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FOUNDERS AND FUNDERS:
AN INTRODUCTION TO ENTREPRENEURSHIP AND VENTURE CAPITAL

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Founders and funders:
an introduction to entrepreneurship and venture capital

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Abstract

By focusing on the economics of productive and unproductive entrepreneurship and in particular on the mix of entrepreneurial activities, this paper explains the role and the presence of venture capitalism in different institutional contexts. These context are defined in terms of property rights, freedom of contract and competition.

It is shown that venture capitalism is just one among the various possibilities of transforming good ideas into success stories; and that tends to be discarded when the rules of the game are such that transaction costs are high and less than transparent. Although venture capitalism tends to be positively correlated with growth, it is not a necessary condition for growth. But its presence can provide important signals as for the nature of the prevailing institutional framework and possibly signal unexploited opportunities to direct entrepreneurial resources toward productive goals.

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1. Introduction

Many advanced European countries seem to suffer from the inability to grow at a satisfactory pace. Surely, defining growth is not as easy as it sounds, let alone finding out what satisfactory growth means (Colombatto 2006). Still, by considering the traditional perspectives suggested by most theorists, two elements stand out. Those sympathetic to the exogenous explanation of the growth process expected Europe to bridge the gap with the US in the past couple of decades. In fact, the opposite seems to have been the case. Similarly, believers in endogenous-growth theory are stuck with the fact that despite its wealth in human capital and know how, Europe is unable to match the growth performance of a number of undeveloped countries. To put it bluntly, traditional growth theory is not logically persuasive and not consistent with reality (Olson 1996; Boettke and Coyne 2003).

Research on growth and development has also followed different paths, of course. As a result, it is now widely acknowledged that institutions – the rules of the game – play a key role. Excessive regulation, high taxation and fruitless expenditures depress productive efforts and thus affect economic performance. The protection of property rights is also crucial, as Adam Smith (1776) explicitly stated over two centuries ago: "in countries where there is a tolerable security, everyman of common understanding will endeavour to emply whatever stock he can command". On the inverse case he said "where men are afraid of the violence of their superiors, they frequently bury and conceal a great part of their stock".

Not surprisingly, when discussing the quality of the institutional environment, politicians prefer to ignore most questions related to property rights, taxation and

regulation; and concentrate instead on the notion of market failure. In particular, European policymakers claim that institutions in their part of the world are 'about right'. That is, privileges and redistribution are justified since they are supposed to meet widely-perceived social demands, collective needs that market mechanisms are unable to take into account. It is not denied that sets of rules that involve redistribution and – more generally – restrictions on property rights and freedom of contract often produce negative externalities that reduce individuals' willingness to invest and carry out otherwise desirable, growth-promoting activities. Hence, the repeated calls for additional political action to encourage investors to take initiatives, to avoid undesirable effects; and for subsidies to producers engaged in high-tech areas, where risk taking often plays a more relevant role.

In this light, increasing attention has recently also been devoted to Venture Capital (VC). Since it is believed that innovation is a prerequisite for growth, the high correlation between innovation and the presence of venture capitalists has led many observers to single out VC as an effective engine of growth and thus worthy of political attention[1].

This paper relies on the argument that any conclusions as regards desirable policies for growth should take into account that a convincing theory of growth must necessarily be based on the notion of entrepreneurship (Baumol 1990; Boettke and Coyne 2003). To be precise, on how entrepreneurs react to institutional incentives. The analysis of the various kinds of entrepreneurial actions and of their impact on growth will then shed light on the nature of the interaction between entrepreneurs (founders) and other agents, including a special category of funders, i.e. the venture capitalists. The rest of the paper is then structured as follows. In the next section, we discuss the various roles of the entrepreneur. This discussion is followed by a detailed analysis of the role of venture capitalists. We then draw some conclusions regarding the role of policy making (section 4) and the dynamics of growth (section 5). Section 6 sums up the main results and concludes.

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[1] This is noted, for example, by Zingales (2000) and Garicano (2000). See also Gompers and Lerner (1999) for more details on the contribution of venture capital to growth.

2. The different roles of the entrepreneur

Contrary to common belief, it is here maintained that entrepreneurial abilities at the core are not a function of the institutional framework. Human beings always strive to improve their well-being. Longing to be better off is a typical trait of human nature and does not depend on the rules of the game, geography, culture or history[2]. Entrepreneurship is thus the propensity of each individual to improve his condition by exploiting his knowledge and/or by trying to acquire new knowledge and make a profit[3]; to take risk factors into account and act accordingly. Of course, this is not the same as saying that everybody is equally endowed with entrepreneurship. Individuals do present different talents and preferences. It does mean, however, that the distribution of talents – if not preferences – is random: it does not follow race, religion, geographic location, political regime.

The entrepreneur's contribution to the economic growth of a community amounts to his ability of doing something new that consumers appreciate, or doing something already known but in a cheaper way. Acquiring and using knowledge to start a new economic activity is what entrepreneurship is about. Hence, the entrepreneur is not necessarily an innovator, nor does he necessarily conceive new ideas. But he definitely bets on new ideas and takes the necessary organizational steps so that those ideas can be transformed into profitable opportunities[4]. In some cases this engagement benefits both the economic actor and the community. If so, economic growth takes place. In other cases all the benefits are internalized: the advantages are thus restricted

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[2] See Mises (1949). This applies even to those individuals who pretend not to be interested in their own well-being. For they are actually considering their chances to improve their welfare in a future life, possibly for eternity. Or may just have a strong preference for immaterial goods, as opposed to material consumption.

