the shares traded on the stock exchange and which constitute the bulk of the transactions challenge the company's decision-making power only rarely. A 10-million franc investment in a multinational has no impact on the power structure. In contrast, investing in an SME nearly always involves challenging the entrepreneur's decision-making power. In addition, the latter is often the main shareholder, the 'owner-shareholder'. Holding shares is thus very directly linked to management control.

In the survey we conducted, direct investors in SMEs, be they other firms or private individuals, were always involved in management of the firm.

3.4 The Role of Proximity

When a new firm is created, or in the event of a capital increase, the entrepreneur has to find equity capital. To the extent that he has a sufficient personal fortune or that the firm can finance itself, there are no problems. If not, he has to find funds from those around him, from the members of his family, former work colleagues, funds originating from various public economic promotion agencies or from persons or firms whose participation the entrepreneur has succeeded in securing. Apart from his skills as a technician or manager, it is thus mainly the entrepreneur's personality and ability to mobilize his social relations that are determining. This type of relation is frequently dependent on geographic proximity, as the latter reflects all the social and institutional relations of a territory.

It is not because one lives nearby that one decides to invest in one company rather than another. On the other hand, physical proximity may be coupled with an institutional, social and cultural proximity which is crucial to matching supply and demand. Because they belong to the same institutions, because they have developed a knowledge of the local industrial fabric and reputations, or because there are meeting-places in the region, the various parties can be sure that the procedure is reliable, and that confidentiality will be maintained.

Dei Ottati (1994) shows that in the case of the Italian industrial districts, local financing channels in the broad sense are extremely active. A company's self-financing ability stems mainly from its 'credit' or trust that it manages to inspire in potential partners. Furthermore, social proximity (family, political networks, etc.) is coupled with an economic proximity in the sense that the specialization of these areas facilitates evaluation of an industrial project.

Indeed, it is easy for a professional from the sector to judge the soundness or risk of a project. Thus, lengthy evaluations by experts are not absolutely necessary, which makes transactions involving low amounts possible.

Lescure (1996) explains that in the 1920s SMEs were able to rely heavily on local and regional banks to obtain financial support. Even if some large companies were deeply indebted to regional banks, they nevertheless depended less on this type of lending than did small companies: in fact, this close collaboration between the two types of bodies was continuing a long-standing tradition. The strength of the bonds between these banks and their regional clientele explains to a large extent rates of regional bank financing sometimes exceeding three-quarters of total financing during those years. At that same period the local banks drew their strength from their highly developed industrial commitment. This was reflected in particular by the taking of financial stakes in local industry. In 1922 one example that was highly representative of the age shows that the local bankers' participation exceeded that of the founder, as well as that of the large industrial group that was supporting the company at the time. However, the local bankers were not involved in the day-to-day management but had seats on the board of directors.

Subsequently the inadequacy of bank financing prompted SMEs to resort to informal lending channels, that is, all the non-bank forms of financing or those not originating from the financial market. Nevertheless, it should be pointed out that even if this mode of financing is far from being the preserve of SMEs, it nevertheless plays a very important role for the latter. However, in the case of SMEs this informal capital is essentially regional.

More recently, a British study underscored the importance of informal capital in the financing of SMEs, a capital which in most cases was raised within a radius of no more than 150 km. The investors, nicknamed 'business angels', are generally private individuals having management experience and wishing to participate in the running of the company. This market is considerable since it is estimated that it amounts to £2.5 billion, whereas 'institutional' venture capital represents only £1.5 billion (OECD, 1995).

As we showed in the above-mentioned survey, proximity capital in the Swiss Jura Arc remains one of the only modes of financing small- and medium-scale innovative projects. However, this market is completely unstructured: the players and institutions are dispersed, there is no meeting-place for suppliers and consumers, experience is on a case-by-case basis and consequently there is little learning in this area.

4. Accumulation of Capital in Regional Productive Systems

Starting from the two spatial structuring logics for the financial channels described above, we shall seek to reconstruct various regional modes of financing SMEs, taking into account their potential development. These modes are of course dependent on the structure of the supply of capital and financial services in the region. These elements constitute the 'financial territory' of the firm (Belletante, 1991).

