



REGIONAL POLICY LETTER

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Business Incubators as an Economic Development Strategy

State and local governments have a key role in creating and implementing economic development strategies. Recruiting new industry remains these governments' focus, despite uncertainty about their probability of success (Smith and Fox). While some counties are able to grow and prosper by attracting manufacturing investment from outside the local area, many communities have limited potential for attracting new manufacturing investment. Communities not located near metropolitan areas, without well developed infrastructure to support manufacturing, and without an existing manufacturing base to support new firms are at a disadvantage in efforts to attract new manufacturing investment (McNamara and Kriesel). Thus, recruiting new industry might not be a viable strategy for growth in these communities. Local leaders need to explore different approaches to development to increase their communities' economic viability and make informed decisions about their communities' future.

This report provides information about one option, business incubators—what they are, what makes them successful, how they affect the local economy, and how to determine whether incubators are a viable strategy in a community.

Business Incubators

Business Incubator Definition.

Business incubators are locally based institutions created to encourage and support business development. Incubators provide shared office, commercial, and/or manufacturing space to start-up businesses or young firms. In addition, business incubators provide business assistance, business services, and the opportunity for networking among the tenants. Incubators are as much a process as simply physical space. Firms enter the incubator as tenants, spend a period of time in the facility becoming viable businesses, and then graduate as firms ready to stand alone and be competitive in the market.

Although organizational and physical structures of incubator facilities vary, most incubators share certain characteristics. Incubators provide tangible benefits to new firms such as technical assistance, reduced rent, and flexible space. They also provide intangible benefits such as moral support, advice, and camaraderie among incubator tenants. Business incubators represent an innovation over development programs that provide assistance only to individual firms, since incubators bring firms together in one facility to receive assistance and offer mutual support.

Incubators vary significantly in terms of the type of tenants located in the facility. Most incubators have a mix of tenants, primarily service and light manufacturing firms. Some incubator

facilities are suited for heavy manufacturing and consequently attract more manufacturing tenants. Some incubators house retail firms, and a few are devoted exclusively to retail operations.

Most business incubators have strict graduation policies designed to force a business out into the competitive marketplace. These policies help businesses plan their entry into the commercial real estate market. Some incubators increase rental payments over a firm's tenancy, so that, at graduation time, the firm is paying close to or above market rents. These rent increments provide an incentive for firms to find suitable space outside the incubator as graduation approaches. Graduation policies are usually flexible, however, so that firms are not forced out too soon or if adequate commercial space is not available for the firm.

Growth of Business Incubators.

Business incubators are a relatively new economic development innovation. The incubator recognized as the first in the U.S. was established in 1964 in an inner-city Philadelphia neighborhood as part of an urban renewal effort (Campbell and Allen). There has been tremendous growth in the number of business incubators during recent years, from about 200 in 1986 (Campbell and Allen) to almost 500 in 1993. The National Business Incubation Association (NBIA) reports that among its membership during the 1992/93 year, 56 incubators opened their doors, while 19 were forced to cease

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operations, citing lack of financing as the reason. And, NBIA figures may understate the growth in new incubators since all incubators are not association members.

More incubators are in operation today than ever before. Incubators operate in 49 states, with Pennsylvania, New York, Wisconsin, and Texas having the greatest number of facilities. The average number of incubators per state is ten, but they range from 53 facilities in Pennsylvania to only one facility in smaller or more sparsely populated states like Delaware, Rhode Island, Wyoming, and the Dakotas (NBIA). The growth in incubator facilities in spite of recent fiscal constraints on both public and private institutions suggests their increased acceptance as a small business development tool.

Types of Business Incubators.

Business incubators are as varied as the communities in which they are located. The NBIA classifies incubators in four general categories: public, non-profit; private, for-profit; university-sponsored; and hybrid. In 1993, 44% of incubators were public, non-profit, 14% were private, 14% were university-sponsored, and the remaining incubators were hybrids, e.g., public-private, private-university (NBIA).

Each type of incubator has a different set of goals. *Public, non-profit incubators* are usually established by a local government or economic development organization to encourage economic development through new business start-ups that create jobs and income, and diversify the local economy. Some public incubators may have more specific goals, such as revitalizing a particular inner city neighborhood or providing employment to disadvantaged workers. Many public incubators are started with public funds for operations and/or renovation of a facility. In some cases, the incubators gain self-sufficiency, covering operating expenses with rental and service income. In other instances, continued public support is necessary.

Private, for-profit incubators are established by real estate developers or investment groups. The goal for these private companies is to achieve an economic return through investment in new start-up ventures or through the development of commercial property

into a shared office or manufacturing facility. Creating jobs or increasing income within the local economy may be a positive result of a private incubator, but it is not an operating goal.

University-sponsored incubators are created to provide an outlet for the commercialization of research ideas and to attract small firms that could benefit from access to university researchers and facilities. Local economic development is frequently a goal of the facility. These facilities tend to attract firms that can benefit from new technology developed by university researchers and firms started by faculty.

Hybrid incubators usually have a mix of goals derived from those of the organizational sponsors. Public-private efforts can bring the expertise of private sector developers together with the economic development experience and objectives of a public sector institution. Public partners may be in a better position to tap into sources of government funding that may help capitalize the incubator in its early stages.