[3] According to this definition, consumers are not entrepreneurs. They do use their knowledge and skills in order to enhance their well-being. But they do seek profit through the sale of products or services. Honest politicians are not entrepreneurs, either; since they are supposed to make rules in the public interest, not in their own.

[4] See Boettke and Coyne (2003) for the difference between this entrepreneur and Schumpeter's or Kirzner's.

to the actor. This applies to the rather theoretical cases of the introduction of new products by a seller who is able to apply perfect price discrimination. It also applies to the much more frequent situations where individuals protect their property from external aggression. Negative externalities emerge, too. If so, entrepreneurship actually leads to losses of welfare for the rest of society. Examples are tax avoidance, rent-seeking or even criminal behavior.

As noted earlier, entrepreneurial abilities at the core are not a function of institutions and political regimes. But individuals do react to the institutional environment where they operate, including culture. And apply their entrepreneurial talents in different ways and to different degrees following the external stimuli and their own inclinations, emotions, ideologies. As will be detailed in the next paragraphs, this allows to explain growth episodes, opportunities, observed behavioral patterns as a function of the diverse classes of institutional incentives[5].

Baumol (1990) observed that entrepreneurs' efforts could be employed in different directions. Not all of them follow the productive opportunities that are commonly attributed to entrepreneurs, as a result of which buyers have access to new and/or cheaper goods[6]. Instead, one may observe destructive activities that deprive others from the ability to choose (or increase the cost of choosing). That is typically the case for protectionism, regulation and, more generally, rent-seeking. Similarly, defensive entrepreneurship may be applied, so as to protect property from legalized or criminal intrusion.

How these efforts are allocated at a given time depends on the reward structure of the economy[7]. In particular one may expect that productive entrepreneurship will

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[5] Although their importance can hardly be overestimated, ideological and cultural issues will not be central to the discussion developed in these pages.

[6] The notion of constructive/productive entrepreneurship also includes the activities of those who try to destroy rent-seeking situations. For instance lobbying to introduce tariff barriers is an act of destructive entrepreneurship (see the text). Whereas lobbying in order to remove tariff barriers or normative constraints to the freedom of contract is an act of productive entrepreneurship.

[7] Baumol (1990) brings historical evidence from ancient Rome, China, the Middle Ages and the Renaissance. In his analysis the nature of the entrepreneurs' activity changes from one period to another and suggests that during certain periods entrepreneurial efforts were directed towards unproductive activities. In contrast we view the entrepreneur as acting in simultaneous roles: for instance, as output generating and as wealth protecting.

flourish when institutions conform with and protect the principles of economic freedom – freedom from coercion, private property rights, freedom of contract[8]. While under different circumstances entrepreneurship will be directed towards other goals. It will reveal destructive features if rent-seeking opportunities seem relatively promising, or if law enforcement is weak. And it will bring to light defensive elements whenever economic freedom is jeopardized, either by other individuals or by state organizations.

Surely, reality is never as clearly cut as theory sometimes represents it. Indeed, even when entrepreneurs develop productive efforts, destructive and defensive ingredients are present at the same time. In particular, for the purpose of the following pages two features need to be emphasized. First, all productive entrepreneurs must necessarily engage at the same time also in some kind of defensive activities. In advanced economies they are usually needed in order to protect the rewards of productive activities from expropriation. Even an ideal free-market system requires that energy be spent on preserving freedom from potential rent-seeking coalitions. Put differently, what observers usually define as entrepreneurship is in fact a mix of different entrepreneurial features, the composition of which depends on current institutional elements and expectations about institutional evolution.

This may shed some new light on what is usually called the culture of entrepreneurship. By and large, much of the institutional literature maintains that productive entrepreneurship tends to be a cultural element, based upon the ethics of property and the notion of self-responsibility (Pejovich 2005). In short, entrepreneurial cultures are characterized by individuals who believe that wealth can be legitimately appropriated through voluntary exchange or by making use of resources not previously homesteaded by others. And by the shared belief that agents deserve to be rewarded for their contribution to somebody else's welfare, but should also bear the cost of the damage inflicted, if any. This traditional view would explain – among other things –

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[8] Historical research shows that any prolonged period of instability and uncertainty hinders economic growth. Similarly weak safeguards to secure property rights also reduce economic growth. Such events are usually framed in terms of economic intervention by taxation and regulation of national governments and by the legal system that they chose to employ. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997). As Glaeser and Shleifer (2003) noted, the degree of enforcement of existing laws as well as the actual use of regulation are also important. Laffont (2000) also supports that view.

why some countries find it difficult to grow: even if previous distorted institutional constraints are no longer in place. When entrepreneurial culture is absent or changes very slowly a key prerequisite for growth is missing.

What argued in this paper does not deny the importance of the cultural elements outlined above. Still, it is here maintained that by focusing on the entrepreneurial choices all individuals face on almost a daily basis – production, destruction, defense – the emphasis shifts from the cultural element to the returns to given entrepreneurial attitudes. If accepted, this conceptual repositioning implies that individual attitudes might well depend on genetic traits as described in terms of tradition and culture. But they might also depend – and perhaps to an even larger extent – on expectations for the future.

