

Institutional Reform for Innovation and Entrepreneurship: An Agenda for Europe (New York: Springer, May 2017)

Niklas Elert, Magnus Henrekson and
Mikael Stenkula

Part of the program: Financial and Institutional Reforms for the Entrepreneurial Society



Funded by the European Commission as part of the European Union's Horizon 2020 research and innovation programme under grant agreement No 649378.

Utrecht and Stockholm



Background & motivation

- EU Commission 2010: “Innovation emergency”
 - “Innovation Union” flagship initiative in the 2020 strategy
- Where to look?
 - Common idea: more R&D spending
 - But innovation (**I**) requires entrepreneurship (**E**) for the benefits to be reaped
 - → stronger incentives for **I** and productive **E**
 - → economic growth, more jobs and enhanced social welfare

Crucial aspects

- Member states and Brussels should institute **E-**friendly institutional reforms
 - Improved entrepreneurial ecosystem
- 28 member states
 - Widely different initial conditions
 - Institutional complementarity
 - “Varieties of capitalism” aspects cannot be ignored
- Yet, rulings of the European Court of Justice (ECJ)
 - Member countries barred from protecting national regulations that impede any of the four freedoms
 - Pushes policy in a liberalizing direction

Crucial aspects II

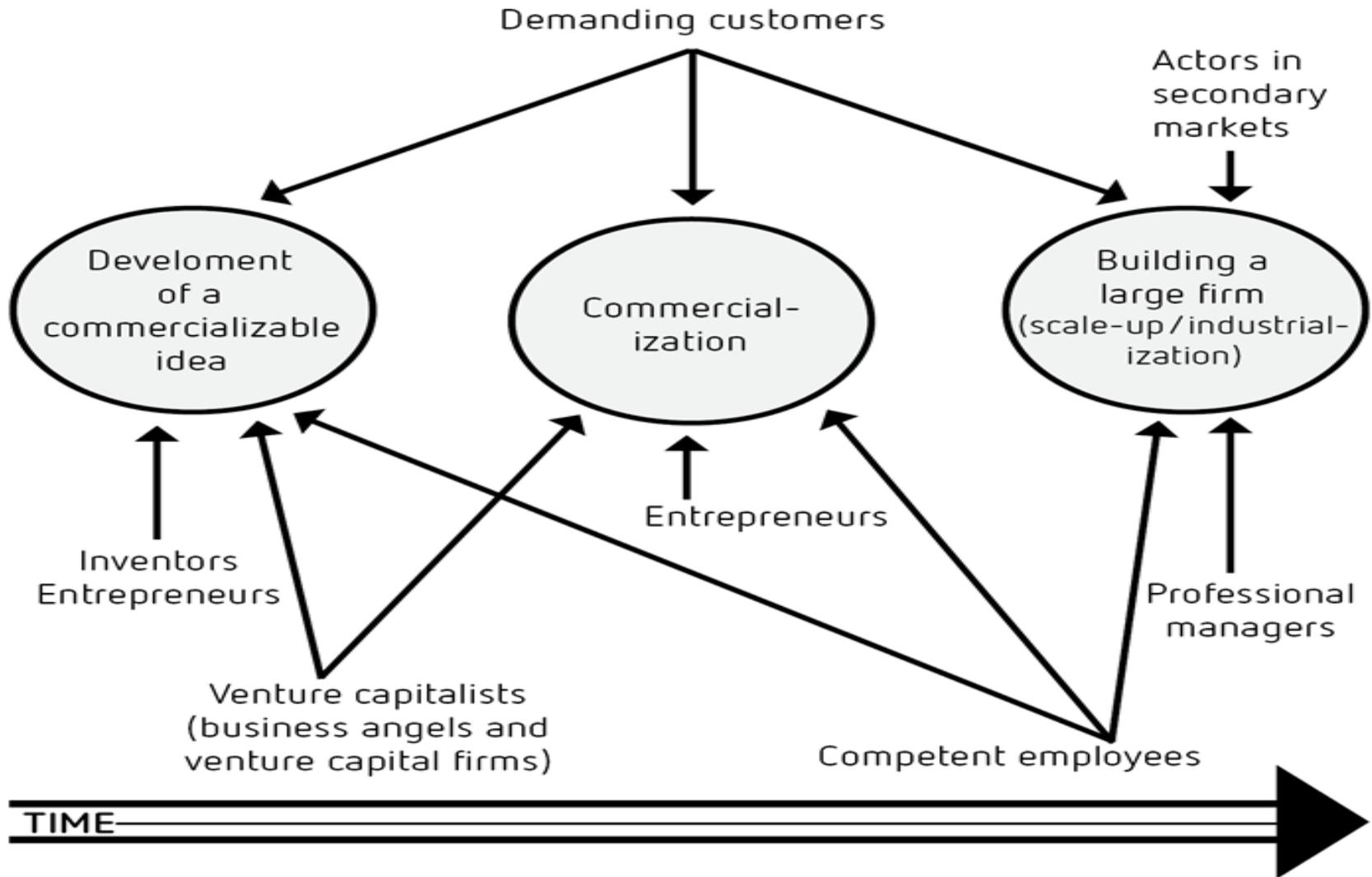
- Large cross-member differences in
 - Per capita income
 - Innovativeness
 - Innovative and growth-oriented **E**
 - Employment rates (Sweden 26 %-age points > Greece)
 - Shadow economy size
- Devil is in the details
 - Most studies too aggregated
 - Identify key agents and their incentives
 - Systemic perspective → entrepreneurial ecosystem

