Financial and Institutional Reforms for an Entrepreneurial Society

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We need to imagine things to make them happen. If you don't imagine, it will never happen.
– Muhammed Yunus, Nobel Peace Prize Laureate

Abstract Mark Sanders, chapter author, discusses David's key role in the advancement in academic thought regarding the creation, promotion, and maintenance of an entrepreneurial society. Highlighting key contributions that David made to the entrepreneurship literature, Sanders details the manner in which this concept has developed. Again, David accounts for much of the inspiration that many researchers cite as they advance this academic cause.

Introduction

In May of 2018 we concluded the Financial and Institutional Reforms for an Entrepreneurial Society (FIRES) project (www.projectfires.eu) in Brussels. David Audretsch was one of the great inspirators for this project and helped us all enormously in making it a success. When he wrote his book about the rise of the Entrepreneurial Society in 2007 (Audretsch, 2007), the term (coined in 1985 by Peter Drucker) stuck with me and ultimately became the major inspiration for this project. At the time it was not immediately clear to me why this concept appealed to me, but in the end it dawned on me. There is a clear relationship between David's concept of the entrepreneurial and Popper's (1945) idea of an open society. In Popper's work the status quo in an open society should always be contestable. Freedom of speech and democracy guarantee an open exchange of ideas. And Popper argued that if we bring all ideas to the debate and weigh them on merit,

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progress is the result. Popper's Open Society has been the rallying cry for liberal democrats around the world to fight the big historicist, closed society ideologies of the twentieth century: Communism and Fascism. Fukuyama (1992) in his End of History and the Last Man declared victory for liberal democracy and the capitalist market economy after the fall of the Berlin Wall. But by his own admission, he cried victory too soon. Perhaps the closed society ideologies of the day had to admit defeat, but it proves more difficult to create and maintain a truly open society. As in politics, so in economics. The entrepreneurial society too, has its enemies. Many of them from within.

The idea of an entrepreneurial economy, first formulated by Schumpeter (1934), underpins the entrepreneurial society that the FIRES project aimed to promote in Europe. Schumpeter (1934) argued that entrepreneurship drives progress in capitalist societies, when everybody can propose an idea, enter a market, challenge the status quo and compete on a level playing field for the favor of the client. But once the entrepreneur becomes the incumbent, his interest no longer lies with maintaining an open system in which his position in turn, can be challenged. As we cannot trust the voters to protect democracy, so we cannot trust the entrepreneurs to maintain an entrepreneurial society. Instead it has to be entrenched in the institutions we build. Like Popper (1945), in FIRES we then asked ourselves: What institutional framework would best support a more open, entrepreneurial society in Europe?

And there are two ways to go about this. One can try to tailor very detailed reform strategies to the heterogeneous local contexts to do justice to Europe's diversity. Or one can focus on what all entrepreneurs need and propose more general and simple solutions. The FIRES-consortium has gone the former route and we developed well-received tailored strategies for three European member states. Tailoring the strategy to local conditions allows you to prioritize and address the bottlenecks in specific entrepreneurial ecosystems to achieve maximum impact for given reform efforts. In this essay, however, I will explore the latter route. And in the spirit of the quote from Yunus above, I will here present three reforms that, although perhaps unconventional, I believe will promote entrepreneurial activity, more or less across the board.

The enemies of the open society are those that stick to tradition, wish to keep people in their position and believe history has a higher purpose that men need to realize. To them, society is closed and there is no doubt or uncertainty about the way ahead. Similarly, the enemies of the entrepreneurial society are those that wish to maintain the economic status quo and suggest that in the end, we can decide the way forward by looking back using algorithms that are essentially closed. The most powerful weapon of these enemies is our collective fear of the unknown. By claiming that the institutions that history has left us with are somehow in accordance with some natural or divine order, they offer stability and predictability. But in the process, these voices close up society and the economy. And there is no room (or need) for entrepreneurship in a closed society.

Popper (1945) instead teaches us that the institutions we have in place are not God given but man-made. They are inherently flawed and should therefore be rethought and improved and in fact, according to Popper (1945), it is our responsibility to do so. Not only as politically active members of society, but also as scientists. Modern scholars hesitate to engage in that debate, as one cannot deduce normative statements from purely positive analysis. There is no regression model or dataset I can offer in support of the reforms I will propose below. Still I firmly believe academics should get engaged in imagining the future. To leave this only to (populist) politicians and pundits is to leave the future in the hands of the enemies of the entrepreneurial society.