For instance, uncertainty and fears about discretionary power lead to a mix dominated by destructive and defensive entrepreneurship. On the other hand, a stable and predictable institutional framework encourages productive efforts. As will be examined later, and contrary to much of the mainstream literature, reputation and credibility are relevant both in a world of security and in one of uncertainty. Thus, there is no such thing as a culture of credibility as commonly debated. What is relevant, instead, is to assess to whom and under which conditions credibility is directed in the first place and which counterparts would be privileged under pressure. In a word, the entrepreneurial mix becomes a function of institutional expectations; and cooperation a function of priorities in reputation[9].

The size of the firm

While the entrepreneur conceives his strategy following his institutional predictions, he also undertakes a number of operational steps: For although productive entrepreneurship is indeed the engine of growth, engines do not operate in a vacuum.

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[9] Colombatto (2003) has argued that one may also observe endogenous institutional changes so as to enhance protection for business owners and commercial entrepreneurs. The basic idea is that institutional choices are not only handed down by government and that they can also be created from below by a structured response to outside pressures. Form a different standpoint, Wittman (1989) already argued that in a democracy economically efficient institutions are the outcome of a continuous competitive political process. Nevertheless, unless stated otherwise institutions are assumed to be exogenous for the remaining part of this paper.

The size of the firm and organizational structures matter, too[10]. Choices in this area can affect the outcome of the efforts. And when they have been made and are at least partially irreversible[11], they can affect the balance among the various economic allocations of talent. For example, in a context where labor-market regulation increases with the size of the firm and flexibility matters, entrepreneurs are likely to stay away from vertical integration. Similarly, if tax evasion is "the name of the game", then small firms are definitely more effective than large companies. If rent-seeking is more relevant, then large companies are going to be effective on a national or supranational scale, but small and medium size operators may have an easier time with local, small-budget administrations.

More generally, it may well be that technological conditions suggest organizational structures that are actually desirable in a free world, but that are no longer such when freedom of contact is violated or distorted. Of course, this is not the same as introducing transaction costs into a neoclassical production function (see for instance Williamson 1981). Instead, it suggests that individuals often face a trade off, between transaction costs of a technical nature and transaction costs of an institutional nature. And that one may choose to incur higher costs in (technical) production in order to reduce institutional transaction costs. Furthermore, one may also choose to engage in unproductive activities in order to make productive efforts profitable, as mentioned earlier on in the text. By withholding scarce resources – entrepreneurship – the producer is once again inefficient *stricto sensu*. But not necessarily irrational or wrong.

Put differently, entrepreneurship within a highly regulated and rather unpredictable institutional framework is a complex phenomenon, where the choice of the best way to take advantage of human talents is not just a question of technical skills and research, resources or abilities. Organization, company structure, allocation of entrepreneurial talents among various productive and unproductive uses all depend on

[10] To be precise, once expectations are taken into account, the individual behaves according to his preferences, to his current situation, to his talents. And that applies both to the decision on whether to undertake entrepreneurial activities and, subsequently, to the entrepreneurial mix. But although innovation is possible in this domain as well, his choices are more limited when it comes to selecting the means through which the chosen ends are pursued.

[11] For instance, that applies to the case of an inherited firm characterized by substantial assets specificity.

the prevailing and expected rules of the game. True enough, the above paragraphs call attention to a possible new institutional loop[12], which has remained to a large extent ignored until now. This loop concerns the returns to entrepreneurship – in its various forms – as a function of expected institutions on the one hand, and of the trade off between technical and organization efficiency on the other.

As argued in the previous paragraphs, expected institutions provide incentives as for the entrepreneurial choices individuals undertake. At the same time, the organizational structure that enhances a given kind of entrepreneurship is not necessarily suitable to carry out the intended activities. For instance, it may well be that an agent opts to engage in productive entrepreneurship because he believes he has the technical abilities and knowledge to be successful and because he also believes that future institutions will be neutral and strong enough to guarantee his property rights. Still, suppose that his breakthrough technology allows to profit from large economies of scale only when production volumes are high. And suppose that regulation increases operational costs for large companies. If so, two scenarios may apply. One is characterized by potential productive entrepreneurs that direct their efforts towards defensive activities despite their technical skills. Another generates the loop and consists of the actions undertaken in order to change regulation. In particular, a community can end up with a growth-promoting loop, if institutions protect property rights, but are ill suited to accommodate technological requirements. For in this case pressure will build up to deregulate and enhance economic freedom. But if property rights are vulnerable the loop can also generate a perverted mechanism, whereby destructive efforts further discourage productive entrepreneurship and justify at most renewed defensive activities.

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[12] See Hodgson (1988) for a description of the traditional institutional loop, whereby human action is shaped by institutions, which are in turn affected by men's endeavors to change the rules of the game to their own advantage.

3. The different roles of a venture capitalist

Venture capitalists are loosely defined here as stockholders with a substantial share of equity in the companies where they are present. They pick potential winners, rather than manage promising companies[13]. Therefore, although they share ownership with the incumbent stockholders (the founders), they do not usually engage in daily management. This also implies that VCs are usually more effective in appreciating a chance given the current state of the industry, rather than following the dynamics of the company within the industry, evaluating potential challenges, elaborating marketing or productive strategies. Put differently, VCs are willing to run the risk when there is a chance to make a breakthrough, but are much less inclined to take chances when the quasi rents are eroded by imitation and competition at large. The contrast between funders and founders in this area is striking and very important[14]. As a result VCs operate on a relatively short-term basis and since they raise their capital from risk-loving investors that expect high returns, investment tends to concentrate in high-tech sectors.

