Chapter 4
Summary and Conclusions

Abstract To promote innovation and economic growth in the European Union, we propose a reform strategy with respect to the aforementioned nine areas, which we consider to be the most pertinent institutions and policies in order to foster a productive entrepreneurial economy. Overall, the proposed institutional changes move in a liberalizing direction, but we acknowledge that one-size-fits-all policy reforms aimed at freer markets will not necessarily be successful. Instead, a successful reform strategy must consider country differences that affect the viability of reform. Nevertheless, policymakers should not lose sight of the long-term goal of institutional liberalization to promote entrepreneurship, innovation and growth. Hopefully, this work inspires both confidence and humility regarding Europe's innovation future.

Keywords Entrepreneurship · European Union · Innovation · Institutions · Policy reform · Regulation · Self-employment

The purpose of this study has been to propose an institutional reform strategy to enhance innovation and entrepreneurial activity in Europe. In doing so, we acknowledged the existence of several types of capitalism among the EU member countries. These types have evolved into highly complex entities that are held together by a number of complementary institutions. None of these models consistently exhibits superior performance in terms of social welfare, making it difficult to determine which model the European Union as a whole should strive to converge towards.

The observation that the European Union overall suffers from a lack of innovation motivates the analysis in this study. We identify entrepreneurship and innovation as the relevant aspects that policy reforms should strive to improve. Entrepreneurship and innovation are crucial for the growth of the polities in which they occur and for their effect on growth on a global scale. An innovation is the translation of an idea or an invention into an economically valuable good or service, and if it can cross borders the innovation can be implemented to the benefit of the inhabitants of countries far different from the one in which it originated.

N. Elert et al., *Institutional Reform for Innovation and Entrepreneurship*, SpringerBriefs in Economics, DOI 10.1007/978-3-319-55092-3_4

It is increasingly understood that innovation is important for the European Union and its member states, as evidenced by the broad consensus on the political goal that the Union become more innovative and entrepreneurial. The most appropriate strategy to achieve this goal is a complicated issue. Should all member countries adopt reform packages that make them more alike, further increasing the political and economic convergence that has been ushered in by years of negotiation and collaboration? Or should those member states that can reasonably be classified as belonging to the same variety of capitalism espouse a reform strategy specifically designed for that variety?

Our answer falls somewhere between these extremes. While we identify what we believe would be the most beneficial institutional framework for innovation and entrepreneurship, we also acknowledge that this agenda is easy to identify only at a rather high level of theoretical abstraction (Rodrik 2007), to say nothing of how difficult it may be for member states to achieve it in practice. In fact, given the many institutional complementarities in the framework conditions of member states, the idea of all of them embarking on an immediate and straightforward journey towards best-practice institutions is naïve to say the least; at worst, it may even be detrimental to achieving the very institutional reforms we advocate (Pistor 2002; Dixit 2009). Rather, a reform strategy must be tailored to each country's specific needs. Overall, the proposed institutional changes are slanted in a liberalizing direction, but this does not mean that one-size-fits-all policy reforms towards freer markets are likely to be successful, at least not immediately. Below, we identify several points to which such a strategy should adhere.

First, a European reform agenda, even though its eyes should be set on liberalization, needs sophistication. While the identification of best-practice institutions is a *sine qua non* for the agenda to be successful, it must be accompanied by a recognition that first-order economic principles—the protection of property, contract enforcement, market competition, etc.—do not map onto unique policy packages. Hence, no unique correspondence exists between functionally good institutions and the form that such institutions take. Desirable economic ends can be achieved through a number of different institutional bundles. What is most appropriate is highly context-dependent; at worst, a thoughtless introduction of first-class legal institutions can backfire if instead of taking hold they undermine existing domestic institutions (Rodrik 2008). It falls on reformers to creatively package the principles into institutional designs that are sensitive to local constraints and take advantage of local opportunities.

Second, a reform agenda must be appropriately concrete. Most historical and econometric studies about institutions and growth (e.g., North and Thomas 1973; Hall and Jones 1999; Acemoglu et al. 2001) tend to remain at a high level of generality and do not provide much policy guidance (Besley and Burgess 2003; Rodrik 2008). In this study, we have attempted to go beyond abstract reasoning and drilled down to the specific effects of particular measures. Much more work is required in this respect, but hopefully, we have proceeded somewhat further down the ladder of concreteness.

Third, the reform agenda must prioritize, and the EOE and VoC perspectives are valuable for understanding how. The EOE perspective helps us identify which institutions matter the most for the key actors in the entrepreneurial ecosystem, whereas the VoC perspective elucidates how countries group with respect to these institutions and hints at the institutional complementarities that characterize a particular cluster of countries. Much more work is required here, an important part of which is to identify and remove so-called institutional bottlenecks (Acs et al. 2014). Doing so will make it possible to more directly identify the problems that ought to be the top priority within a cluster. Furthermore, countries in a cluster can be more or less successful, and their relative rank within the cluster has important informational and practical value when the reform process is undertaken. Rather than trying to leap-frog directly to an institutional bliss point, a laggard within a cluster should try to become more like the leader in its cluster in the short and medium term. This goal is likely to be more attainable by virtue of its relative modesty and because the reforming country then aspires to something that has been tried by a country with a similar institutional setup.