What Entrepreneurs need

I will not get entangled in the academic debate on what defines "the" entrepreneur. Scholars have given many definitions and depending on the data they have available will define it as they like. For me, an entrepreneur must be defined by what she does. All agents performing the entrepreneurial function in the economy qualify. And this function is, in essence, to challenge the status quo. A firm owner or self-employed person that does not challenge the status quo, is not an entrepreneur. An employee or unemployed person who does, is. For Kirzner (1973) challenging the status quo meant acting on existing arbitrage opportunities and making a profit by bringing the economy back to short run equilibrium. Say the George Soros type. For Schumpeter (1934) it meant introducing new products, services and methods to capture the profits of incumbent firms or even create entirely new markets, upsetting short run equilibrium. Think of Steve Jobs. Whatever your definition of choice, it is clear that for a person or firm to challenge the status quo, she needs access to resources that often the beneficiaries of that status quo will seek to keep from their challengers. Wherever they succeed in doing so, the entrepreneurial society is dead or dying. In this essay I will therefore zoom in on what I consider three key resources to any entrepreneurial venture: Finance, Labor and Knowledge. The access to these key resources in society is governed by institutions. And I believe these institutions should be reformed to promote entrepreneurial activity.

Entrepreneurs need:

- a secure payment system that allows you to transact, store value and smooth consumption;
- an efficient financial system that allocates sufficient (equity) capital to high-risk experimental early stage activity and allows proven concepts to scale to global markets rapidly;
- a form of social protection that ensures that the basic needs of life for everybody at some minimum level;
- a redistribution system that closes the system by stimulating the creation of wealth but also provides mechanisms to prevent its unproductive accumulation and instead promotes its productive reconstitution:

- that starts with universal access to education and health care;
- culminates in an academic environment that fosters excellent basic research and broad access to knowledge;
- and is completed with an intellectual property system that rewards individuals for the fruits of their effort and creativity but does not exclude others from building on that knowledge or challenging it.

With these basics firmly in place, entrepreneurial talents in any specific cultural context will have every opportunity to succeed. And then I have every confidence that they will, giving shape to a more prosperous and Open, Entrepreneurial Society.

Imagine better finance…

For finance I propose a transition to a system of full reserve banking or alternatively a (return to a) fully publicly backed system of payment and savings services to individuals and companies using modern technology. This will take deposits and transaction money off private banks' balance sheets, effectively decreasing their leverage. More equity in banks, required by both regulation and the market, will then increase their risk absorbing capacity and justifies deregulating them on the asset side of the balance sheet. This would allow banks to return to a role of intermediation (borrow to lend out, originate to hold) with more equity and hence shareholders' skin in the game. Good banks will thrive and attract investors. Bad banks go bust without endangering the system or requiring taxpayer bailouts. This separation of functions will allow and incentivize banks to take more of the right risks, financing real, innovative economic activity, not toxic mortgage backed securities, exotic derivatives and boring government debt.

For the long run one might consider reforming the current monetary system, that has commercial, private banks issue debt obligations serving as the public medium of exchange. As long as private debt circulates as money in society, that debt on the liability side of the banks' balance sheets is subsidized. Banks can thus finance their assets too cheap. To tackle the ensuing moral hazard problem, regulators are forced to monitor and interfere heavily in the capital allocation decisions banks make on the asset side of their balance sheet. And this regulation, by prioritizing security and limiting downside risk, works against a more Entrepreneurial Society. There are many ways in which such a transition can be shaped (Lainà 2015) and the debate in the academic literature is still ongoing (Fontana and Sawyer 2016; Dyson et al. 2016). The FIRES-project did not research this option in great detail, but the appealing feature of such a system is that the money in circulation again becomes a claim on the central bank, whereas commercial banks only intermediate the savings they attract before they can be invested. In the modern economy, however, banks will also be competing against alternative intermediation mechanisms. To survive that competition, banks will have to return to building long term relationships in specialised niches. A more diverse landscape of such smaller, better capitalized and more specialized banks is likely to cater better to the heterogeneous needs of the

Entrepreneurial Society (DeYoung et al. 2015). At the same time as a system it is more resilient to exteral and internal financial shocks. More diversity in the banking sector should then be coupled with more diversity in the financial system at large.