As regards size, large companies usually undergo much slower change. Moreover, acquiring control would oblige each VC to concentrate his resources into a very small number of firms, thereby increasing the risk of failure. That is why VCs are interested in supporting either young companies, or existing small-size companies undergoing substantial change, from a sectorial or dimensional perspective. Each venture capitalist follows some eight, nine companies at the same time, which allows him to attend periodical, non-technical meetings with the management, study the reports and occasionally sit on the board of directors. As mentioned earlier, the cost and the effectiveness of monitoring are crucial (Gompers 1995): VCs know that most companies they are involved in will not produce the expected results. In fact, the difference between a good and a bad VC ensues both from his ability to select potential

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[13] Being pickers, startups are not expected to rank very high in VCs preferences.

[14] This is at least partially at variance with the literature according to which VCs are more prone to risk than the founders. Instead, in this paper the emphasis is on the object and timing of risk.

winners and from his talent to drop losers before too much money has been disbursed[15]. As a result, the ideal partnership between a VC and a founder is often a situation where competitive pressures reduce the cost of monitoring the investment.

In addition, a VC would hope that returns be substantial in the short run; and that the investment be fairly 'liquid'. This happens, for example, if the industry is characterized by the presence of a few large companies that do not develop innovative activities. Therefore, they are eager to compete for, and buy out, small- and medium size successful innovators, with easy-to-patent technology[16]. Of course, this requires that the personal role of the founders be limited, to make sure that the value can be transferred with the company, rather than with the founders. In short, the ideal partners of a venture capitalist are capitalist technocrats that would manage the new firm in a "glasshouse" under competitive pressure. In this context VCs risk their resources along with the technocrats, but are in effective control when it comes to the strategic decisions, and do not meet resistance when an opportunity of going public arises.

Clearly, this ideal picture fails to match reality. For it would include neither founder-capitalists, nor entrepreneurs in the true sense of the word. Indeed, the peculiar nature of venture capitalism is such that these agents come into the picture only after some funding has already taken place. That is, the funders are invited to join the firm after entrepreneurial spirits have emerged and – in most cases – after such spirits are already in action. Put differently, the very conditions that make venture capitalism possible are those that ensure that venture capitalists will never operate under what they perceive as ideal conditions.

Surely, founders appreciate venture capitalists (the 'funders'), since they provide needed capital and contribute by reducing the costs of risk. Unlike banks, they do not require collateral, and unlike public providers of equity funds they do not force the founders to disclose their plans to a wide public (including potential competitors), not to

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[15] VC financing usually takes place in rounds. At each rounds results are evaluated and strategies reassessed, if needed. In extreme – but not infrequent – cases financial support is discontinued.

[16] The literature emphasizes the negative correlation between agency costs and venture capital. Agency costs are higher when assessing intangibles. That explains why VCs are indeed attracted by high-tech venture, but remain eager to leave quickly. Easy-to-patent technology is an exception, for in this case intangibles are made "transparent", their value can be assessed and enter into market transactions.

mention the cost of being quoted on a public stock exchange. In addition, VCs usually offer an extensive network of contacts, which in many cases represents a much welcome contribution to the marketing opportunities of the founders. Finally, and perhaps even more important, venture capitalists fulfill an important signaling function. Most recently-born companies, especially if started by a limited number of entrepreneurs with limited financial resources and modest access to the public, find it difficult to persuade potential customers of intermediate-consumption goods about the quality of their products. Under such circumstances the presence of VCs certifies the producer[17].

On the other hand, venture capitalists might also turn out to be a burden, for their short-run maximization goals sometimes contrast with the strategies of the founders, once unforeseen events come to the surface. In a perfect world short-run and long-run horizons should command the same business policies, since long-run expected results would be incorporated in current stock prices. In other words, if all the entrepreneurial elements included in a company are of a productive nature, if propensity to risk-taking is roughly the same for venture capitalists and founders and if tax regimes do not discriminate according to time profiles, then venture capitalists and founders tend to behave similarly. The potential for conflict would thus be limited and VCs should be all over the place. Still, things look different if the institutional framework provides incentives to engage in defensive entrepreneurship. In that case the role of personal relations and informal routines can become very important.

As an example, when it comes to small and medium-size companies, some destructive activities are transparent and usually of minor importance, like acquiring the subsidies that the company managers succeed in extracting from the local governments. Their value is rather easy to assess and are unlikely to lead to disagreements between funders and founders. On the other hand, defensive activities are more frequent, for they are based on personal connections, widespread risk-sharing, common interests, conniving and are reflected in flexible bookkeeping.

These defensive practices suit small companies where managers are few, often times close relatives to each other or at least long-time friends. Under such

[17] See also Gompers (1995, p.1403), Cable and Shane (1997, p.171), Hellmann and Puri (2000, p. 960).

circumstances company loyalty and personal loyalty are one. Venture capitalists are still an attractive possibility for the founders (and vice versa) if they are friends or relatives. Otherwise tensions are likely to surface, as transparency needs to be replaced by trust, formal procedures by informal dealings, asset specificity increases.

To conclude, outsiders feel uneasy, as they remain unwilling to invest in enterprises that might be profitable, but require substantial investments in the enforcement of informal contacts[18]. As a result, they tend to react by imposing excessive constraints on the founders. In a nutshell, when destructive and defensive entrepreneurships play an important and enduring role, venture capitalists and founders are unlikely to bring alive a smooth partnership. Other solutions tend to be preferred: personal or family funds, bank loans guaranteed by personal assets, funding partners that become founders themselves.