The first logic, which we have just described above, is based on the firm's integration into a broader network (either membership of a large industrial group or of a 'financial core', or listing on the stock exchange) which enables it to secure equity capital financing. A region in which this scenario predominates participates in a capital accumulation process that takes place on a much wider scale, either national or international. The players are large groups or large banking and financial institutions or even national governments. The predominant logic is *organization*. We shall therefore speak in this case of 'financial integration', even if this integration is only partial.

The second logic describes the way in which regional SMEs find in their immediate environment the financing they require. A region comprising mainly this type of enterprise is

EVOLUTIVE TREND ↗		Autonomy	Integration
		S T A R T I N G	Autonomy
S I T U A T I O N	Integration		Reconstitution of a (deliberate or spontaneous) regional capital accumulation dynamic
			I) Autonomous regional accumulation
		III) Gradual reconstitution of a regional financing systems	IV) National or international accumulation

Figure 1. Typology of spatial forms of financing channels.

Source: Crevoisier *et al.* ocre (1996).

characterized by its *autonomy* in terms of capital accumulation and mobilization. Autonomous does not mean that the region is self-sufficient: movements of goods and services frequently transcend regional borders, thereby participating in the process. The players are SMEs, some private individuals, local institutions, regional banks, economic promotion agencies, local authorities, etc. To the extent that companies do not manage to finance their expansion themselves, they resort to proximity capital.

Dependent on whether the integration logic or the autonomy logic predominates in a region and dependent on whether the regional system is evolving towards more integration or more autonomy, we can draw up a four-case typology (Figure 1). These cases do not aim to catalogue the entire reality, but to stimulate reflection on regional financial channels and on capital accumulation and utilization dynamics. The various cases are not mutually exclusive. On the contrary, regions in which only one would be found are very rare. The Figure characterizes the various development possibilities for regional financial channels. We will deal successively with the four quadrants.

4.1 Situation I

This first situation concerns regions whose financing channels are coherent at the regional level. Local savings find channels to be reinvested regionally. Capital is thus accumulated on a regional basis. This presupposes the existence of a—formal or informal—regional market which allows supply to meet demand. As we have seen above, such a market is based on a number of institutions that allow it to function. Historically, some of the very first industrial

414 *Research Briefing*

regions developed on the basis of such channels. This is the case in particular of Lancashire and the West Riding (Hudson, 1989).

A current example of such a situation is the mountain resort of Zermatt in the Swiss Alps. Most of the financing of the hotel and restaurant industry, ski-lifts, etc. at this resort is in the hands of what is called the local 'bourgeoisie'. The latter is a centuries-old institution grouping together families originating from the valley and which thus controls most of the land. There is no Hilton or Holiday Inn at Zermatt! Even substantial indivisible investments like the Alpine metro are financed by the local bourgeoisie.

4.2 *Situation II*

In the second case, a regional financing system is maintained, but relations develop with one or several 'financial cores' situated elsewhere. Direct investments can take place in one direction and the other. Should they be direct investments from the region to other spaces, the system is expanding. If it is only the taking of controlling stakes from outside, there is a progressive emigration of decision-making centres and a loss of autonomy. The flows can also go in both directions at the same time.

One example of how partial control is gained is Emilia-Romagna towards the end of the 1980s. The companies that had expanded up to a certain stage found themselves being taken over by large Italian groups (Tolomelli, 1990). Silicon Valley has been described as a region having its own players for financing SMEs (Planque, 1986), while attracting outside capital and making investments outside the region from within the latter (Gordon, 1993).

4.3 *Situation III*

In this case one moves from a region that is dependent on players located elsewhere in terms of its development financing to the creation of an autonomous regional dynamic. Unfortunately such cases appear to be more theoretical than real. However, it can be noted that great efforts have been made in the last 15 years to develop, for example, regional venture capital. Currently people are wondering about the possibilities of financing the development of innovative SMEs (OECD, 1995). Yet the needs are considerable. Indeed, at the moment the need for equity capital is greater than in the past due to increased uncertainty in industrial activities. Now the regional financial structures in place are frequently unsuitable. Innovative SMEs do not find the starting capital or are bought out during their growth phase.

4.4 *Situation IV*

The last scenario forms part of an integrated system that defines at one and the same time central regions and regions that are dependent in terms of the financing of their activities. Capital accumulation therefore takes places not coherently at the regional level but on a wider scale. There are no regional financing channels.

