Determinants of the Prevalence of Start-ups and High-Growth Firms

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ABSTRACT. The purpose of this study is to identify key institutional determinants of firm emergence and growth. We do this using various types of data from Sweden. A characterization of a number of institutions and policy measures shows that they are likely to have contributed to an environment that discourages entrepreneurial activity and firm growth. Aspects dealt with include: missing arenas for entrepreneurship in the care sectors and for household-related services, taxation of entrepreneurial income, incentives for wealth accumulation, wage-setting institutions and labor market regulations. Using original data, we provide evidence of a low prevalence of nascent entrepreneurs and a small net employment contribution by high-growth firms. We admit that indisputable evidence for the effects of institutional arrangements is almost impossible to establish. However, the consistency of our theoretical arguments and empirical data makes a strong case for the notion that the Swedish case illustrates the costs of giving too little weight to economic renewal in policy making.

Introduction

There are strong reasons to believe that productive entrepreneurship is an essential explanatory factor of the economic performance of a country, and hence that cross-country differences in the degree of productive entrepreneurial activity are likely candidates for explaining part of observed cross-country differences in economic performance. As a concrete manifestation of a vibrant entrepreneurial culture, one would expect to observe (i) a high rate of firm formation and a high prevalence of nascent entrepreneurs, and (ii) that the most viable commercial ideas are translated into a sizable number of high-growth firms.

A large body of empirical research aims at identifying micro-level factors explaining the emergence and growth of firms. As regards emergence, long lists of psychological and socio-demographic characteristics of business founders have been compiled and examined by Gasse (1996), Miner (1996) and Stanworth et al. (1990). Concerning growth, Storey (1994), in an extensive survey of this literature, identified 35 such factors. Delmar (1997) and Wiklund (1998) provide more recent literature reviews. These studies focus on differences in performance across firms while taking the broader institutional framework (“the rules of the game”) as well as the aggregate outcome as given.

By contrast, in this study we focus on the links between social institutions and firm start-ups and growth, and between such micro-level dynamics and aggregate economic development. The express purpose of the study is to attempt to identify the most important institutional determinants of firm emergence and growth, using various types of data from Sweden.

There has been little room for the entrepreneurial element in theoretical mainstream economics (Baumol, 1993; Kirchhoff, 1994; Kirzner, 1997). The main reason for this disregard of the entrepreneur is that he or she largely eludes analytical tractability. However, if one subscribes to the view that the main rationale for economic

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research is to enhance our understanding of the workings of the real world, this is, to put it mildly, a tenuous excuse.

It is easy to point out several institutional studies that broadly deal with the grand issue of why some countries, such as the U.K. of the late 18th century, had the requisite institutional set-up to allow a long-term growth process to start. Or analogously, why other technologically advanced countries, such as China under the Ming Dynasty, did not embark on a similar growth path. Three of the most influential studies in this tradition are North and Thomas (1973), Rosenberg and Birdzell (1986) and Mokyr (1990). The most important proposition in these studies is that a necessary condition for a long-term take-off is that property rights are well defined \textit{ex ante}. Baumol (1990) specifically deals with the effect of institutions/the social payoff structure on the supply of productive entrepreneurship across highly varying historical contexts. However, to our knowledge, there are few, if any, studies before Davis and Henrekson (1997, 1999) that analyze how various institutional set-ups in a contemporary context affect firms of different size, industry, age \textit{et cetera}. In this paper their analysis will be extended to the effects on entrepreneurial behavior and firm growth.

It is a formidable task to construct convincing tests of the hypothesis that the institutional setup is an important determinant of firm growth and entrepreneurial activity. Ideally our approach would be able to explain why the quantitative effect of a certain individual or firm specific factor may vary across institutional setups. To provide a fully satisfactory answer, the analysis would first have to identify the relevant institutions and their likely effects on behavior. The institutional arrangements we analyze include missing arenas for entrepreneurship in the care sectors and for household-related services, taxation of entrepreneurial income, incentives for wealth accumulation, wage-setting institutions and labor market regulations. Second, we need high quality data. The micro-level data sets we utilize have been carefully checked and prepared for our purpose. We are thus confident that limitations to data quality will not be a source of distorted results. Finally, we need a yardstick for comparison and a means to rule out competing explanations.

An analysis of the influence of institutional arrangements is almost by definition restricted to situations with few observations and many possible influences. In this regard the validity of our conclusions will in part have to be judged in terms of the strength of the theoretical arguments in combination with the correspondence between theoretical predictions and empirical results. A test of the hypothesis is greatly improved if there is institutional variation. This can be achieved in two ways: (i) by studying differences in behavior across countries with differing institutions (see Davis and Henrekson, 1999, 2000) and (ii) by studying a country over time during periods when institutions change. We will mostly use the latter approach in this paper. As regards comparisons we have comparable (common methodology) international data for start-up activity. For business growth we will have to rely on relevant within-country comparisons.

Figure 1 provides an overview of our analytical framework. Our main focus is on the effect of certain institutional arrangements on specific forms of entrepreneurial activity, as portrayed by the straight black arrow. The expected causality is inferred by means of theoretical argumentation. We will also examine empirically whether the patterns in the data are consistent with these theoretical arguments.

An underlying reason for our interest in the effect of institutions on entrepreneurial activity is the assumption that entrepreneurial activity positively affects national economic performance. In this paper we will not engage in a theoretical analysis of this relationship. We will, however, loosely examine the empirical consistency of this proposed relationship.

The paper is organized as follows. In Section 1 a brief characterization of Sweden’s long-term growth and employment performance is given. In the two following sections we carefully assess whether the performance observed at the macro level is consistent with studies at the individual and firm level. In particular, we investigate the extent of independent business start-ups and the role of high growth firms for job creation. The remainder of the paper is devoted to an analysis of the pertinent institutions and rules of the game that may explain the empirical findings in Sections 1–3. In Section 4 it is argued that the production of services generically is highly amenable to