Veni vidi VC – the backend of the digital economy and its political making

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Over the last three decades, the European Union (EU) has actively created a venture capital market in Europe. A crucial player in that mission is the European Investment Fund (EIF), a unique state agency specialized in intermediated financial investments to reach policy goals. The EIF manages mandates for other agencies, such as the European Commission (EC), national ministries and development banks. In the case of venture capital (VC) investments, the reasoning behind that strategy of 'governing through financial markets' was to spur innovation and job growth by strengthening the digital economy. By carrying out that strategy the Commission and the EIF become part of investment chains (Arjaliès et al. 2017), including both private and public actors. In this study, I analyze parts of the chain that spans between the EU government bodies, venture capital, the digital economy and its subjects. The scope is confined to the linkage between European government bodies, one starting point of European VC chains, and the venture capital market over thirty years, beginning with the 1990s. A central node within that chain, and consequently the focus of the analysis, is the EIF. I trace how the EIF has become a major actor in European VC markets over three decades of crisis-led institutional innovation and the implications of this governance strategy.

1 Venture capital is the backend of the digital economy

Venture capital is a major source of funding in the digital economy: in Europe 87% of all startup companies founded between 2010 and 2020 that reached a valuation of over $1bn – so-called unicorns- received VC financing (Atomico 2021). Globally, as of December 2020, venture capital had backed seven out of the eight largest firms by market capitalization prior to their listing: Microsoft, Apple, Amazon, Alphabet, Facebook, Alibaba and Tencent, which, at the same time, are the lead firms of the digital economy. Most existing debates on the digital economy focus on these corporations and their United States home base Silicon Valley. In contrast, this article shifts the analytical attention: regionally towards Europe, and structurally towards the backend of the digital economy – that is venture capital. Just as the user interface we see on the displays of our computers is structured by a layered code on the backend, I argue that the digital economy is fundamentally shaped by its financing structures and that these financing structures are not one-dimensional but take the form of investment chains.

2 Empirical strategy

Empirically, I triangulate document analysis, interviewing methods and descriptive statistics to trace the emergence of the EIF and European VC markets and their implications. The main data source is publicly available documents from official European sources. These are complemented by VC market data provided by Invest Europe and semi-structured expert interviews. I conducted two interviews with senior EIF management to flesh out their agendas and derive operational insights. In addition, I conducted six interviews with VC investors, which mainly serve as background to understand VC investing and the European VC market and do not figure centrally in my analysis.

3 Governing along the investment chain and infrastructural power

Beyond the empirical effort, the intention of the article is to contribute to a theory of linkages, where the links between spheres rendered as separate, in this case politics, finance and the digital economy, figure centrally. To this end, I propose the theoretical framework of governing along the investment chain, which synthesizes a political economy account of 'governing through financial markets' with the notion of the 'investment chain', which was born in a Latourian tradition within the social studies of finance. The theoretical framework comes with a drawback: the analysis does not include all actors presumably involved in the configuration of European venture capital policy. I do not analyze the role of nation states, national development banks and lobbying groups. The proposition of this article is to analyze the length of the chain, rather than the breadth of any given interaction point. This not only serves the mission of theoretical innovation but is also founded on the claim that the established state-finance links prove valuable in understanding the structure of the digital economy.

The interplay between public and private actors produces entanglements when governing along the investment chain, which have been conceptualized as 'infrastructural power' (Braun 2020; Braun and Gabor 2020). When political actors rely on infrastructures to govern, they create entanglements which financial actors can leverage in the political process. These entanglements become two-way streets: state actors send their capital along these streets to achieve policy goals, and financial actors may use the streets to make demands, positioning themselves as gatekeepers at essential junctions. In my article I show how VC firms are granted infrastructural power as they are used to govern.

4 The European Investment Fund has become a crucial actor in European VC markets

The EIF is a unique institution within the European polity. Its main shareholder, the European Investment Bank (EIB), is the largest multilateral development bank globally. What makes the EIF unique is that it manages mandates for others, such as national ministries, development banks or the European Commission. The EIF has two statutory objectives, namely to 'foster EU objectives, notably in the field of entrepreneurship, growth, innovation, research and development, employment and regional development' and 'to generate an appropriate return for shareholders, through a commercial pricing policy and a balance of fee- and risk-based income' (EIF 2015). This dual role serves to avoid public market interference and has set the ground for the emergence of public-private infrastructural entanglements and the strategy of governing through financial markets

Over the last three decades, the EIF has come to hold a unique and central position in the European political economy: as a key policy arm of the Commission in its strategy to govern along the investment chain; as a translator between European government bodies and VC funds; and as a central node in the European VC investment chain. My analysis shows how the Commission harnesses the EIF, and how the EIF harnesses VC funds for governance purposes. It reveals how in acts of crisis-led institutional innovation over thirty years the Commission has established the EIF as a key investor, shifted investment risks away from the private markets towards EU government bodies, and granted infrastructural power to VC firms.