Lastly, it is important that the reform process is incremental and leaves room for experimentation rather than imitation without reflection. From a Schumpeterian perspective, the quest to develop an optimal set of legal rules ignores a central feature of successful economic development, namely, the continuous change, innovation and adaptation of institutions and organizations in a competitive environment. Reforms that are tailor-made to a country's specific constraints and opportunities through experimentation during a discovery process will likely be more beneficial than reforms based on mere imitation (Lau et al. 2000; Qian 2002; Hausmann and Rodrik 2003; Imbs and Wacziarg 2003; Sabel and Reddy 2007). That being said, given the complexities involved, it is important to keep in mind that simple legal principles often are preferable to a detail-oriented case-by-case approach. One possibility is to strive for the sort of "simple rules for a complex world" advocated by Epstein (2009).

We have proposed institutional reforms pertaining to nine broad areas:

(i) *The rule of law and protection of property rights*. These are the most fundamental rules of the game, and all member states must ensure that they are stable and secure. Regarding 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 and 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 currently goes into pension funds, it is important that at least part of these assets can also be invested in entrepreneurial firms, 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. 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 the 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 a tenured job to realize entrepreneurial ideas.

(v) *Regulation of goods and service markets*. Preventing market-leading incumbents from unduly exploiting their dominant market position is essential. Lowered entry barriers are key to this reform area, as is the opening of areas that are typically closed to private production, such as healthcare and schooling. Within a well-designed system of public financing, sizeable private production and contestability should be encouraged.

(vi) *Bankruptcy law and insolvency regulation*. Entrepreneurial failure provides valuable information to other economic actors. Such ventures must be discontinued 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 would encourage exploitation and destructive entrepreneurship, harming creditors as well as the rest of the community.

(vii) *R&D, commercialization and knowledge spillovers*. R&D-spending is an input; for it 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 incentives that encourage 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 that it seems more responsive to the economic needs of society than European university systems, although Europe must avoid the 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. The social legitimacy of entrepreneurs is particularly important in this respect. Likewise, norms and habits that facilitate cooperation and impersonal exchange need to be strengthened, especially with respect to trust. High-trust environments have been found to nurture market entry, enterprise growth and productive entrepreneurship. However, the extent to which policy can influence this is unclear. Furthermore, informal institutions vary considerably across regions, which is likely to affect the level at which measures should be implemented.

In summary, we hope that this work has inspired both confidence and humility regarding Europe's innovation future. Later work could analyze and present specific policy proposals linked to the different clusters of European countries in more detail. A good starting point for a more detailed reform agenda would be to identify the leader in each cluster and base reform advice directed to that cluster or the individual countries matching the leader's institutional framework.

References

Acemoglu, D., Johnson, S., & Robinson, J. A. (2001). The colonial origins of comparative development: An empirical investigation. *American Economic Review, 91*(5), 1369–1401.

Acs, Z. J., Autio, E., & Szerb, L. (2014). *Global entrepreneurship and development index 2014*. Washington, D.C.: Global Entrepreneurship and Development Institute.

Besley, T., & Burgess, R. (2003). Halving global poverty. *Journal of Economic Perspectives, 17*(3), 3–22.

Dixit, A. K. (2009). Governance, institutions and economic activity. *American Economic Review, 99*(1), 3–24.

Epstein, R. A. (2009). *Simple rules for a complex world*. Cambridge, MA: Harvard University Press.

Hall, R. E., & Jones, C. I. (1999). Why do some countries produce so much more output per worker than others? *Quarterly Journal of Economics, 114*(1), 83–116.

Hausmann, R., & Rodrik, D. (2003). Economic development as self-discovery. *Journal of Development Economics, 72*(2), 603–633.

Imbs, J., & Wacziarg, R. (2003). Stages of diversification. *American Economic Review, 93*(1), 63–86.

Lau, L. J., Qian, Y., & Roland, G. (2000). Reform without losers: An interpretation of China's dual track approach to transition. *Journal of Political Economy, 108*(1), 120–143.

North, D. C., & Thomas, R. P. (1973). *The rise of the Western World: A new economic history*. New York: Cambridge University Press.

Pistor, K. (2002). The standardization of law and its effect on developing economies. *American Journal of Comparative Law, 50*(1), 97–130.

Qian, Y. (2002). How reform worked in China. William Davidson Institute Working Paper No. 473. Ann Arbor, MI: William Davidson Institute.

Rodrik, D. (2007). *One economics, many recipes: Globalization, institutions, and economic growth*. Princeton, NJ and Oxford: Princeton University Press.

Rodrik, D. (2008). Second-best institutions. *American Economic Review, 98*(2), 100–104.

Sabel, C. F., & Reddy, S. (2007). Learning to learn: Undoing the Gordian knot of development today. *Challenge, 50*(5), 73–92.