Enterprise Creation by Spin-offs:
Putting Jane Jacobs to Work

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Abstract

This note presents policy ideas about entrepreneurship and enterprise creation derived from or, at least, inspired by Jane Jacobs' writings. The argument is that the main training grounds for entrepreneurial, technical, and business capacities are existing businesses. There are two ways that this training can lead to new growth—just as there are two ways that existing biological DNA can lead to the growth of bio-mass, namely, (1) existing organisms getting bigger or (2) by spinning out offspring who in turn can spin out more offspring. Where growth has been vibrant, e.g., Silicon Valley, it has followed the second route, growth by offspring which is also the biological principle of plenitude. The conventional ownership structures lessens the incentives for spin-offs since managers do not want to have a smaller "empire" under their control. The biological principle of plenitude is best implemented with employee-owned or cooperative firms (e.g., as in the Mondragon group). This paper explores ways for development agencies to address the conundrum or trap that those who have the on-the-job training in business capacities and their managers do not have the incentive to foster new businesses.

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Having offspring: the biological principle of plenitude

Every company has two products: its product and itself. By "itself" is meant the company as an organization of people trained in the systems necessary to run the business and in the technologies necessary to produce the products or services of the company. While some skills are already possessed by people when they join the organization, the company still has to have the training capacity to specialize those skills to the systems and technologies specific to the firm. And as people leave or retire, the company has to recreate those human capabilities within the firm.

While the company's ordinary products may be protected by patents and trademarks, there is generally no such exclusive rights over the human capabilities developed in the company. When those capabilities leave the company, then it is a positive externality. In A. C. Pigou's classic book on normative economics, he noted that the businesses in a country provided the positive externality (meaning their social product exceeded their private product) of training people in business:

> One very important indirect service is rendered by the general economic organisation of a country in so far as, in addition to fulfilling its function as an instrument of production, it also acts, in greater or lesser degree, as a training ground of business capacities.[1]

Modern economics texts seem to have lost sight of this fundamental point that existing businesses are major training grounds for entrepreneurial and managerial capability and major incubators for new businesses. Yet the conventional business sees this social product as no part of its corporate goals. Quite to the contrary, businesses want to grow by expansion rather than spin-offs and they want to retain their potential future managers rather than lose them to new businesses.

In a vibrant entrepreneurial environment, such as Silicon Valley in California or Silicon Gulch in Taiwan, people routinely leave companies, often together with some colleagues, to start new companies. But this tends not to happen in poorer business environments—a fact that may be both cause and effect of the underdeveloped environment.

In biological terms, there are two ways in which the biomass is increased: existing life getting bigger or existing life having offspring. Diminishing returns set in as companies get bigger and the same happens to biological organisms. The limits of increasing biomass by existing creatures getting larger in size are soon reached. Most of the biomass that covers the globe comes from the second strategy of having offspring. That is the biological principle of plenitude. Indeed, biology gives little choice. While organisms can grow larger within certain limits, the organism must eventually die and so the DNA can only survive by having offspring. These ideas have been primarily inspired by the economic development thinking of Jane Jacobs in *The Economy of Cities* (1969) and in *Cities and the Wealth of Nations: Principles of Economic Life* (1984).[2]

Corporations are subject to various forms of diminishing returns to increased size but they have no natural limitation on lifetime. Hence the first tendency of companies is preserve their "business DNA" by growing bigger rather than fostering offspring. In this sense, the company's "second product" (its trained people) is sterile—particularly in a

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[1] Pigou, A. C. 1960. *The Economics of Welfare.* (4th ed.) London: Macmillan, p. 204.
[2] For more of this background, see my paper: How Do We Grow?: Jane Jacobs on Diversification and Specialization. *Challenge.* 48 (5 May-June 2005): 50-83, downloadable from: www.ellerman.org .

less-than-vibrant business environment; the company may grow but it does not breed. Hence there is relatively little increase in the "economic mass" and the business environment stagnates. That is the conundrum.