Cable and Shane (1997) argue that venture capitalism is not about a principal-agent relationship, but a question of cooperation. And that it comes to an end when cooperation is no longer possible. We argue that it revolves around a rather explicit contract, where the relationship between funders and founders is not hierarchical. Thus, it does not break down when the principal-agent contract is badly specified. We claim that VC is feasible as a contributing agent when formal contracts based on shared goals are satisfactory enough. And that it is not suitable when informal contracts become more important. Informal contract are reliable when they are the result of repeated interaction over a long period of time among individuals that share the same time horizons and the same structure of accountability.

4. Company dynamics

As aired earlier, the complexity of the relationship between VC funders and the original founders, which ultimately defines to what extent their roles are compatible, depends

[18] The focus of the academic literature on this subject has been the design of optimal contracts that would reduce conflicts of interests between VCs and entrepreneurs. For a recent survey see Hart (2001). Kaplan and Strömberg (2004) provide the support of empirical evidence by analyzing such contracts.

heavily upon the institutional context, which provides incentives as for the mix of entrepreneurial activities to be undertaken. Hence, it identifies the counterpart of a potential VC funder. This section deals with three features that contribute to characterize the institutional environment – property rights, freedom of contract, competition. Each topic will then be evaluated in order to assess how the role of VCs is affected, to what extent the presence of VCs is necessary, how companies are likely to evolve.

Property rights

Obviously enough, life would be physically impossible if all rights to appropriate goods and services were denied. For instance, humans could not breathe, for they would have no rights to appropriate the air. Indeed, nobody would question that property rights are crucial for any economic activity to take place. Not even the advocates of central planning, who are ready to concede that property rights are in the hand of the central decision-maker, be an individual dictator or a Central Committee. Rather, the debate today regards to what extent property rights should be private and to what extent an external authority – call it government – is entitled to expropriate the individual and either transform private ownership into collective property, or transfer property from one agent to another.

Be as it may, the incentives to undertake constructive entrepreneurial activities are likely to be weak wherever private property rights are not enforced. As a matter of fact, in most cases the real issue is not the weakness of property rights, but the principles underlying their assignments, their protection and the incentive structure that those principles imply. Property rights may be clearly defined, but they are of little relevance if they can frequently be altered by the authority. Similarly, economic activity is likely to be discouraged if in order to acquire property, a share of it must be paid out to somebody else. The fact that such a share is known in advance with certainty and remains constant does not make the situation much better. For instance, in many modern societies personal income taxation means that the property rights on a variable fraction of the labour which enters a monetary transaction are legally assigned to the policy-

makers. Moreover, the policy-maker has a legal monopoly on violence in order to enforce his property rights or even expand them, if he wishes to do so.

The distinction between enforcement and assignment is of some consequence. For when enforcement is weak, entrepreneurship is likely to be defensive or devoted to endeavors characterized by short-term-bandit features (Olson, 1993). In these cases most efforts are devoted to protect what one has from outside aggression, or to become aggressors. Establishing legitimate ownership does not pay and violence is the name of the game. On the other hand, when enforcement is credible, but assignment is discretionary, peaceful, destructive entrepreneurial activities are encouraged. Rent-seeking games in the political arena are the obvious examples.

As regards VCs, one may thus conclude that when property rights are not enforced, non-defensive activities are restricted to short-term initiatives that do not generally involve violent encroachment. It would not be worth it. In other words, activities take place within a restricted geographical domain, where they enjoy some recognition by local communities. Profits are hardly visible and usually take the form of self-consumption. Financing entrepreneurship is not frequent and is restricted to insiders. Surely, venture capital is not an option[19].

On the other hand, when rights are enforced, but private property is not accepted as a matter of course, destructive activities (rent-seeking) tend to prevail. Venture capitalists may be present, as long as property rights re-assignments take place at (long) intervals, i.e. as long as the rules of the game are clear, can hardly be dodged and are not revised too frequently. Under such circumstances it is likely that rent-seeking occurs at a national level, rather than with local administrations. Thus, in large countries destructive entrepreneurship is interesting for large-size companies that stand a chance of internalizing a significant share of their rent-seeking efforts. While constructive entrepreneurship will be significant among small and medium-size companies – where VCs prefer to invest, as argued earlier on.

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[19] This indeed consistent with what observed in Opper (2005), who notes that the success of transition in the former Soviet-bloc countries does not depend on the quality of institutions (assignment), but rather on the degree to which they can be put into effect (enforcement).

Freedom of contract

The analysis of freedom of contract is in fact the economics of regulation. Restrictions on the freedom of contracting generate two sets of consequences. They reduce efficiency and productivity, so that living standards are bound to drop below their free-market levels. Furthermore, they provide incentives to concentrate productive (and entrepreneurial) efforts in those trades where formal contracts play a lesser role. Company size and industry matter, of course. For instance, *ceteris paribus,* a baker shop under certain conditions is likely to be more attractive than a textile plant. Contrary to the case of the textile plant, foreign competitors are unlikely to ship their bread and displace local inefficient producer. And a small bakery can dodge regulation much more easily than a large, bread-manufacturing plant.

The loss of efficiency provoked by regulation is of little importance to the local producers. They may even view it as protective. As long as such producers are engaged in protective industries they will benefit from regulation as a consequence[20]. Such producers will also pay little attention to overall living standards. Rather, they will consider the rewards to evasive and unproductive entrepreneurship. And they might be substantial.

