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**A report to the European Commission
Directorate-General Regional Policy**

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List of abbreviations

- AIR Annual Implementation Report
- ECA Export Credit Agency
- EEN Expert Evaluation Network
- ERDF European Regional Development Fund
- FEI Financial Engineering Instrument
- FVCA Finnish Venture Capital Association
- MEE Ministry of Employment and the Economy
- NSRF National Strategic Reference Frameworks

Executive summary

The role of Financial Engineering Instruments (FEIs) in ERDF programmes in Finland is rather limited. There are two forms of FEI in use in the present programming period: (1) subsidised loans and guarantees to SMEs, and (2) provision of venture capital for seed and start-up stages for innovative SMEs. Both forms of FEI are organised and administered by Finnvera, a specialised financing company owned by the State of Finland.

The share of finance for FEI (subsidised loan & guarantee support and venture capital) is 5.6% of total ERDF commitments (June 2012). The share of new jobs and new enterprises created by FEIs receiving support from the ERDF, loans and guarantees in particular, is much higher.

While subsidised loans and guarantees were already used in the previous ERDF programming period, venture capital for SMEs became available as a new ERDF instrument as late as August 2011 when Finnvera established a new fund *Aloitusrahasto Vera Oy* - Seed Fund Vera Ltd. It is the only ERDF co-financed venture capital measure in the present programmes. Aloitusrahasto Vera makes ERDF co-financed venture capital investments in start-up and early-stage innovative enterprises. The requirements for receiving financing are innovativeness and growth potential.

1. Use of financial engineering instruments

FEIs are defined as all kinds of financial support other than non-refundable grants and subsidies. The report focuses on FEIs which are co-financed by the ERDF.

The role of FEIs in ERDF programmes in Finland is relatively small. There are two forms of FEI in use in the present programming period, both organised and administered by Finnvera, a specialised financing company owned by the State of Finland. It provides its clients with loans, guarantees, venture capital and export credit guarantees. Most of its services have no link to the ERDF. The two forms of FEI which are included in ERDF programmes are: (1) subsidised loans and guarantees to SMEs, and (2) provision of venture capital for the start-up and early stages of innovative SMEs.

Finnvera is the official Export Credit Agency (ECA) of Finland. It raises funds mainly on the capital market but it also draws on specific sources of funding. Long-term borrowing instruments can be used for bonds. The State can provide absolute guarantees on loans taken out by Finnvera which means that it obtains its funds at relatively low interest rates.

Subsidised loans from Finnvera to SMEs are provided for starting a business and developing the business through investment and there are also special loans available, such as for women entrepreneurs. In addition, Finnvera provides guarantees for SMEs. Finnvera's services are available for enterprises right across the country. ERDF support is used to lower the interest rate for the loan recipient and to cover the risk of guarantees in disadvantaged regions. The rate of subsidy is greater the more disadvantaged the region, with the largest subsidies in Eastern and Northern Finland. Finnveras loans are also available in these regions without interest rate support from the ERDF.

Venture capital for SMEs became available as a new ERDF instrument in August 2011. Finnvera established a new fund *Aloitusrashtra Vera Oy*¹ (Seed Fund Vera Ltd) as a subsidiary with total assets (ERDF and the State) of around EUR 17.5 million, though assets are intended to increase to EUR 30 million. The funding is distributed between regions as follows: Southern Finland - EUR 2.0 million, Western Finland - EUR 7.5 million, Eastern Finland - EUR 5.0 million and Northern Finland - EUR 3.0 million.

Aloitusrashtra Vera is the only functioning venture capital fund which is co-financed by ERDF, though there is a plan to create another in Northern Finland (Northern Start-up Fund) with ERDF support.

The role of Finnvera in providing subsidised loans to SMEs is basically the same in the present programming period as in the previous one (2000-2006). The right to use ERDF funding for guarantees came into effect in 2005. Finnvera had no venture capital fund supported by the ERDF in the 2000-2006 period, though some regional venture capital funds had a link to the ERDF but they were of marginal importance and none of them were continued in the present period (see comments in section 5).