The EIF was founded in 1994 to overcome legal limitations in the EIB's statutes and at the same time be able to provide financing to startups and small and medium-sized enterprises (SMEs). Against the backdrop of the Lisbon Agenda's ambitious goals the EIB became the EIF's majority shareholder, which enabled the EIF to focus and expand its operations. Following the great financial crisis (GFC), the European Fund for Strategic Investments (EFSI) enabled the EIF and EIB to take on riskier projects without impacting its ratings, which the EIB in particular needed to refinance on the financial markets.

Along with these institutional reconfigurations, I show how the shape of European VC investment chains has transformed. The position of the EIF became more and more central over the observed period. First, in the 2000s the EIF started to manage mandates from external state actors, such as the German Ministry for Economic Affairs. Consequently, the EIF became deeply rooted both on a European and national level and became the largest institutional investor in European VC markets. Second, as part of the Juncker plan the EIF introduced a funds-of-funds program, which extended the investment chain by one nod and increased the share of profits accrued by private VC funds.

All along the EIF was founded to take on risks. At first, the EIF took on EU policy risks by guaranteeing SME and infrastructure project loans. After three years, the EIF started equity investing from its own means and carried the capital gains risk. From 1999 onwards the EIF took on mandates by other political bodies. The EIFs value model transformed into a fee-based model, and the capital gains risk was henceforth carried by its mandators. In the 2000s, in the aftermath of the dotcom bubble bursting, the EIF began explicitly taking on the idiosyncratic risks of the VC asset class by disproportionately focusing on early-stage investments the riskiest investment stage. In response to

the GFC the EFSI enabled a fourth shift, which comprised taking on the systemic risks of a financialized economy. Consequently, VC investors value model was de-risked. In other words, the risk carried by VC investors shifted to European governance agencies.

5 Implications - the EIF at a crossroads

Overall, the discussed transformations are ambiguous and put the EIF at a crossroads. On the one hand, the EIF's central position in the European VC market may equip the EIF to achieve progressive policy goals. Indeed, under the European Green Deal 30% of the EIF's volumes are to be invested sustainably. The EIF's profitability orientation may, however, counter a truly progressive agenda. As the EIF depends on the relatively predictable high profits to sustain its market-based nature, VCs can lever their political power to counter strict regulations and controlling. In addition, the current set-up, which balances risky investments in new markets with less risky investments in winner VC funds, could translate into a setup where climate-friendly VC funds are balanced with aggressive hyper-growth-oriented ones, while potentially only taking into account the climate effects of the former. The very proposition that has granted the EIF its central position takes the edges off that position and inhibits a truly proactive and progressive role of the EIF. In other words, in its current market-based setup the EIF depends on the goodwill and returns of powerful VC investors.

This paper has several implications beyond the empirical understanding of the dynamics surrounding the EIF. Regarding debates on governing through financial markets, the analysis points to the urgent need to consider the shape of investment chains instead of merely focusing on interaction points. Two results are noteworthy in particular. First, my analysis of the EIF shows how financial actors' business models, particularly regarding risk-return, impact potential outcomes of governance. The EIF's de-risking strategy has enabled problematic tendencies in VC, such as the narrow range of innovation or the built-in need for aggressive business models in winner-takes-all markets. Second, the analysis reveals how governing through financial markets creates new interaction points and infrastructures, which financial market actors can leverage to adapt policies in their favor. Regarding debates on the digital economy, the analysis points to the crucial need for a shift in focus towards understanding the structure of the digital economy (monopolistic, platform business models, focus on software) as fundamentally shaped by the underlying financing structure.

Together these implications ask for a new perspective on political answers to the digital economy. A political angle should revolve not merely around regulating emerging economic entities but also, in the spirit of this paper, problematize the EU's role in stabilizing a highly financialized system and develop alternative financing structures. The EU, via its EIF-engagement, takes the edges off financialization by stepping in in times of crisis. However, this does not reach the economy broadly but rather primarily secures a few privileged actors, namely those financial actors that the EU has grown so entangled with. Startups are not necessarily reached by these measures and have to defer to the rule of VC. Instead of this EU-enabled VC regime, democratic and truly long-term forms of financing new businesses are needed.

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