

## Why Public Funding of Venture Capital Has Failed

By Dan Richards

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*Josh Lerner is a professor at the Harvard Business School, with a joint appointment in finance and entrepreneurial management. Much of his research focuses on the structure and role of venture capital and private equity organizations. He recently led an international team of scholars in a study of the economic impact of private equity for the World Economic Forum.*

*Dan Richards interviewed Professor Lerner at the American Economic Association conference in early January. A video of this interview is*

*available [here](#).*

**About a year ago, you released your book, *Boulevard of Broken Dreams*, which focused on why public efforts to boost entrepreneurship and venture capital have failed and what to do about it. What was the catalyst that led to you write this book?**

It was a real-world push, which is that, particularly in light of the financial crisis, there is a real sense in a lot of the western economies that we've got to get growth started again. Everyone is struggling with the question of jobs, government revenues and so forth, saying we need to create growth. Based on the experience in both the United States and elsewhere, it seems clear there is a very strong relationship between entrepreneurship, new venture formation, and venture capital on the one hand and job creation and economic growth on the other.

It is not surprising that in a lot of the developed world we are seeing enormous interest in this area. Even in a lot of places that you might think don't need to worry about this stuff, like Saudi Arabia or China, you are seeing an enormous concern about employment and creating quality jobs for the legions of young people who are coming into the workforce. These well trained young people are asking how they can work in fulfilling jobs. Often they are looking toward entrepreneurship as a way to do it.

It would be great if there was a long track record of success on the part of governments in terms of doing catalytic programs for venture capital and entrepreneurship. But the sad fact of the matter is that, for every successful program, there are probably a dozen unsuccessful efforts where things have gone very badly. That legacy of failure and avoiding those mistakes of the past is really what motivated me to dig into this.



**You mentioned that most of these programs have been unsuccessful, but there have been some successes. Can you point to one success and talk about what we can learn from it?**

Probably the poster child in terms of success along these lines would be the Israeli experience. If you go back in a time machine to the early 1990s, venture activity was something that was really rare there. There was only one venture fund that did not have the best of reputations. Entrepreneurs by and large did not want to give up equity and just relied on bank loans. "It's not a lot of money," they typically said, "we'll just grow slowly." They were very much in equilibrium along those lines.

Then, through a series of efforts, there was an explosion in terms of venture activity, to the point where the Tel Aviv area has emerged over the last decade as being the second-largest hub of venture activity worldwide after San Francisco.

**Can you point to the specific things that led to that success in Israel?**

It is clear that they didn't start with a vacuum. There was not only a lot of interesting science within their universities; there was also a defense complex that had a lot of interesting things going on. They had all this immigration in terms of scientists and highly educated people from Russia who provided a lot of the scientific advances and innovation that were preconditions for the launch of successful start-ups.

But it is clear that they did, on the public side, a whole series of things that very much jump-started their venture activity. That ranged from basically providing matching funds for people with small companies to spend on R&D to essentially encouraging foreign venture funds to come in, again with the provision of matching funds. Israel essentially told investors: If you do really well, you can keep more than your share of the gains, but if you do poorly, we'll both lose money.

They were able to attract with that combination of things some of the best venture groups – not just from Europe and the UK but from the United States, Taiwan and elsewhere – to come in and set up funds there. Within a few years, many of the local partners in those groups spun off and started their own funds, and they succeeded in creating a diverse, rich venture-entrepreneurial ecosystem there.

When you look at that, you see several hallmarks of success that you can contrast with some other places that have not always adhered to some of those features.



**Perhaps we could talk about Canada, where we have had labor-sponsored funds since the early 1990s. Today, those are generally accepted as something that was not a success.**

Why have government funded programs in Canada done so poorly and what lessons can we draw from this?

Well, you can point to several things in terms of ways that my “Golden Rules” were violated in the process. One thing was just simply the scale of the program; it was done at a level that was completely disproportionate to the size of the market. If you look at the amount of money that flowed into the venture market through the labor-fund program, it dwarfed the existing venture pool. This is a business that is very sensitive to supply and demand conditions. There was just a flood of money coming in. It drove up valuations; the market couldn’t handle that supply of funds.

Secondly, one of the really important things is making sure that the money gets in the hands of the right people. If you look at where the labor-fund money by and large ended up, given the nature of the political process, the decision was to put the money in the hands of organized labor. Organized labor does many things well. Investment management, however, is not generally one of the strong suits that we give them credit for.

In many of these cases, the people who ended up managing the money were relatively inexperienced in these venture areas and ended up making a series of rather naïve decisions in terms of how they went about doing their investing. There wasn't really a careful screening of who got the money. Also, by the way it was structured, there wasn't an emphasis on getting or on insisting that entrepreneurs be able to raise matching funds from the private sector in a way that might provide a real test that they were able to go out and raise money from sophisticated people. As a result, they could have been able to do some degree of screening there.

**Have you seen those three mistakes that you've identified in the labor-sponsored funds in Canada in other markets as well?**

Absolutely. If we were to do a little tour of the European community and look at many of the efforts that were done there, we'd see many of the same mistakes. We'd also see the idea – another manifestation of what reared its head in Canada – that rather than saying “let's focus on a couple of places that have the best probability of success,” instead it was once again, “let's be fair and let every province have its own efforts. “

You ended up with these situations of a fund, let's say in Manitoba, with a mandate that it can't go and invest in something in Alberta. As you can imagine, in many of these markets the imbalance between supply and demand was exacerbated by the extreme limits on where they could invest.



We see the same thing in Europe, where they'll essentially say, "Let's do a venture initiative. Let's cut it up among the 27 member countries. Let's cut it up among each province, and then we'll divide it between the north and the south provinces, and everyone will get their own little bit." Rather, they should be saying there are probably four areas that have a viable chance of really being the hub, and let's just focus our efforts on trying to get those places to work really well.

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