Policy Brief on Institutional Reform for Enhanced Innovation and Entrepreneurship in Europe

Niklas Elert, Magnus Henrekson, and Mikael Stenkula

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Policy brief on Institutional Reform for Enhanced Innovation and Entrepreneurship in Europe

Authors: *Niklas Elert, Magnus Henrekson, and Mikael Stenkula*

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Abstract

We argue that institutional changes in a liberalizing direction are a *sine qua non* for economies of the European Union to become more entrepreneurial in order to promote innovation and economic growth. However, this does not mean that one-size-fits-all policy reforms towards freer markets are likely to be successful. An important reason is that the 28 union member states have very different histories, and distinct institutional structures, affecting their efficiency and the viability of reforming them. These differences imply that the same policy reform may yield very different results in different countries, ranging from the good to the bad to the ugly. We therefore formulate a reform strategy that takes country differences into account without abandoning the long-term goal of institutional liberalization in order to promote entrepreneurship, innovation and growth. The proposed strategy concerns reforms with respect to (i) the rule of law and the protection of property rights, (ii) the tax system, (iii) regulations governing savings, capital and finance, (iv) the organization of labor markets and social insurance systems, (v) regulation of goods and service markets, (vi) bankruptcy and insolvency regulation, (vii) R&D, commercialization and knowledge spillovers, (viii) human capital investments, and (ix) informal institutions.

Introduction

The European Union suffers from an "innovation emergency" (European Commission 2015). As a way out of this predicament, we argue that member states need to undertake liberalizing reforms in nine important areas (Elert, Henrekson and Stenkula 2016). However, a viable reform strategy must take important country differences into account if it is to be successful. The reform strategy we propose takes the entrepreneur's reality in the entrepreneurial ecosystem as a starting point, notably the complementary skill structure needed to realize entrepreneurial ideas.

The institutions on which the actors in the skill structure depend are the ones that reform efforts should focus on.

Methodology

By drawing on the theory of the experimentally organized economy and the literature of entrepreneurial ecosystems we identify six competencies, in addition to that of the entrepreneur, necessary for ideas to be generated, identified, selected and commercialized – namely inventors, professional managers,

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competent employees, venture capitalists, actors in secondary markets, and demanding customers. The methodology is evolutionary and comparative; it asks which types of processes make fallible human beings experiment, learn and interact with others; and it asks what political and economic arrangements will provide the most favorable economic outcomes.

We also draw on the *varieties of capitalism* literature, where institutional complementarities are considered a main driver of the persistence of institutional differences across different varieties of capitalism (Hall and Soskice 2001). Institutions are complementary if the presence or efficiency of one institution increases the returns from or efficiency of the other. The existence of institutional complementarities implies that viable policy changes must be compatible with existing institutional patterns. Complementarity also implies that a specific change will have effects that extend throughout the institutional system.

Results and conclusions

We propose institutional reforms pertaining to nine broad areas.

(I) Rule of law and protection of property rights. These are the most fundamental rules of the game, and all member states need to ensure that they are stable and secure. With regard to intellectual property rights, an important balance must be struck: The rules must be strong enough to incentivize investments in innovation, yet weak enough to allow knowledge diffusion.

(II) Taxation. Many types of taxes affect entrepreneurial decisions. While tax rates should generally be low or moderate, policy makers should strive for simplicity rather than (targeted) exceptions. In addition, they should aim for a high degree of tax neutrality across owner categories, sources of finance, and different types of economic activities.

(III) Savings, capital and finance. These institutions should be reformed to support more private wealth formation and the creation of a dynamic venture capital industry, as these are crucial sources of finance particularly in the early stages of an entrepreneurial project. As a large share of savings in the economy nowadays goes into pension funds, it is important that at least part of these assets also can be invested in entrepreneurial firms and not just in real estate, public stock and bonds.

(IV) Labor markets and social security. Institutions should facilitate the recruitment of workers with the necessary competencies and reforms should strive for the removal of legal and institutional hurdles that prevent firms from firing underperforming workers. Overly stringent employment regulations may also create strong incentives for actors in the skill structure to devise arrangements to circumvent the regulations, including the emergence of an underground economy. Furthermore, incentives are best served by government income insurance systems that encourage activation, mobility and risk-taking. Social security institutions should enable portability of tenure rights and pension plans, as well as a full decoupling of health insurance from the current employer, to avoid punishing those individuals who leave employment in order to realize entrepreneurial ideas.

(V) Regulation of goods and service markets.

It is essential that market-leading incumbents should not be allowed to unduly exploit their dominant market positions. Lowered entry barriers are therefore key in this reform area, and the opening of areas that are closed to private production, such as healthcare and schooling. Within a well-designed system of public financing, sizeable contestability and private production should be encouraged.

(VI) Bankruptcy law and insolvency regulation.

Entrepreneurial failure provides valuable information to other economic actors. Such

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ventures must close down so that their resources can be redirected to more productive uses. Bankruptcy law and insolvency regulation should therefore be relatively generous and allow for a "second chance." However, it should not be too easy to file for bankruptcy as that encourages exploitation and destructive entrepreneurship, harming creditors as well as the rest of the community.

(VII) R&D, commercialization and knowledge spillovers. R&D-spending and even patents are inputs; for them to translate into economic growth, entrepreneurs must exploit the inventions by introducing new methods of production or new products in the marketplace. Hence, instead of focusing on quantitative spending goals and targeted R&D support, policy should strive to generally make it easier to start and grow businesses.

(VIII) Incentives for human capital investment. Policy should strive to create good incentives for the individual to acquire knowledge and skills, whether through formal or workplace education. There must also be incentives to supply such opportunities by the education system itself. In particular, the U.S. university system could be a role model in some respects in that it seems more responsive to the economic needs of society than European university systems, although Europe must avoid steep tuition fees that would hinder talented students from entering the university.

(IX) Informal institutions.

Informal institutions affect the workings of formal institutions but may also be important for the fostering of entrepreneurship in its own right. Notably, the social legitimacy of entrepreneurs is important in this respect. Likewise, norms and habits that facilitate cooperation and impersonal exchange must be strengthened, especially with respect to trust. High-trust environments have been found to nurture market entry, enterprise growth and productive entrepreneurship. The extent to which policy can influence this is nevertheless doubtful. Furthermore, since informal institutions vary considerably across regions, this is likely to affect the level at which measures should be implemented.

Implications and recommendations

A. A European reform agenda should strive for economic liberalization, but it needs to carefully consider the economic and institutional starting conditions of countries. It falls on reformers to creatively package the policy suggestions into institutional designs that are sensitive to local constraints and take advantage of local opportunities.

B. An important part of this process is to prioritize and focus on institutional bottlenecks, but this can only be achieved through a clear understanding of how institutions in a country or a cluster of countries reinforce and complement one another.

C. The reform process should be incremental, and leave room for experimentation rather than thoughtless imitation, so as not to ignore the continuous change, innovation and adaptation of institutions and organizations in a competitive environment.

Concluding remarks

Our study has underlined the importance of heterogeneity among the member states of the European Union and how this will influence policy conclusions. Policymakers would do well to remember that there is no undisputable quick fix that will boost entrepreneurial activity in all member states irrespective of institutional context and cultural background. Different policies complement and reinforce one another and countries have adapted different varieties of capitalism over time. Any reform strategy will have to build on that foundation to be successful.

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Sources and further reading

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