Not surprisingly, a successful incumbent will devote at least part of his efforts to raising barriers against competitors. But he will also try either to collude with the policy-maker, so as to restrain the latter's exercise of violence and maximize his long-run rents; or to reduce the scope of the policy-maker's discretionary power. Of course, the names of the game are unproductive and evasive entrepreneurship, respectively.

Venture capitalists are not necessarily deterred by such an institutional environment as long as transparency is satisfactory and the rules are enforced consistently, so that monitoring costs do not become prohibitive. It is however important to observe that the demand for VC funders is likely to be modest. As emphasized earlier on, within a regulated environment profits are in fact established

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[20] It is hardly worth pointing out that it makes little sense to claim that regulation affects competitiveness. Since competitiveness is a relative notion, a region will always have a comparative advantage in a set of industries and a comparative disadvantage in another set of industries. Instead, regulation affects physical productivity. But what matters for the single producer is whether restraints on the freedom of contract increase or reduce his quasi rent.

rents guaranteed by normative barriers to entry. Thus, opportunities to make additional profits concern incumbents that might have dissipated the rent through bad management, rather than newcomers that compete for market shares and possibly displace obsolete or inefficient producers. Venture capitalists will therefore be eager to provide financing to companies that had been poorly-managed and where the incumbent management has been recently replaced or where it can be easily replaced. Then, the VC profit would amount to the previously dissipated normative rent. Still, why should founders need venture capitalists to get rid of the bad management and replace it with new staff? In fact, they don't. That explains why VCs are not numerous in highly regulated economies.

Of course, one cannot rule out the possibility of changing the rules of the game by introducing new limitations or by removing those in place. Still, these scenarios would be hardly attractive for a typical venture capitalist. Helping a newcomer to force its way in by suffering significant entry costs is viable only if the newcomer is flexible enough to play around with the rules, which entails low transparency and considerable asset specificity. While attempts to modify the normative context often turns out to be a lengthy process suitable for relatively large companies. And it is well-known fact that VCs are not inclined to support established large companies over long periods of time.

Competition

When venture capitalists intervene to support an existing producer, their role is to make sure that the target company changes its features, sometimes by increasing its size, more frequently by moving to new segments with new products and possibly a new image, too. That is why venture capitalists concentrate on financing small-size entrants. The main reason is that venture partners are themselves capitalists with a propensity to engage in entrepreneurial activities. Moreover, and unlike investors in listed companies, they are ready to take the risk of not finding a buyer for their shares should they decide to quit. But they expect to be remunerated accordingly. And in order to solve the asymmetric-information problem they expect to be able to carry out close supervision. That is why they shy away from established large enterprises, which would require significant investments to acquire control, reduce the possibility of spreading

risks and entail substantial monitoring costs. In the end, the remuneration of their entrepreneurial spirits would also shrink.

Contrary to common beliefs, a competitive industry is not one featuring a large number of relatively small companies, none of them enjoying market power. The intensity of competition and firm size are not necessarily correlated. And venture capitalism is only one among the options available to entrants.

Although it has inspired considerable anti-trust legislation and has sometimes proven suitable to satisfy demagogy (envy), the standard neoclassical approach to competition is a poor instrument to represent and understand human economic behaviour and the role of venture capitalists. When engaging in economic activities, human beings always try to maximize their own surplus, that is, to maximize the difference between the satisfaction and the costs associated to a transaction. Clearly, when it comes to producers, costs are a question of technology and efficiency, whereas buyers evaluate satisfaction. The surplus is in fact a quasi rent that can vanish either because costs increase, or because buyers reduce their appreciation of the good offered to them and move to other suppliers.

In this light, counting producers does not contribute much to understanding the economics of competition. A competitive industry is one where anybody is free to enter the exchange system, and find new ways to satisfy buyers... As a consequence, successful entrants create new quasi-rents, sometimes in addition to those already existing, sometimes replacing them. Clearly, since it makes little sense to assess the optimal size of a transaction, it also makes little sense to establish *a priori* how big a company should be or how many companies should operate in a given market. Instead, the key notion is that all participants enjoy non-negative rents; otherwise nobody would engage in economic activities. And that in a competitive market these quasi rents can vanish as a result of the action of new successful competitors[21].

Venture capitalists are not always the obvious partners to new entrants - neither in competitive markets, nor in a regulated world. In the former case success may take

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[21] Of course, a quasi rent can be transformed into a rent by means of the introduction of regulation and legal barriers to entry, so that newcomers are at a disadvantage with respect to incumbents. When this occurs, the rules of competition are violated.

years before materializing. It would not be easy find venture capitalists ready to engage in long-run projects. As mentioned earlier on, venture capitalists tend to specialize in short-run, high-income projects, where weak supervision can be replaced by market monitoring as described in the balance sheets[22]. In particular, venture capitalists are interested in the creation of the quasi rent, but do not want take the risk of seeing their quasi rent eroded by competitive pressure.

The above discussion leads to conclude that venture capitalists in a competitive framework are suitable partners when it comes to small companies engaged in developing new products with rather familiar technologies, or new technologies or high-tech products that can be sold fairly rapidly to established companies. This may well be the case in areas where economic freedom is substantial; but definitely not in economies where the remuneration of risk-taking is dwarfed and/or there exists an institutional bias against large companies[23]. True enough, globalization allows venture capitalists to develop their efforts in one country and then close operations by selling to buyers located elsewhere. This is typically the case in high-tech industries where the main output is not a good, but the know-how. Still, one may doubt whether in regulated countries productive entrepreneurship is devoted to high-tech projects.

