



The more the merrier? Economic freedom and entrepreneurial activity[☆]



Andreas Kuckertz^a, Elisabeth S.C. Berger^{a,*}, Andrew Mpeqa^b

^a University of Hohenheim, Stuttgart, Germany

^b University of Applied Sciences and Arts Northwestern Switzerland FHNW, Basel, Switzerland

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ABSTRACT

The current research addresses the question of how policy makers might design specific components of economic freedom (EF) to most effectively encourage high levels of entrepreneurial activity (EA). Given that entrepreneurship is a multifaceted phenomenon, the study analyzes the effects of four components of EF on EA and relies on fuzzy-set qualitative comparative analysis (fsQCA) to do so. The research collates data from 63 different countries and analyzes EA as it applies to factor-driven, efficiency-driven, and innovation-driven economies. The current research also differentiates between opportunity-driven entrepreneurship and necessity-driven entrepreneurship. The results suggest that the effects of EF vary according to the developmental stage of an economy and the type of EA in question. The results reveal that simplistic explanations implying that high levels of EF trigger high levels of EA regardless of a country's developmental stage are inadequate.

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1. Introduction

Policy makers worldwide seek a platform that can increase levels of entrepreneurship because economists associate entrepreneurship with innovation, employment, and overall economic growth (Wennekers & Thurik, 1999). Hence, institutional influences on the level of entrepreneurship in societies and economies attract the interest of academics and policy makers alike. However, the relationship between those factors and entrepreneurial activity (EA) in a particular country is far from simple. Scholars offer a plethora of explanations with regard to the cognitive and normative pillars of institutions, including concepts that revolve around cultural or societal influences (Kuckertz, Berger, & Allmendinger, 2015; Simón-Moya, Revuelto-Taboada, & Guerrero, 2014). The third pillar according to Scott's (1995) typology is the regulative form.

While acknowledging the relevance of EA, the research community offers little information on how to design regulatory frameworks for economic freedom (EF), or on which component to prioritize to foster EA. The issue is particularly apposite in times of economic crisis when governments are under pressure to introduce reforms to stimulate long-term growth. Some research is noteworthy, including that of Kreft and Sobel (2005), who provide empirical evidence by comparing

the different levels of EF in US states and describe entrepreneurship as the “missing link” between EF and economic growth. Kreft and Sobel's findings suggest entrepreneurship helps to translate the positive effects of EF into successful economic development. On the cross-country level, Nyström (2008) identifies a small government sector, better legal structure, established property rights, and little regulation as components of EF that help increase EA. While the results of Bjørnskov and Foss (2008) support those findings in the context of a small government sector, they cannot identify significant relationships between other forms of EF and EA, an outcome that may relate to the specific form of EA investigated. McMullen, Bagby, and Palich (2008) assert that understanding the impact of EF on EA requires researchers to differentiate between opportunity-driven entrepreneurship (ODE) and necessity-driven entrepreneurship (NDE).

The above-mentioned background gives rise to an interesting puzzle: Why does a clear theoretical rationale seem to exist for the positive impact of EF on EA, an impact reinforced by several institutions offering a ranking of countries in terms of EF (and therefore suggesting that more freedom should be an unconditional aim of the state), while at the same time the results of the available empirical research are at best mixed? One reason for the theoretical rationale being empirically unsubstantiated may be the failure of researchers to differentiate between ODE and NDE (McMullen et al., 2008). Other reasons for the lack of empirical support might be single country study designs and relatively small sample sizes in cross-country research (Bruton, Ahlstrom, & Li, 2010), which often result in a low explanatory power and therefore demand the application of new methods (Woodside, 2013).

The present study addresses the research gap identified by investigating how economists might design particular components of EF to

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* Corresponding author at: Institute of Marketing and Management, University of Hohenheim, Entrepreneurship (570 C), Wollgrasweg 49, Stuttgart D-70599, Germany.

E-mail address: elisabeth.berger@uni-hohenheim.de (E.S.C. Berger).

encourage high levels of EA. To do so, the current research applies a configurational approach, namely, fuzzy-set qualitative comparative analysis (fsQCA), and incorporates the differentiation between ODE and NDE as well as the categorization of economies based on their developmental stage. The selected approach assumes EF will have very different consequences in the developed world and in less-developed countries. By analyzing data from the Global Entrepreneurship Monitor (Global Entrepreneurship Monitor Consortium, 2013) and the Index of Economic Freedom published by the Heritage Foundation (Miller, Holmes, & Feulner, 2013), the current study offers a unique perspective on the debate on EF and generates reliable results despite using a comparatively small sample.

To achieve its objective, the study proceeds as follows. First, the research examines the relationship between EA, EF, and economic development by reviewing prior literature. Second, the researchers introduce the data and method and illustrate why a configurational approach has the potential to generate novel insights. Next, the paper discusses models resulting from the fsQCA that help to address the research gap. Finally, the research presents the implications of its findings for both academics and policy makers interested in the relationship between EF and EA.