This conundrum pointed out by Pigou gives grounds for some public policy support to schemes that try to improve the social role of existing businesses as spawning new businesses. Pigou also recognized that some organizational forms more than others might lend themselves to this social role. In particular, "associations of workers combined together in small co-partnership workshops" would constitute the "first school in which this capacity can be developed" and thus such companies would contribute to the community not just "boots and shoes" but the second product of "well-trained competent" people [ibid., 205-6]. There are also examples where more conventional organizations have promoted this role (see below on Thermo-Electron and 3M).

An appropriate social role for a medium-to-large company would be to structure itself in part as an incubator for spin-offs and break-aways of related but majority locally-owned (preferably cooperatively owned) companies to maximize local business development and job growth. How could this be done?

How might a company foster offspring? There are at least four ways for a company to accelerate the production of its "second product" (trained people) to foster offspring.

Four ways to implement the principle of plenitude

1. Sheltered or associated spin-offs of routine products and services as separate companies.

Inside any medium to large-sized company, there are routines products or services provided for the company such as printing, graphics design, catering or food services, trucking, and cleaning services. These could be organized first as a separate profit-center and then as a ‘sheltered spin-off’ majority locally or cooperatively owned with a multi-year contract with the mother firm. But as a quasi-separate firm (associated with the original firm or group of firms), it would be free to do business with other companies to expand its market. There is only so much printing etc. that is needed by any one company. That will create job growth to serve the expanded market. Moreover, it will build entrepreneurial and managerial skills on the part of the people leading the spin-off.

This strategy should be differentiated from “out-sourcing” where the purpose is to reduce the payroll of the mother company and introduce competition in the supply of those services, not to expand the market and jobs in the business unit. The spin-off could remain associated with the original company perhaps even carrying part of its name, e.g., Acme Printing, Acme Food Services, or Acme Trucking as spin-offs from Acme Company. It should have a multi-year sole-source contract to counteract any suspicion that it was just an “out-sourcing” scheme.

Eventually a group of companies might form around the original mother company. The group might sponsor a second-tier organization to help spawn more offspring.[3]

A slight variation on this theme occurs when a production company wants to eventually upgrade machinery. Given limited space, they may scrap the old machinery and replace it with the new equipment. But there might be several years of effective operation in the old equipment which could be moved off-site to a more disadvantaged area as a job-creation scheme. Some workers in the factory might take that as an opportunity to start their own production shop with low start-up costs and some guaranteed sales but where they have the possibility to finance other machines and produce parts for other clients. This type of urban-to-rural spin-off helped to fuel the rural industrial development in township-village enterprises in China.

2. 'Ad hoc' or 'Light Touch' franchising: Seconding entrepreneurs to learn about a business

Most entrepreneurs do not start from scratch. They have worked in companies and learned how companies operate first hand before striking out on their own with some colleagues. But in many cases an entrepreneurial individual may not have had that relevant experience so an economic development agency could sponsor secondments in an existing company (e.g., by paying most of the salary of the seconded person). The seconded person would work with the manager and various departments to learn about their functions. Since the existing company would not want to be training new competition, the new company would have to commit to operate in a non-competing zone, e.g., in another city outside the business region of the original company. If the new company develops well, there might be future business partnerships with the original company where the entrepreneurial received the training.

This could be thought of as an 'ad hoc' or 'light-touch' franchise. A franchise also tries to replicate the business systems and procedures of an existing company and to insure that such clones will be in non-competing niches. But franchising requires a rather sophisticated legal system to enforce all the intellectual property rights. And franchising is a rather top-heavy system due to the large up-front fees and strict rules since all the franchisees will be advertising under the same name and should be enforcing the same quality standards. Hence this light touch franchising scheme tries to use as a development tool the enterprise multiplication or replication part of the franchise idea without all the other top-heavy parts of the system.