The share of the ERDF going to FEIs, which cover the Finnvera loan and guarantee schemes and the *Aloitusrashtra Vera VC* fund, is some 5.6% of the total (June, 2012). Three quarters of this goes to Finnvera. The share of funding for FEIs is largest in Western Finland – where the role of

¹ A more detailed description is in section 4.

Aloitusrahasto Vera is relatively important – and Eastern Finland. The share is smallest in Southern Finland (Table 1).

Table 1: ERDF funding (commitments) and the share of FEI by region at 1st June, 2012

Commitments of ERDF and the State	Mainland Finland Total	Region			
		Southern	Western	Eastern	Northern
Grand total all priorities (EUR million)	1,305.4	195.8	231.2	471.4	407.0
Finnvera's finance (EUR million)	55.3	5.0	8.8	26.6	14.9
<i>Aloitusrahasto Vera</i> , VC (EUR million)	17.5	2.0	7.5	5.0	3.0
FEI total (EUR million)	72.8	7.0	16.3	31.6	17.9
FEI total, % of grand total	5.6	3.6	7.1	6.7	4.4

2. Rationale for using financial engineering instruments

The mid-term evaluations of the Objective 1 and 2 programmes in the period 2000-2006 made recommendations for enhancing FEI instruments in the new programming period and these were noted in the *ex ante* evaluations of the ERDF programmes of the period 2007-2013. The rationale for the recommendations was the lack of availability of funding from venture capital for start-up firms with high growth prospects which were considered to have an important role in regional development. In the National Strategic Reference Frameworks (NSRF) (2007) for the period 2007-2013 the need for developing venture capital supply for SMEs is mentioned but the strategy does not consider any other FEIs than those already provided by Finnvera. For two of the four OPs of mainland Finland the need for FEIs is mentioned but not developed any further.

The discussion in the OPs of FEI as alternatives to grants is limited to enterprise support. There is a difference in the rationale between using grants (allocated mainly by regional Centres for Economic Development, Transport and the Environment) and subsidised loans and guarantees (allocated by Finnvera). As a general rule grants are provided for R&D projects, business development projects, and physical investment with relatively high risk. Subsidised loans are provided for starting a business and for lower risk “normal development” for SMEs, such as investment in machinery and working capital. There is some overlap especially in the case of investment. Evaluations carried out in both the previous and current programming periods (e.g. Laakso et al 2005; Karjalainen et al 2011) show that there is a large deadweight attached to certain forms of enterprise support (e.g. Koski & Ylä-Anttila 2011; Tokila 2011). It has been suggested that there is a need to reconsider the eligibility criteria especially for investment grants. There is also economic and political pressure to reduce and restructure enterprise support.

While there is no analysis of market failure as regards the access of SMEs to finance in the official documents of the ERDF programmes, evaluations and scientific studies provide some evidence in this regard. The evaluation of Finnvera (Heinonen et al, 2012) points out that the basis for Finnvera's strategic activities in financial markets relates to the three reasons for intervention generally presented in the literature: addressing market failure; stimulating private financial institutions; increasing competition between banks and ensuring fair pricing.

A problem for many expanding SMEs needing finance for investment is the shortage of guarantees required to obtain loans from the market. Finnvera's loans and guarantees are designed to cope with this type of market failure. Another problem is that new, growing firms

find it especially difficult to get risk capital from the market. The problem is more severe in the disadvantaged regions than in advantaged ones where they tend to be concentrated. Support through venture capital funds and the establishment of *Aloitusrahasto Vera* are aimed at responding to this market failure by increasing the availability of risk capital to young growing firms as well as to firms starting up.

Although there is little discussion on the role of FEIs in the official programme documents (NSRF and OPs), both the Ministry of Employment and the Economy and the coordinating bodies in the regions considered it to be urgent to include a venture capital fund in the ERDF programmes. The steering committees of the four programmes of mainland Finland decided in Summer 2009 on the creation of an ERDF co-financed venture capital fund but, the administrative and legal procedures (including a change in the law) took a long time to complete so that *Aloitusrahasto Vera* only became operational in August 2011.

Although on average there is not a lack of venture capital in Finland² there are market gaps in this regard in the disadvantaged regions. The role of *Aloitusrahasto Vera* is to fill these gaps.