2. The relationship between entrepreneurship, economic freedom, and economic development

A high level of entrepreneurship is a worthy aim because new businesses prompt job creation, innovation, more efficient resource allocation, growth, and welfare. However, not every entrepreneurial action is innovative or very profitable from an economic perspective (Baumol, 1990). Accordingly, merely looking at rates of EA in a country teaches little about the innovative power of EA in that country. A more helpful method differentiates EA according to the motives of the entrepreneur in setting up a business, resulting in the designation of either necessity-driven (NDE) or opportunity-driven entrepreneurship (ODE) (Global Entrepreneurship Monitor Consortium, 2013). The Global Entrepreneurship Monitor (GEM) defines necessity-driven entrepreneurs as people pushed into starting businesses by a lack of employment opportunities and limited sources of income. ODE covers individuals starting a business primarily to pursue an opportunity, a form of entrepreneurship economists generally label innovative, and therefore more valuable than other forms of entrepreneurship (Global Entrepreneurship Monitor Consortium, 2013).

The institutional environment can either foster or hinder the discovery and exploitation of EA, and as a result policy makers seek to create an environment that nurtures EA. According to institutional theory, cultural, societal, and regulative influences create the framework supporting the establishment and survival of organizations (North, 1990). Accordingly, policy makers shape the regulative pillar of institutions, for example, through legislation, incentives, and industrial standards. The regulative influences determine the rules of the game or the reward structure of the economy, which ultimately influence entrepreneurial activity and the allocation of resources. Economists refer to the resulting scenario as EF (Minniti, 2008).

In other words, EF can be a subset of the set EA. Institutions can thus provide the EF that can encourage EA. On the other hand, an environment that does not guarantee sufficient freedom of action can impede EA and hence growth (Bjørnskov & Foss, 2008). If institutions succeed in establishing an effective economic structure, the success of businesses depends primarily on the characteristics of the ventures themselves. Accordingly, the level of EF would have a larger explanatory power in terms of EA in countries in the earlier developmental stages, as institutional frameworks in such countries tend to be less efficient (Aidis, Estrin, & Mickiewicz, 2012). In other words, the current research presumes that the relevance of EF to EA decreases as economic development advances. Linking the above argument to the understanding of the

developmental stage of a country influencing the type of entrepreneurship, the current research proposes the following:

The subset of EF explaining the set EA differs according to the type of EA, and the relationship is more pronounced in less-developed economies.

Researchers should not assume EF alone clearly influences EA. Economists would be wise to treat EF as a composite describing the environment for EA that encompasses the rule of law, limited government, regulatory efficiency, and the openness of markets in a given economy (Miller et al., 2013) rather than as a single factor (Carlsson & Lundström, 2002; Kuckertz et al., 2015).

The rule of law refers to the degree to which the law regulates the market. If the rule of law is strong, national law will protect property rights, and doing business will be largely unaffected by corruption. The rule of law contrasts with the rule of man. The former ideally improves predictability and provides stability, thus facilitating EA, whereas the rule of man gives rise to an unstable and unreliable setting where the populace cannot rely on having legal redress if another person or institution breaches their rights. The latter situation is detrimental to entrepreneurial activity (McMullen et al., 2008).

Limited government encompasses the degree to which the government intervenes in the market mechanisms through taxation (fiscal freedom) and consumption and redistribution (government spending) (Bjørnskov & Foss, 2008). Economists associate a high level of fiscal freedom, associated with low government income and low consumption, with a high level of EF. Some arguments point toward a large government sector positively influencing EA, as the presence of EA can contribute to strengthening the rule of law and reducing vulnerability to corruption (Aidis et al., 2012). State support can also stimulate EA. A government might, for example, offer reduced business rates for newly founded ventures, or provide access to expertise, or to seed capital. However, the empirical evidence is that as government size increases, EA seems to reduce dominates the discussion (e.g., Nyström, 2008). Accordingly, higher tax rates reduce ODE for two reasons: First, the individual's desire for wealth aggregation is lower since the reward from EA is lower due to the higher tax rates; second, less private capital is available for ventures, and therefore individuals have fewer opportunities to develop their businesses. Limited government also influences NDE in that more government spending on a social security system eases the pressure on individuals to generate income from employment or self-employment (Aidis et al., 2012).

Regulatory efficiency is a component of EF that embraces the freedom to establish and run a business without excessive interference from the government in the form of regulation (business freedom); the freedom to work where, for as long, and under whatever conditions an individual is happy to accept (labor freedom); and a stable currency as a basis for exchange (monetary freedom). Low regulatory efficiency creates entry costs to entrepreneurship and increases the burden on all businesses, and especially on early-stage EA (Kanniainen & Vesala, 2005). However, even if two countries have the same regulations, the countries might enforce those regulations differently and offer regulators opportunities to benefit from corruption (McMullen et al., 2008). Therefore, regulatory efficiency and the rule of law are closely linked.

Open markets constitute the fourth component of EF as the open market condition affects the free flow of goods and services across borders (trade freedom), the availability of financial capital (financial freedom), and its free flow nationally and internationally (investment freedom) (Miller et al., 2013). Open markets have a positive impact on EA as they create competitive pressure, which stimulates innovation and hence ODE. In addition, the ability to recognize and exploit opportunities internationally—in other words in a larger market—and to access the required capital stimulates ODE. Furthermore, open markets increase the availability of funds for ventures, which further supports EA (McMullen et al., 2008).

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