

Understanding Entrepreneurship: Definition, Function and Policy



Stimulating entrepreneurship is high on policymakers' agendas. But what should we mean when we talk about entrepreneurship, and why is it so important? Should policymakers try to influence entrepreneurial activity, and if so, how can this best be done? Magnus Henrekson and Mikael Stenkula analyze these issues in a comprehensive new textbook – Understanding Entrepreneurship – designed as a core text for undergraduate and graduate courses in entrepreneurship and economics.

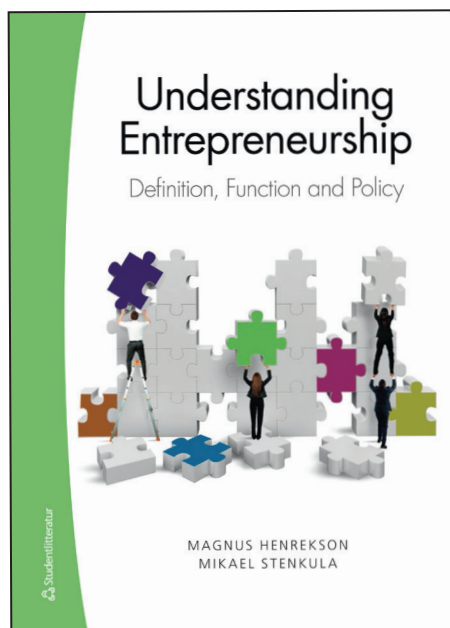
A country's business sector seems closely related to its entrepreneurs. But is a nation rich because of them? How would wealthy countries have developed if the entrepreneurs associated with their industrial breakthroughs had never been born or emigrated to the United States? Would these economies have undergone a similar process regardless, even if it may have played out slightly differently?

In any event, giving a fair account of a country's economic history is impossible without discussing the companies that have played a central role in its development. Inevitably, behind these company names stands a founder and a strong driving force—an entrepreneur. A scientific understanding of the entrepreneurial function is therefore essential to determining its importance for a country's historical, contemporary and future development.

Yet the entrepreneurial contribution plays a very modest role in both micro- and macroeconomics, and is often completely neglected in teaching. The basic microeconomic models do not include firms or businesspeople and entrepreneurs. Business activity is reduced to a production function that mechanically maps the maximum production that can be obtained with a certain amount and combination of inputs. In the basic macroeconomic models, growth results from investment, technical change and increased inputs of labor. These models also lack explicit accounts of the activities of entrepreneurs.

Economic models are thus silent about who, subject to uncertainty, combines resources in the form of capital (financial and physical), labor (with different education and intrinsic abilities) and knowledge to produce the goods and services demanded. Instead, most research on entrepreneurship has been done outside mainstream economics, or in other academic disciplines, such as business studies, sociology and economic psychology.

In *Understanding Entrepreneurship*, we analyze and explain what entrepreneurship is, why it plays a crucial role in creating prosperity, growth and employment, and how economic policy can encourage entrepreneurial activity. Our analysis is based on an extensive body of theoretical and empirical literature.



The book is organized in three parts. In Part I, we systematically discuss what entrepreneurship really is, how it should be defined, and how entrepreneurial activity is typically quantified. We also position the entrepreneur in a larger context, by describing how the entrepreneur depends on a range of actors with complementary competencies. The entrepreneur plays a central role in what we refer to as the “competence structure”.

Definition

In Chapter 2, we discuss how to define the notion of the firm, and why firms exist.

In Chapters 3 and 4, we discuss different meanings of the term entrepreneurship. We show that it is a multidimensional concept that has been defined in several ways over the years. We define entrepreneurship as the ability and willingness of individuals, both 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; and
- to create value, which often, though not always, means that the entrepreneur aims to expand the firm to its full potential.

In Chapter 5, we adopt an empirical perspective and examine the various measures, narrow and wide, that researchers use to assess entrepreneurial activity.

Chapter 6 addresses the entrepreneur from a wider perspective. Here, we examine the various roles of complementary actors, including the role of risk capital in developing firms. We also analyze the differing roles of small, new and large firms in the economy.

Function

In Part II, we examine why entrepreneurship is so important.

Chapter 7 addresses the crucial role played by entrepreneurship in achieving economic growth and generating new jobs. The ensuing chapter pits these findings against the traditional view of the determinants of economic growth, which ascribes either a very limited role to entrepreneurs, or none at all. Even if some models have been augmented in recent years, they tend to take firms, business ideas and innovations as givens. These models do not incorporate the activity of discovering or creating business ideas, or the formation of firms. The theories also ignore the activities required to successfully combine new or available factors of production. The entrepreneur, who can be regarded as the agent who transforms the new knowledge into business opportunities, is missing in these models and theories.

In Chapter 9, we present the most important empirical studies that assess the importance of entrepreneurship for economic growth.

Chapters 10 and 11 lay out an analytical framework that shows how the extent of entrepreneurial activity in the economy can be determined. Normally, the same person both supplies and demands entrepreneurship services. Supply depends on both individual and social factors, such as access to capital and attitudes towards risk taking and business ownership. The demand for entrepreneurship services arises because of the presence of entrepreneurial opportunities, and it is influenced by factors such as new technologies, industry structure, macroeconomic conditions and individual subjective assessments of the surrounding environment.