3. The effectiveness of financial engineering instruments: selected examples

This section considers the two FEI systems in Finland.

Finnvera's loans and guarantees

Finnvera provides a wide range of financial services to enterprises in Finland. ERDF funding is concentrated on specific kinds of finance service (loans and guarantees) and geographically on less advantaged regions. The same services are available for enterprises in advantaged regions but without subsidy from the ERDF. The administrative procedures and the decision making processes are the same for ERDF supported and non-supported funding. Finnvera has an advanced way of examining the economic preconditions and business plans of enterprises applying for loan or guarantees. Finnvera does not require full guarantee for granting loans but accepts a higher risk than the private sector. For this reason the loans and guarantees offered by Finnvera are also in demand from by firms in regions where ERDF support is not available.

Finnvera is a state owned company which operates under the control of the Ministry of Employment and the Economy. The ministry is also responsible for regional policy, including ERDF and ESF programmes. However, Finnvera is an independent organisation. One consequence is that the reporting systems and steering arrangements for of Finnvera differ from those of other administrators of the ERDF, such as the regional Centres for Economic Development, Transport and the Environment.

In the ERDF programmes of mainland Finland the projects supported by Finnvera are included in the priority axis "Support to enterprises". The objectives and targets are set for the priority as a whole and there are no specific targets for projects receiving funding from Finnvera. These cover new jobs created, those created for women, new enterprises created and new enterprises created by women receiving support from loans or guarantees. However, Finnvera reports only

² For example, in 2011 Finnish private equity firms raised new funds worth EUR 415 million, a third of which from foreign institutional investors. They invested EUR 360 million in domestic and foreign portfolio companies. The total amount of capital under management at the end of 2011 amounted to EUR 5,300 million. The Finnish Venture Capital Association (FVCA) has 39 full and 49 associate members. (www.FVCA.fi)

projected achievements and there is no verification of achievements after projects are completed, unlike other organisations responsible for ERDF administration. This problem has been highlighted several times and is also mentioned in the Annual Implementation Reports but so far nothing has changed. Consequently, the actual outturn is unclear in this regard and it is estimated that planned figures are about 20% higher than those realised (Laakso et al, 2011). It is, however, intended to change this practice and it has been decided to verify the achievements of projects co-financed by Finnvera during the present programming period.

Nevertheless, Finnvera makes a major contribution to the creation of new enterprises and new jobs since the number of project supported is large and the cost per project is low, consisting of an interest rate subsidy and risk premium. On the other hand, deadweight is estimated to be larger than for direct grants (see section 6). According to the core indicators at the end of 2010 (Laakso et al, 2011, annex) Finnvera was responsible for 46% of new jobs (42% of new jobs for women) and 76% of new enterprises (81% of those for women) created with the support of the ERDF³.

The administrative costs⁴ of Finnvera were EUR 42 million in 2011. This is 30% of the net yield and 1.5% of the balance sheet total (1.8% of loans and other receivables from customers) of the company. Finnvera receives compensation from the Ministry of Employment and the Economy each year for the extra costs of administering loans and guarantees of ERDF projects. In 2011, it amounted to 0.70% of the total asset value of new loans and guarantees and in 2010 to 0.75%.

Aloitusrhasto Vera Oy (Seed Fund Vera Ltd)

Aloitusrhasto Vera Oy is a subsidiary of Finnvera though it has three other shareholders. ERDF co-financed interventions are regulated by a contract between Finnvera and *Aloitusrhasto Vera* agreed in May 2011 which requires ERDF finance to be separated from other finance within the fund. There is also separate book-keeping for each ERDF programme.

Aloitusrhasto Vera Oy makes venture capital investments in start-up and early-stage innovative enterprises. In practice higher risk is accepted for investment receiving support from the ERDF than for other investment. The requirements for funding to be provided are innovativeness and growth potential. The focus is on SMEs operating in ICT services, other innovation intensive services and manufacturing. While the regional focus is on less advantaged regions such as Eastern Finland where the number of start-up and early-stage innovative firms is limited the requirements for firm to obtain funding are equally lower in these regions. In practice, there has been excess demand in Southern Finland and shortage of good applications in Eastern Finland. Around 7-10% of applications have led to funding being provided as at April 2012.