On the other hand, traditional venture capitalists have very little scope in non-competitive markets, where unproductive entrepreneurship plays the key function of transforming a quasi rent into a normative rent. On the one hand, the previous comments on the unsuitable role of a venture capitalist when dealing with unproductive entrepreneurship apply. Furthermore, it is worth observing that normative rents are usually embedded in formal systems of rules. But they can also be enforced through informal rules – say through the inexplicitly codified behavior of bureaucrats and regulators at large. While the former can be transferred with a company, the latter are person specific and tend to follow the founder, rather than the funder.

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[22] It is clear that the accounts do not discount future expected income streams; nor are small and medium-size companies attractive targets for outside monitoring.

[23] It may be worth pointing out that one can indeed have a competitive market within a regulated economy as long as entry is not legally constrained.

Preliminary conclusions

The previous paragraphs suggest that venture capitalism is just one among the various possibilities of transforming Kirznerian founders into successful producers of goods and services. The appeal of this form of financing depends on many variables that can, however, be summarized by referring to the institutional features of the market within which entrepreneurs operate. In particular, institutions provide incentives to develop various forms of entrepreneurship and to apply entrepreneurial skills to fitting structures of governance, which in turn may be more or less appropriate to the various industries.

Clearly, venture capital tends to be a poor choice when informal rules are at odds with the formal institutional framework; or when productive entrepreneurship does not prevail. New competitors may feel more at ease with bank loans, family governance (and family capital) – they are cheaper and often times based on trust and personal links. If available, they are better alternatives when property rights are violated, freedom of contract and competition restricted. Under such circumstances exchange is no longer impersonal, transaction costs are high and far from transparent. In the end, either the time horizon becomes very short and the outcome depends on the founders' action; or it becomes very long. Both scenarios imply high monitoring costs and are anyway far from the VCs' ideal.

As for growth, we do not deny that venture capitalism is positively correlated with productive entrepreneurship as well as with company dynamics, that is an environment where risk taking is not avoided systematically, where failure is more than a remote and shameful possibility, but that offers also a fertile ground for new ideas to be developed and rewarded, if valuable. Still, it is a case of spurious correlation. For only in a world characterized by economic freedom is productive entrepreneurship motivated, thereby leading to short lived quasi rents for small and medium-size companies and thus to more opportunities for venture capitalists.

5. The dynamics of growth

Growth and structural change

There are no doubts about the very important role of VC funders vis-à-vis promising small and medium-size companies founded and led by devoted entrepreneurs either reluctant to disclose their know-how to a wide public, or engaged in risky undertakings and willing to share the risk with a financial partner during the initial period of growth. Still, not all the companies that are potential candidates for VC partnerships are willing to enter the deal; and vice-versa.

It has been observed that in countries where the institutional environment encourages unproductive entrepreneurship VCs tend to be absent: the cost of monitoring is too high and an exceedingly large share of the company assets is embedded in the founders. Put differently, under such circumstances contracts are necessarily incomplete and the exit costs that VC funders would meet are likely to be exceedingly high. At the same time, founders are less than enthusiastic when required to disclose their rent-seeking and defensive activities, for obvious reasons. Nor are they willing to forego the rent they are aiming at, when they operate within a framework with limited economic freedom.

Despite their role, however, growth without venture capitalists is possible. Founders are almost never short of financial resources, especially when they engage in attractive - i.e. potentially profitable - business ventures. The absence of VCs is however important in two respects. It is a tell-tale sign about the prevailing institutional conditions and the incentives for productive entrepreneurship. In addition, growth without VC might reveal undesirable path-dependence processes.

If companies grow by carrying out substantial destructive and defensive activities financial sources tend to be banks and private funds. Banks are relied upon when founders need to expand on relatively safe grounds, or when they supplement or replace private funds (personal collateral is required to cover the risk). Put differently, the banking sector plays an important role either in order to manage the rent-seeking economy, or to support small, flexible companies that do not disdain dodging regulation, do not care much about competition, solve the private property right

problems by shortening the time horizon, so that long-term investment plans are in fact a sequence of short-term projects.

If so, the economy is likely to develop according to a bimodal structure characterized by a number of large companies engaging in destructive entrepreneurship and large number of small firms. The former are unlikely to expand following a process of domestic acquisitions, for there is not much to buy. But collusion with the banking sector becomes important, possibly more than going public: lack of transparency and of political credibility scares stock-exchange investors to a larger extent than (domestic) bankers. The latter are family funded. They are seldom based on high-tech breakthroughs, for this area is too risky and usually requires considerable investment in R&D. And are unwilling to increase in size: they would be too big and risky for family financing, too little and reticent to obtain support from the banking sector.

In the end, an economy that does without venture capitalism is one where globalization plays a relatively modest role, both because of high barriers to entry and due to the lack of skills in interacting within impersonal frameworks. Growth is then imported from outside, as new technologies are bought or imitated. Product innovation remains attractive, especially if developed by small-size companies that subsequently sell their rights to larger firms. Still, overall growth prospects are going to be constrained by the inability to take risk on a large scale or - more precisely - to share risk and thus allow productive entrepreneurs to pursue their intuitions. In addition, and perhaps more important, countries that fail to create suitable conditions for VCs are likely to be heading towards a management problem. Managers in modern societies are required to run a company, that is to attend a number of routine tasks and to interact with entrepreneurs – innovators and imitators. In particular, successful management means a high capacity to discover entrepreneurial abilities and exploit them. This kind of interaction is typical of the VC story, where managers are required to show entrepreneurship and founders are required to meet managerial constraints. When these stories are erratic, managerial culture suffers and managers tend to become (risk averse) bureaucrats. The consequences can be far reaching and not always easy to redress.

