LOCAL BANKING DEVELOPMENT AND THE USE OF DEBT FINANCING BY START-UPS (SUMMARY)

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EQUITY FINANCING

SUMMARY

LOCAL BANKING DEVELOPMENT AND THE USE OF DEBT FINANCING BY START-UPS

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Principal Topic

Start-ups often find it hard to obtain external finance, due to a large informational wedge between insiders and outsiders which creates adverse selection and moral hazard problems. Banks are able to overcome the severe information problems of start-ups via close monitoring, which allows them to acquire “soft” information through contacts with the firm, its owner and the community to which they belong. In this study, we investigate how banking development at the local level affects the access to debt for start-ups, taking into account the presence of different types of banks at the local level.

Method

Our empirical analysis is based on a large sample of 153,659 Italian start-ups, founded in the period 2007-2010. We estimate two-stage least squares regressions using measures of the local supply of credit in 1936 as instruments of local banking development in the 2000s. We also control for key local characteristics that might be correlated with local banking development, as well as key firm characteristics.

Results and Implications

We find that debt is a significant source of funding for Italian start-ups. Start-ups are more likely to use debt and have a higher leverage ratio when they are founded in provinces with more bank branches. Despite the argument that local banks are better suited for start-up financing than large banks that operate nationwide, we do not find any significant differences between national banks, large and small local banks. However, our results do suggest that the presence of foreign banks in a province significantly reduces access to debt for start-ups. This finding is consistent with the “cream skimming” effect of foreign banks’ lending to the most profitable local firms and making it more difficult for local banks to lend to start-ups.

Our paper contributes to a better understanding of the role of finance in entrepreneurship. Moreover, our study suggests that a particular concern for policy-makers may be the increasing globalization in the banking industry. Finally, while policy-makers tend to focus on the role of venture capital and business angel financing for early-stage ventures, our findings highlight the importance of banking development at the local level for start-ups.

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