Investment decisions involving ERDF funds have been made in respect of 17 firms in the four regions with total investment amounting to EUR 4.5 million (August 2011–April 2012). Currently, there are 12 applications under study for a total amount of investment of EUR 4.4 million. (Table 2).

³ The percentages are calculated from planned figures of Finnvera and actual figures of other administrators. Consequently, they may overestimate the share of Finnvera.

⁴ The separation of the costs from ERDF activities is not available.

The following indicators are reported by *Aloitusrahassto Vera* to the EURA⁵ steering system at enterprise level: identification data for the firm, size class of the firm, number of new jobs and women's jobs created, number of R&D jobs and R&D women's jobs created.

The administration of the ERDF funds in *Aloitusrahassto Vera* has been delegated to a separate management company, Veraventure Ltd, a subsidiary of Finnvera. According to the contract, the annual administration costs can be no higher than 3% of the total amount of ERDF funding. The costs consist of a fixed administration fee of 2.5% and a reserve for additional costs of a maximum of 0.5%.

Table 2: Venture capital investments by *Aloitusrahassto Vera* from ERDF funds (Oct. 2011–April 2011)

	Southern Finland	Western Finland	Eastern Finland	Northern Finland	Total mainland Finland
ERDF funds to be invested (EUR million)	2.0	7.5	5.0	3.0	17.5
Investment decisions (EUR million) (number of cases)	1.7 (5)	0.7 (4)	0.6 (3)	1.5 (5)	4.5 (17)
Cases in process (EUR million) (number of cases)	0.4 (1)	0.9 (2)	1.4 (4)	1.7 (5)	4.4 (12)

4. Main problems in using financial engineering instruments

Evaluations carried out in the previous and present period indicate that Finnvera's ERDF co-financed loans and guarantees work well. A recent evaluation of enterprise support co-financed in the present programming period (Karjalainen et al, 2011) does not indicate any specific problems relating to Finnvera nor do the AIRs. An evaluation of enterprise support in the 2000-2006 period (Laakso et al 2005) in which representatives of regional social partners and administrators were involved, which assessed different qualitative aspects of support, ranked Finnvera as the best functioning support system co-financed by the ERDF. In addition, the evaluation noted that Finnvera's contribution to the number of new firms and new jobs was very high while the costs in terms of interest rate subsidies, guarantee premiums, bad debts and administration were relatively low compared to direct grants for similar purposes. However, replacing grants with subsidised loans in the case of support for R&D, business development and high risk investments was not considered sensible.

The new ERDF based venture capital instrument *Aloitusrahassto Vera* has only been operating since August 2011 and there is not much experience with it so far. However, the programme coordinators of some regions tend to be critical. For example, in Southern Finland, the added-value of the VC fund for the regional development programme is said to be low because the investment policy of the fund is based on national priorities and does not take region needs and priorities into account. Consequently, Southern Finland has only allocated EUR 2 million from the ERDF (+ the government contribution) to *Aloitusrahassto Vera*, less than other regions (Table

⁵ EURA is the centralised steering data base managed by the Ministry of Labor and the Economy.

2). There has been discussion on launching a regional VC fund in Southern Finland in the next period.

In the 2000-2006 programming period several regional venture capital funds were co-financed by the ERDF. The *JyväsSeed Fund Oy* in the Central Finland region for instance was established in 2004 and its purpose was to invest in early stage growth firms in the region. The fund totalled around EUR 3 million and funding mainly came from regional public sector organisations, regional banks and major companies. Because it was too difficult to comply with the EU regulations, it was decided to operate it without ERDF support. Similar decisions were taken in respect of other regional funds. In the present programming period there are no regional venture capital funds operating under the ERDF.

5. Evaluations of financial engineering instruments

Finnvera's subsidised loan and guarantee schemes were covered by evaluations of enterprise support (section 4).