On the instability of growth

The notion whereby human interaction is characterized by different kinds of entrepreneurial attitudes at the same time is of some consequence and may shed a different light on the dynamics of productive entrepreneurship. The latter has usually been considered the logical consequence of a favourable institutional framework, which many scholars find convenient to define as the "rule of law". So far, central to the notion of righteous rules is the idea whereby a group of industrious and long-sighted individuals succeed in preventing short-term bandits from shaping a legal system that would legalize discretionary encroachment upon economic freedom. This view no longer holds, however, if one conceives individuals as agents that always have a choice as for how to use their entrepreneurial talents.

If one follows the new-institutional insights, whereby institutions are endogenous, one can then conceive a theory of the growth cycle based on the prevailing features of entrepreneurship. By and large, one can think of the institutional framework as the result of the expected returns to entrepreneurship. In order for a country with substantial economic freedom to resist pressure in favour of rent-seeking practices, size matters. A large country where economic freedom applies (and in particular where trade is free and unhampered by transaction costs) and where freedom of entry and of exit are expected to guarantee social mobility is likely to enforce private property rights and restrain regulation. Hence, since the expected returns to constructive entrepreneurship exceed those to destructive or defensive entrepreneurship, pressure to violate economic freedom for the sake of rent-seeking is easier to resist. Growth tends to be stable and deviations from the long-run trends dictated by technological progress or individual preferences are random.

On the other hand, small countries will face different scenarios. Unless they have a consolidated experience of close integration into larger economic communities (so that in fact they can no longer be considered "small countries") large companies operating in small countries might be tempted to react to their loss of competitiveness by carrying out destructive entrepreneurship at a local level. More generally, the cumulative nature of innovations implies that early entrepreneurs are likely to try and block the entry of potentials rivals to the market. Early innovators, in general, wish to

obtain a significant head start in the race for market domination. For example, in markets where entrepreneurs compete to create an improved product (the proverbial better mousetrap). The profits of the initial entrepreneur may be drastically reduced, if one of the following entrepreneurs wins a significant market share due to an even better product. Therefore, early innovators would resort to defensive activities, for example, they would seek the protection of the state (e.g. by imposition of licensing requirements). Such defensive tactics may prove fruitful. If there is no second round, the first entrepreneur, who succeeds to block competitors via collusion with the state, may enjoy monopoly profits. Once constructive entrepreneurship shrinks to an ancillary role, growth retains imported features and can be unleashed anew only by random shocks that happen to create new productive leaders on a large-enough scale. When this happens, a new growth cycle can take off.

In short, the presence of venture capitalist is to be considered an effect, rather than a cause. Its presence reflects a relatively healthy economic environment with sustained prospects for growth. When absent, it reflects more modest opportunities, with important exceptions that may fed by the banking sector or by personal resources (especially in the service sector). These outbreaks are however short-lived, either because they are the consequence of rent-seeking activities that sooner or later generate inefficiencies, or because they stem from micro-entrepreneurial successes that seldom create opportunities for further large-scale developments. Of course, this argument does not mean that steady growth is only a matter of size and of the culture in social mobility. Still, we argue that growth is largely determined by the incentive structure that drives entrepreneurial efforts. These incentives are the object of study for the institutional scholar, but are synthetically revealed to the external observer by the role of venture capitalists.

6. Summary and conclusions

Bottazzi and Da Rin (2004) rightly note that European venture capitalists fund less than one third of the projects financed by their American counterparts. Contrary to common

beliefs, however, this does not imply that Europe is lacking entrepreneurship or that free enterprise in Europe is about to die. For in order to reach this conclusion one would require some kind of racial or geographical theory of talents – which would lack any scientific content.

Furthermore, such an analysis would be misleading, as it would divert attention from the relevant issues. Rather, different capitalist practices are just one of the consequences of the deep institutional disparities between – say – Continental Western Europe and the US. Indeed, differences in financing, formal and informal company structures and industrial specialization are the logical responses to diverse incentive structures. By developing Baumol's original insight, this paper has claimed that such responses can be framed and understood according to the features of entrepreneurial efforts. One way or another, individuals that engage in productive efforts always engage in some kind of destructive and/or defensive activity as well. And the presence for venture capitalism depends on the mix of the varieties. Put differently, institutional features affect agents' behaviour, which in turn determines to what extent cooperation with VCs is mutually profitable. Finally, institutional incentives and financing options lead to alternative structure of development and potential feed-back effects upon the institutional context.

This paper has focused on the interaction between venture capitalism and entrepreneurship by providing a testable and falsifiable theory that may form the object of future empirical investigation. More challenging from a speculative viewpoint is however the analysis of the eventual feedback mechanisms, which also lies beyond the scope of this work. Still, one normative clue of some consequence seems to come to the surface at this stage already: Venture capitalism is not the solution to stagnant growth, in Continental Europe or elsewhere. Hence, government policies targeted on VC would be a waste of resources, if not a further set of opportunities to engage in fancy financing practices that further reduce the incentive to take chances, share risk when necessary, and engage in productive-entrepreneurial action.

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