Our definition of entrepreneurship

the ability and willingness of individuals, independently and within organizations

- to discover and create new economic opportunities
- to introduce their ideas in the market under uncertainty, making decisions regarding the localization, product design, use of resources and reward systems
- to create value (often means entrepreneur aims to expand firm to its full potential)

The ecosystem and its skill structure



Key lessons

- All types of agents necessary
- Same person can sometimes fulfill several roles
- No one "owns" or is in charge of the ecosystem
 - Experimentally self-organized
 - Top-down policy approaches likely to fail
- Policy should
 - Stay away from tampering with the self-selection process
 - Instead encourage and support an institutional system that encourages socially productive **E** regardless of business form

A reform agenda

- Focus should be on the entrepreneurial ecosystem and its agents
 - A spontaneous evolutionary process
 - Efficiency hampered if some link very weak or missing
 - Variety of capitalism: Countries should be inspired by more successful “siblings” with similar conditions

I. Rule of law, protection of property rights, and gov't effectiveness

- Fundamental, yet large differences among EU countries
- No alternative but to improve these aspects in laggard countries

II. Taxation

- **Corporate:** effective and statutory rate equalized, institutional competition should be transparent
- **Labor:** reasonable marginal rate, separate taxation
- **Dividends and capital gains**
 - Return on **E** in these forms
 - Low and uniform rate (avoid concessionary schemes)
- **Stock options:** low and at final exit
 - Mechanism encouraging entrepreneurship among wealth-constrained key personnel

III. Savings, capital and finance

- Broadly promote private wealth accumulation, but
 - Avoid funded systems that preclude financing of entrepreneurial sector
 - Allow pension funds to invest in VC funds
 - VC and business angels must be able to design tax-efficient incentive contracts with founders and key personnel
 - Neutrality between debt and equity financing
 - *De facto* minority protection to promote a public stock market

IVa. Organization of labor markets

- Overly stringent EPL makes recruitment to entrepreneurial sector difficult
- Avoid size thresholds in EPL stringency: a tax on growth
- Lax EPL for temporary employment poor substitute for overly stringent EPL permanent employment

IVb. Social insurance systems

- Do not tie benefits to current employer
 - Lowers the risk that workers and potential entrepreneurs become "trapped" in mature firms offering safe jobs
- Flexicurity
 - Generous welfare protection, opportunities for retraining + obligation to accept new job offer
 - Weakens demand for strict EPL
- Portability of social insurance rights
 - individual savings acc's, not severance pay etc.

V. Competition policy

- Easy to start a business
 - Not sufficient, also needs...
- Contestability in product markets
- Service sector deregulation most pressing
 - Esp. important in Eastern and Southern Europe
 - low employment rates
- Key areas almost wholly tax-financed today
 - Reform and experimentation especially needed

VI. Bankruptcy and insolvency

- Insolvency regulation to protect inherently healthy and promising ventures
 - Combine with a strengthening of rule of law and security of property rights where necessary
- Person who goes bankrupt because of a failed venture not forever ostracized from future **E**
 - But rules balanced to avoid predatory **E**

VII. R&D and knowledge spillovers

- R&D spending does not automatically result in innovation, patents, and highly valued output
 - Most innovative EU countries have low share of government funding of business R&D
- Spillovers and imitation key channels for social return on R&D
 - Entrepreneurial spinoffs (cf. the Fairchild case)
 - Cluster/agglomeration effects (important for the transfer of tacit knowledge) – facilitate growth of clusters that emerge spontaneously

VIII. Human capital investment

- High quality of basic education
 - Government key role
 - Competition across schools, benchmarking to other countries, stringent auditing by gov't agencies (focus on performance, not processes)
 - Encourage STEM at early age
- Tertiary education sector responsive to changing needs
 - Emphasized in the Horizon 2020 Initiative
- Incentives to excel
 - U.S. vs. European university system

IX. Informal institutions

- **Ideal combination to promote I and E:** high trust and favorable attitudes towards competition
 - SWE and DEN have both
 - ROU and BUL like competition but have low trust
 - FRA, CYP, ESP GRE low on both
- Social legitimacy of entrepreneurs important
- Change most needed in Eastern Europe
- Unclear if they can be influenced directly by policy

Concluding remarks

- **I** needs **E** to translate into valuable goods and services. **E** depends on institutions.
- We propose a reform strategy involving a broad range of areas pertinent to the **agents** of the entrepreneurial ecosystem
 - No one-size-fits-all strategy
 - Our approach helps prioritize and identify weakest links
 - VoC perspective as guidance on national level
 - Reform process should be incremental, leaving room for experimentation rather than unreflected imitation