A comprehensive evaluation of Finnvera was published in June 2012 (Heinonen et al. 2012). The evaluation was commissioned by the Ministry of Employment and the Economy (MEE), which is responsible for governing Finnvera. The evaluation did not focus on ERDF co-financed activities as such but was aimed at assessing the regional effects of Finnvera. The study included 1) an assessment of the MEE strategy and objectives as regards Finnvera, 2) an analysis of the activities of Finnvera on the financial market, and 3) an evaluation of the effectiveness of the support provided by Finnvera.

The study identified three basic reasons for Finnvera intervention: a) addressing market failure; b) stimulating private financial institutions; c) increasing competition between banks and ensuring fair pricing. The evaluation notes that venture capital markets are under-developed in Finland and identifies market gaps for early stages of enterprise development in particular (i.e. as regards seed capital).

As regards the regional impact of Finnvera, the study concludes that although the schemes perform well and are highly valued by SMEs and banks, the contribution to regional development is less clear. There is a danger that the support provided postpones necessary structural adjustment away from "sunset industries" towards new sectors. It is argued that because of the dramatic changes in the global business environment, support in the form of financing enterprises is no longer efficient.

The evaluation also criticises the wide array of financial products offered by Finnvera, some of which are not considered to be very efficient. It recommends concentrating interventions on those activities which have the desired impact and which encourage private risk taking. The evaluation considers that it is justifiable for Finnvera to provide loans to SMEs which would not have access to credit otherwise. It is also important that the loan scheme stimulates local banks in remote regions to compete and that it does not lead to the crowding out of private money. A third strategic use of loans is seen to be as alternatives to guarantees if the banks are not willing to pass on the benefits of the higher credit rating of the guarantor (Finnvera) to SMEs. In this case, Finnvera might prefer to use direct loans, possibly alongside loans from commercial banks. For example, the crisis in 2008-2009 demonstrated the need to have direct loans in Finnvera's portfolio as banks were not capable of lending due to their funding constraints.

According to the evaluation, the strategic value of loan subsidies is questionable. In the current context of low interest rates especially they are found to have little incremental added-value. Guarantees are more appropriate since they help to increase the provision of finance to enterprises. The evaluation also concluded that VC markets are developing but that public intervention is needed particularly in the early phase.

So far as Finnvera's effectiveness is concerned the evaluation points out that much effort has been invested in improving procedures and maximising efficiency and productivity. As a result the organisation was regarded as being well managed and highly professional.

6. Concluding remarks

There are two forms of FEI in use in the present ERDF period: (1) subsidised loans and guarantees to SMEs, and (2) provision of venture capital for the start-up and early stages of development of innovative SMEs. These instruments fill a gap arising from market failure.

While grants and subsidised loans or guarantees do not have the same function, grants are the predominant form of support in Finland. This situation has been criticised. The high costs and deadweight associated with grant schemes have been highlighted by several evaluations. There is also economic and political pressure to reduce public support for enterprises and to restructure the support schemes. For example, the Government has decided to introduce a special tax reduction for R&D investment carried out by enterprises. The decline in tax revenue this will cause will however be compensated by a cutback in direct support for R&D.

Venture capital for SMEs only became available as a new ERDF instrument as late as August 2011. There is not much experience of it as yet. A paradox is that there seems to be shortage of innovative young firms with growth potential in the disadvantaged regions where the ERDF co-financed instruments have been set up. At the same time, there is a lot of demand for venture capital in large urban centres which are not eligible for ERDF funding in this regard.

The evaluation of Finnvera (section 5) raises interesting points concerning FEIs. The evaluation provides clear criteria, based on recent research (and in line with the conclusions of Cowling (2012)), for public intervention in financial markets: a) addressing market failure; b) stimulating private financial institutions; c) increasing competition between banks and ensuring fair pricing. The evaluation concludes that loan subsidies have only little added-value for SMEs. Instead, guarantees are the most strategically justified instruments as they help boost the ability of banks to provide finance to enterprises. The most striking conclusion is that the contribution of Finnvera's interventions to regional development is unclear and promoting regional policy through public support for enterprises is in present market conditions not perceived as efficient. This is quite a strong statement and it has fundamental implications for ERDF co-financed interventions. This conclusion however is not supported by other evaluations.

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