3. Spin-offs of new products using an existing technology

When a company learns or imports into a country the technology or know-how X to produce product A, then often with minor new knowledge, the technology can also be used to produce other products B and C. But those other products may have a different

[3] See my case study of such a "factory factory" in the Mondragon cooperatives: *The Mondragon Cooperative Movement*. Case No. 1-384-270. Harvard Business School 1984, also available on my website: www.ellerman.org.

customer base, require different suppliers, and be outside of the original business focus of the company. Hence companies will not pursue those other feasible products in order not to confuse the strategy and dilute the managerial attention-span of the company. But a few individuals might very well spin off from the company to produce B or C. This is particularly feasible in the information technology industries where the capital requirements to produce the other products may be minimal. This sort of spin-off is commonplace in the business environment of Silicon Valley or Taiwan. In Taiwan, there is the saying that the people leading the spin-off would "rather be the head of a chicken than the tail of an ox."

In an ordinary company, there might be some resistance to fostering spin-offs since talented and already-trained people will be leaving the original company. And, more to the point, it reduces the "empire" under the direct control of the management of the mother company.

In the case of the Thermo-Electron group (www.thermo.com), there is a rule that every new product must be produced in a new company. The mother company owns a portion of the "spin-out" to help alleviate the tendencies to resist spin-offs. Now the children have had children on the same principle so the Thermo group has some 80-odd companies. It is doubtful that such creativity and growth could have been released if it had been confined to one company. Yet this is the exception, not the rule, in conventional companies due to the desire to maintain the ownership and control of the "empire" and any hidden profit potential it might have. Think of how many companies there would be in the "MicroSoft Group" if every new product meant a new company.

Most companies would rather try to exploit such opportunities in a multi-divisional structure. Such a structure could facilitate some growth (e.g., the 3M company—now nicknamed the "Mutation Machine from Minnesota"—is a rare example) but it seems that the growth opportunities would be maximized from the social (job creation) viewpoint if the new products were produced in a new company that was not just a division or controlled subsidiary of the mother company.

4. Spin-offs from failing firms

In the post-socialist transition, the typical situation was a large "dinosaur" firm with little or no prospects to continue in operation without constant government subsidies. Similar situations exist now with the economic crisis in the West in the more industrialized parts of the economy. One radical restructuring strategy is based on spinning off viable parts of the original firm as independent small and medium-sized enterprises—perhaps with the remainder turned into a job placement program. The spin-offs might use what in East Europe were called "asset drop-down transactions." The new prospective owners of the spin-off (investors, managers, or workers) would form a new company with some limited initial investment. Then the needed assets would be "dropped down" from the "mother firm" into the "daughter firm" using a seller-supplied credit purchase. The daughter firm would make installment payments back to the mother firm (or its bankruptcy agent) over a period of years to pay off the credit. These asset drop-down spin-offs use seller-supplied credit so these transactions could be used with rudimentary, under-functioning, or collapsed banking systems.

The spin-off strategy applies not only to existing business segments but to new related "start ups." Many of the middle managers might have "in the back of their heads" ideas for small start-ups. They might not have enough entrepreneurial experience to risk giving up a job to undertake the start-ups. But when their part of the firm is facing complete liquidation, then it might be a viable option. Instead of putting the company space and assets up for public auction, the company might be turned into an "industrial park" where middle managers could exchange some of their unpaid wages or severance for a lease for a certain time period of the space and assets necessary for their new start-up. They would have to scrap together any needed working capital from their own sources. Spaces not taken by these internal tenants would be offered to external tenants. In that matter, a defunct dinosaur with no future prospects might be turned into an industrial park of new start-ups with a real future. Slowly some of the start-ups would grow hiring back a significant portion of the workers from the old company.

> One such renaissance occurred through the ARIA-sponsored liquidation of textile maker Spectrul. A new company, Produse Tehnice, was established to manage an industrial park on the Spectrul site in the city of Chisinau [Moldova]. Attracted by the ideal location near major transportation routes, four spin-off textile businesses soon opened up, followed by private SMEs who moved in like Unolucas, a tiny custom design furniture company. Its owners had searched for two years to find an affordable site for expanding their home-based business and were glad to purchase a dilapidated storage facility in the park. After extensive renovations, Unolucas now has expanded manufacturing capabilities, office space, and a showroom. The furniture company is one of 30 companies currently operating in the Spectrul site, where total employment is now 450.[4]

After one or two industrial parks, a unit was formed to be an "industrial park developer" so that each collapsing dinosaur does not have to reinvent the idea. There are two points of particular interest to facilitate the propagation of this experience. Some might argue that the insiders should not be given first option of the inside space for their start-ups; all assets should be put up for public auction. But the point is that it is the possibility of this "neat exit" from the collapsing dinosaur that entices the managers to switch from their usual strategy of lobbying for more subsidies to the more entrepreneurial strategy of going for the start-up.