Key Elements of Successful Incubators

While there is no single formula for creating a successful business incubator, several elements are key to success. Selection of a competent, dynamic manager is critical to the successful operation of an incubator. Case studies of incubators highlight the importance of the incubator manager in attracting the right tenants, assisting the tenants as their businesses develop, and enforcing an appropriate set of operational rules for the facility (Smilor and Gill). Incubator managers need to be entrepreneurs in their own right, since they are responsible for running a successful "business," the incubator itself. And the manager needs to have the business expertise required to understand problems facing a tenant, perhaps even before the tenant has identified a problem.

A related element that is key to a successful incubator is access to business services and business assistance at the incubator site. A true business incubator provides shared office support and management consulting services. Shared office support typically involves access to a copier, secretarial services, FAX

machine, telephones, and receptionist services on a fee-for-service basis. Tenants are able to minimize initial investment and personnel costs by utilizing these support services.

Availability of management consulting services may be the most critical contribution the incubator makes to a fledgling firm's success. The incubator manager or other staff member provides tenants with business counseling ranging from assistance in developing a business plan to help locating sources of capital. Counseling is critical for small entrepreneurs who have good technical understanding of their business but limited business experience.

Another important factor in incubator success is flexibility-flexible space, flexible rental arrangements, and flexible graduation policies. Since the birth and development of firms is not a precise science, it is important to have flexibility in an incubator. If space is flexible, a tenant can grow without leaving the incubator. Flexible rental policies make it easier for a tenant to ride out slow growth periods and remain in business. Some incubator tenants may be ready to leave the facility after a brief stay of a year, while others may need to remain for a three- to five-year period. Again, the importance of the incubator manager is key since the manager is closest to each tenant and can make appropriate decisions to encourage success.

An important benefit of locating in an incubator is the opportunity to create networks with other entrepreneurs. An incubator that encourages and facilitates this networking is contributing to the potential success of both the tenants and the facility. Networking can be as formal as organized training or educational sessions where tenants come together to discuss mutual problems, or as informal as providing common space where tenants meet when collecting mail or messages from the receptionist. Tenants can share business experiences and technical advice, make valuable business contacts, and support one another as they strive to build successful firms.

Local Economic Impacts of Incubators

As more business incubators are established in the U.S. to support

development efforts, it is important to evaluate their economic impacts. Incubators can have a positive impact on a local economy by increasing the success rate for new businesses. Several studies found a relatively high success rate for incubator firms-about two-thirds of firms succeed (Allen and Weinberg). The success rate for small businesses in general varies by industry, but is about 50 percent for firms in the first five years of operations (Campbell).

If incubator firms locate in the local community once they graduate, the jobs and income they create have a positive impact on the local economy. Most incubator graduates remain in the local area after leaving the incubator according to several studies (Allen and Weinberg, Campbell). These results suggest that the benefits of the incubator, new businesses and resulting jobs and income, tend to remain within the community in which the initial investment is made.

Although incubators appear to be successful in helping firms start up, the direct impact of a particular firm on the local economy in terms of number of jobs created may be small, at least in the short run. Several studies found that, on average, incubator tenants employed less than ten people (Campbell and Allen). However, as the number of graduates increases and as graduate firms grow, the importance of the economic activity to the local economy increases.

Most evaluations of the impacts of business incubators do not consider linkages created by incubator firms to the rest of the local and/or state economy and do not measure the fiscal impacts of incubator firms. These past studies address direct employment and sales impacts and do not attempt to quantify the relationship between incubator firms, other local industries, and local/state governments.

Researchers at Purdue are analyzing the direct, indirect, and fiscal impacts of three business incubators to provide state and local policy makers greater insight into the range and magnitude of economic impacts associated with incubators (Markley and McNamara). These results will be featured in a future issue of *Regional Policy Letter*.

Is a Business Incubator a Viable Strategy in Your Community?

To evaluate the potential of a business incubator, community leaders need to ask several key questions. The answers to these questions provide an analysis of the local economy. First, what is the community's economic base? What type of industries are present in the community? How is employment distributed across industries? How has employment changed over time? Community leaders can generally find answers to these questions in published information, like U.S. Census publications and Department of Commerce employment data.

Second, what entrepreneurial potential exists in the community? Are there existing small businesses that could benefit from being in an incubator? Are there market niches for new firms to meet the supply needs of existing industry? Information to address these questions is more difficult to locate, but community leaders can contact local financial institutions and business assistance agencies, e.g., Small Business Development Center or the Chamber of Commerce. Staff at these organizations may be able to identify entrepreneurs or business people who might be appropriate tenants for an incubator facility. Conducting a survey of local industry leaders can help provide appropriate information as well.

If community leaders identify the potential for business development, then they need to determine what the goals of an incubator facility would be. Will the facility focus on increasing jobs and income through the creation

and expansion of local businesses? Will the facility be used to encourage recruitment of outside industry? What criteria will be used to judge the incubator's success, e.g., number of jobs created, income generated, number of successful firms launched, graduation rates? The incubator is a part of an overall economic development strategy, and its goals should be consistent with the community's economic development objectives.

Finally, community leaders must consider the logistics of establishing an incubator facility. What about suitable commercial space for business development? What space is available for the development of an incubator facility? What potential sources of funding might be tapped to renovate or build a facility? What type of facility is needed? Community leaders should evaluate the local commercial real estate market and review the other information gathered during this process of analyzing the local economy to find answers to these questions.

Conclusion

Every community must decide what economic development strategies to pursue, given its objectives and own unique constraints and opportunities. A business incubator is one tool to consider for encouraging the creation and expansion of businesses. Incubators can complement industrial recruitment efforts or serve as the focal point of a long-term strategy for stimulating economic growth. Communities can consider business incubators as one part of an effort to create jobs, income, and diversity in the local economy.

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