These chapters provide a background for the next part of the book. Here, we introduce the concept of entrepreneurial rent, which is the compensation the entrepreneur receives for exercising entrepreneurship. We stress that entrepreneurship is crucial for innovation, renewal, economic growth and job creation. Of course, entrepreneurs do not aim for these noble things. Even if other factors, such as social recognition and media attention, also influence the desire to become an entrepreneur, the pursuit of profit is a central motive driving entrepreneurs.

Entrepreneurs are therefore largely governed by economic incentives—the reward structure. These incentives are in turn essentially determined by the institutional structure of the economic system. Good institutions or favorable rules are prerequisites for encouraging entrepreneurial efforts and for channelling entrepreneurship in ways that are socially productive.

Policy

So what are the essential rules of the game?

In Part III of the book, we examine the most important institutions in this context and discuss how they can be designed to promote productive entrepreneurship. The analysis is limited to institutions that political decisions may directly or indirectly affect.

In Chapter 12, we discuss the basic principles of analyzing policy measures. Importantly, policy should focus on encouraging productive entrepreneurship irrespective of where it is conducted in the economy.

In Chapter 13, we examine a number of policy measures in more detail, and conclusions that can be drawn from economic research regarding the effects of these measures.

Chapter 14 is devoted entirely to analyzing the effects of taxation. Tax structure and levels, the design of the social insurance system, the extent and appropriateness of product market regulations, the design of bankruptcy legislation and the availability of risk capital are factors that politicians, in one way or another, can influence and that have an impact on the rate of entrepreneurial activity and the direction in which it is channelled.

In the final chapter we summarize our findings and note that globalization has led to more intense institutional competition. More than ever, individual countries need competitive institutional framework conditions that encourage the creation of new firms, business expansion and risk taking. When firms can outsource some of their operations, business opportunities arise in the vicinity of outsourcing firms, which tend to be large and mature firms. If a country or a region suffers from a lack of potential entrepreneurs, it runs the risk of transferring activities abroad through international outsourcing or offshoring that could have otherwise served as the basis for new domestic firms.

Understanding Entrepreneurship is a new and unique book, designed as a core text for undergraduate and graduate courses in entrepreneurship. It is also suitable reading for undergraduate courses in economics and economic history that aim to explain growth and evolutionary change.

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IFN Stockholm Conference 2016: Efficient Provision of Public Services

Research on the intersection between the public and the private sectors in markets for education, health care, elderly care and child care is of considerable scientific and practical importance. This event is organized to address the following aspects of efficient service provision:

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Recent Entrepreneurship Research

Do R&D and ICT Affect Total Factor Productivity Growth Differently?

By Harald Edquist and Magnus Henrekson

We analyze the effect of ICT and R&D on total factor productivity (TFP) growth across different industries in Sweden. R&D alone is significantly associated with contemporaneous TFP growth, thus exhibiting spillover effects. Although there is no significant short-run association between ICT and TFP, we find a positive association with a lag of seven to eight years. Thus, spillovers from R&D affect TFP much faster than spillovers from ICT-investments.

We also divide ICT capital into hardware and software capital. To our knowledge, this distinction has not been made in any previous study analyzing TFP at the industry level. The results show that lagged hardware capital services growth is significantly associated with TFP growth. Hence, investments complementary to hardware are needed to reap the long-run TFP effects from reorganizing production.

IFN Working Paper No. 1108

Stock Option Taxation and Venture Capital Activity: A Cross-Country Comparison

By Magnus Henrekson and Tino Sanandaji

One response to uncertainty and transactions cost in VC-finance is to compensate founders (and other key personnel) with stock options under complex contracts. Entrepreneurs are granted stock options contingent on firm performance, vesting and other criteria. While most countries tax stock options as labor earnings, the United States allows them to be taxed at a low capital gains tax rate. The interaction of favorable tax treatment and inherent advantages has led to near universal use of stock options in American venture capital deals, while this remains less common in Europe.

The effective tax treatment of stock options depends on tax practices and is not readily observed using statutory tax rates. We asked the local offices of the tax consultancy firm PwC to calculate the effective tax rate for a standardized entrepreneurial case in 22 countries, finding that countries with favorable tax treatment have more VC activity. One advantage of this tax policy is that it narrowly targets entrepreneurial startups without requiring broad tax cuts.

IFN Working Paper No. 1104

Two Sides to the Evasion: The Pirate Bay and the Interdependencies of Evasive Entrepreneurship

By Niklas Elert, Magnus Henrekson and Joakim Lundblad

Evasive entrepreneurs innovate by circumventing or disrupting existing formal institutional frameworks. Since such evasions rarely go unnoticed, they usually lead to responses from lawmakers and regulators. We introduce a conceptual model to illustrate and map the interdependence between evasive entrepreneurship and the regulatory response it provokes. We apply this framework to the case of the file sharing platform The Pirate Bay, a venture with a number of clearly innovative and evasive features. The platform was a radical, widely applied innovation that transformed the Internet landscape, yet its founders became convicted criminals because of it. Applying the evasive entrepreneurship framework to this case improves our understanding of the relationship between policymaking and entrepreneurship in the digital age, and is a first step towards determining the best responses for regulators confronting evasive entrepreneurship.

IFN Working Paper No. 1103

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