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[4] World Bank 2001b. SME Spin-offs: Industrial Restructuring in Moldova. *SME Facts: News about World Bank SME Initiatives*. 2 (6 April), 1-4, p. 3. Quoted in: Ellerman, David and Vladimir Kreacic 2002. Transforming the Old into a Foundation for the New: Lessons of the Moldova ARIA Project; *Policy Research Working Paper 2866*. Washington DC: World Bank.

Secondly, from the government side, the experience of seeing a few industrial parks with many workers rehired in the emerging SMEs strengthens the government's hand to resist lobbying by other failed firms. Eventually the government sees that this sort of liquidation procedure can be supported without social upheavals and can even offer hope for economic renewal.

In developed market economies, liquidation bankruptcy and new business start-ups are seen as separate economic processes. The down-sized workers will get jobs elsewhere (perhaps with help from a social safety net in the intervening period), and entrepreneurs will come from elsewhere to buy the assets at auction. But in underdeveloped, transition, or crisis economies, these market processes are too weak so that, more often than not, failing enterprises will concentrate on lobbying rather than economic renewal. And government officials, fearing the social consequences, will continue to supply the subsidies—all of which creates a low-level trap.

The spin-offs and industrial park idea addresses this problem. It makes bankruptcy and new business start-ups the *two sides of the same coin*. The organizational capital of the middle managers and their teams can be directly *transformed* from the old to the new—without expecting some broader economic processes to *replace* the old managers with the new entrepreneur-managers from elsewhere.

Why employee-owned firms may promote more jobs

All of these schemes could be promoted by companies themselves or by local development agencies or ministries with appropriate financial incentives. One theme running through these examples is that economics should imitate biology in the sense that existing businesses are the best sources and incubators for new businesses. Bio-mass expands primarily by old life spawning new life, not by old life getting bigger. The ideas broached above are ways to similarly increase the "economic-mass" in a country by getting old firms to spawn new firms.

Another underlying principle is to look at how desired outcomes happen spontaneously (e.g., Silicon Valley in California or Silicon Gulch in Taiwan) without deliberate programs—and then try to see how programs can deepen those channels so that streams can swell to become rivers. Too often, local development agencies tend to think of isolated entrepreneurs creating new enterprises from scratch—yet that is rarely the way it actually happens. The challenge with the creation of more jobs and new enterprises is to figure out how to get existing businesses to more consciously and deliberately play that role as the generator and incubator of new businesses.

One of the big problems in implementing the above ideas is desire of managers and owners to maximize their empire and the "shareholder value" orientation of companies both of which conspire to keep any potential off-shoot under the ownership and control of the mother company—in other words, no new life, only the expansion of old life. Where companies are employee-owned or organized cooperatively like Pigou's worker co-partnerships or as in the Mondragon complex of 100 or so companies in the Basque country of northern Spain [http://www.mcc.es/ing/index.asp], it is easy and natural for one worker-owned firm to expand by becoming two worker-owned firms each controlled by its staff or to have cooperative spin-offs.

With unitary "ownership," the tendency is only to have new divisions or wholly-owned subsidiaries which have a rather different dynamics in (not) fostering local economic development. The challenge to economic policy in a non-employee-owned context is to see how these tendencies of conventionally owned companies can be overcome to increase the role of existing businesses in creating new businesses.

In conclusion, the focus of economic policy for job creation should not be expecting jobless individuals to create jobs or expecting existing companies to expand their current businesses to create jobs. The focus should be to get existing companies to indirectly create jobs by fostering spin-offs of routine segments, as-if franchises, spin-offs putting existing technologies to new uses, and spin-offs to managers and employees in failing firms. Each company's second product, its production of a staff trained in doing business, has potentially significant positive externalities for the local economy so there are grounds for governments to create incentives to increase those positive spillover effects.