This case is unfortunately very widespread today. In the case of the Swiss Jura Arc regional channels gradually disappeared when companies became prosperous enough to rely mainly on self-financing and bank loans. The lack of local channels gives rise to takeovers of expanding companies by large industrial groups from outside the region.

5. **Conclusion on the Usefulness of Such Reflections**

This paper aims to lay the foundations for systematic research into regional financing networks. Various studies (Dei Ottati, 1994; OECD, 1995) and the survey we conducted in

the Swiss Jura Arc (Crevoisier *et al.*, 1996) show that SMEs do use alternative modes of financing, which we have grouped together under the concept of 'proximity capital'. These approaches are, for the time being, exploratory. They still need to be systematized and investigated quantitatively if we are to gain a better understanding of the relations between the financing of SMEs and geographical proximity.

It has already emerged, however, that these approaches are definitely of interest for several reasons. Firstly, financing marks for the time being the limits of endogenous development or of development 'from below' in general. It has been possible to highlight significant regional dynamics at the industrial level, innovation dynamics, etc. On the other hand, there are only rare cases in which a financial activity induced by industrial development has grown up on a regional basis in the past 50 years. Financial activities remain mainly structured according to the conventional urban hierarchy. This limit also marks a hiatus in the operating logics of the economic system as a whole. The fact that a considerable number of dynamic SMEs are taken over during their growth phase by large industrial groups is worrying. Indeed, it means that somewhere the fruits of endogenous development and of regional innovation dynamics are being confiscated by the largest (economic and geographic) centres.

Secondly, a study of proximity capital allows us to (re-)discover modes of financing that existed, for example, at the time of the industrial revolution or those that still exist today in some developing countries. These modalities prove relevant in a riskier context in which it is no longer possible to rely mainly on outside funds.

Finally, it has to be observed that in some countries (including Switzerland), proximity capital remains one of the only possible modes of financing small- and medium-scale innovative industrial projects. To what extent is it conceivable today to reconstitute regional financial channels that had largely vanished for decades? A British experiment in which an interface agency was created between potential investors and industrialists seems to show that it is possible (OECD, 1995). Thus there is an interesting field of experimentation for new regional policies.

References

- BELLETANTE, B. (1991) Pour une approche des spécificités financières de la PME au travers du concept de territoire financier, *Revue Internationale Petite et Moyens Entreprises*, 1, pp. 49–79.
- CREVOISIER, O., MAILLAT, D., WERMELLE, I., RUDOLF, J.-PH. and SCHNEITER, A. (1996) *Le financement du développement endogène dans l'Arc jurassien*, IRER studies, 38, Neuchâtel.
- DAS, D. K. (Ed.) (1993) *International Finance: Contemporary Issues*. London: Routledge.
- DEI OTTATI, G. (1994) Trust, interlinking transactions and credit in the industrial district, *Cambridge Journal of Economics*, 18, pp. 529–546.
- HUDSON, P. (1989) Capital and credit in the West Riding wool textile industry c. 1750–1850, in *Regions and Industries*, pp. 69–99. Cambridge: Cambridge University Press.
- GORDON, R. (1993) *Collaborative Linkages, Transnational Networks and New Structures of Innovation in Silicon Valley's High Technology Industry*. Report for DATAR.
- JULIEN, P.-A. (1994) Mondialisation des marchés et types de comportements des PMI, Quebec: GREPME, Trois-Rivières.
- LESCURE, M. (1996) *PME et croissance économique*, Paris: Economica.
- MORIN, F. and DUPUY, C. (1993) *Le coeur financier européen*. Paris: Economica.
- O'BRIEN, R. (1992) *Global Financial Integration: The End of Geography*. London: Pinter.
- OECD (1995) *Les meilleures politiques pour les petites et moyennes entreprises*, pp. 57–65. Paris: OECD Publications.
- PLANQUE, B. (1986) Pôles d'innovation, PME et planification régionale. *Cahiers du CER*.
- RUIGROK, W. and VAN TULDER, R. (1995) *The Logic of International Restructuring*. London: Routledge.
- TOLOMELLI, C.L. (1990) Policies to support innovation in Emilia-Romagna: experiences, prospects and theoretical aspects, in E. CICIOTTI, N. Alderman AND A. THWAITES (Eds) *Technological Change in a Spatial Context*, pp. 356–378. Berlin: Springer-Verlag.