By clearly separating public from private functions, I believe banks can take a bigger role in financing new ventures and SMEs, as they have in the past. The financial crisis has shown the devastating effects of the toxic mix of public guarantees, failing regulation and strong private profit motives. By requiring more equity in banking and investing, we can responsibly allow traditional financial intermediaries to take on more risk and uncertainty, without having to fear they will offload such risks onto tax payers in case things turn bad. When the core of our financial system has been reformed in that way, this will also create a level playing field for the many innovative FinTech ideas. Because some offer innovative solutions in the public infrastructure of payments and savings, whereas others complement the more traditional forms of intermediation, tapping and providing more and more diverse sources and forms of direct and indirect, debt and equity finance. Currently the regulation and supervision of our financial system drives us to a monoculture that fails to serve the entrepreneurial society (Haldane and May 2011; Polzin et al. 2017). More diversity is key. Separating the public infrastructure from private risk taking in intermediation is the way forward for the Entrepreneurial Society in a bank based European financial landscape.

Imagine more secure livelihoods…

For all the heterogeneity that exists among people and countries, there are some things all of us need secured before any other projects can be considered. In the age of abundance most Western societies find themselves in, we can collectively afford these basics many times over. Still, we have organized our labor markets in accordance with Genesis 3:19: "By the sweat of thy brow shalt thou eat". For labor markets a system of universal basic income (UBI) or negative income taxes (NIT) could ensure that all legal residents attain a minimum standard of living that is unconditional. That standard of living can be agreed upon in real terms. That is, it needs to be cost of living adjusted and indexed. A NIT system ensures all individuals above 18 can be sure their basic needs: Health insurance, a decent home, clothes and food, are met. If you earn less than the amount needed to acquire such basics, the tax you pay on that low income should be a negative amount. In other words: the tax authorities pay out a supplement. The effective marginal tax rate on earnings should then be set such that when you earn the minimum wage, the net tax you pay is 0. Above that you start paying positive taxes.

An initiative to put a universal basic income on the European agenda was supported by over 200.000 citizens and in a briefing to the European Parliament support among EU-citizens was reported to be 60+%. Still, the evidence base to support such a radical reform is (naturally) thin. The FIRES-consortium discussed the proposal only considering the proposed transition to a more Entrepreneurial Society. We agree with some critics (e.g. Kay 2017) that the basic income is unlikely to deliver on all the promises its most ardent supporters make. As Kay (2017) puts it: "Either the level of basic income is unacceptably low, or the cost of providing it is unacceptably high". To finance such a scheme the tax burden should be shifted from labor to consumption. This has many additional advantages. To drive the economy in the right direction on energy transition and more circular economy we should consider carbon, energy and virgin resource taxes in addition to an across the board increase in value added taxation. Such taxes do not distort the level playing field among entrepreneurs and drives them to compete on addressing the important challenges the world faces on energy, decarbonization and reducing its dependencies and ecological footprint. In fact, it may well give the many entrepreneurs dying to show the world their innovative solutions to these global challenges the edge they need to compete with the ecologically outdated industrial heritage of the twentieth century. Note that an NIT-system can be tailored to local conditions by setting the parameters of the system to reflect local cultural attitudes and costs of living. What people consider the social minimum and a fair tax schedule differs from place to place. What is common to all around the world is that challenging the status quo should not imply you risk falling below that minimum.

A UBI or NIT scheme, however low, would eliminate (some) necessity entrepreneurship (and employment) and release talent to engage in more fulfilling lifestyle or more productive opportunity driven entrepreneurship. It is an empirical fact that people are willing, all else equal and on average, to accept much lower incomes when self-employed and receiving an inheritance increases the probability of being self-employed substantially (Blanchflower and Oswald 1998). Currently this is partially explained by the fact that self-employed do and employed workers do not compete on wage and labor conditions. Self-employed are therefore forced to accept lower pay and higher risk. But their willingness to do so also suggests that formal employment carries a penalty. Putting a floor in the income distribution for all will then affect formal employment more than it does entrepreneurship. And as an unconditional basic income reduces income volatility and risks that especially more marginal entrepreneurs face, the predicted effect on entrepreneurial activity would be positive (Nooteboom 1987). Scarce empirical evidence on win-for-life lottery winners in Belgium (Peeters and Marx 2006) has shown that even substantial levels of basic income do not significantly affect people's propensity to become entrepreneurs themselves. But the positive effect may well be indirect. Evidence on how this would affect the willingness of employees to join less secure jobs in start-up firms is absent and well-designed field experiments should urgently fill this gap.

The main benefit of a basic income scheme would be to reduce the need to reform current, highly conditional and complex welfare state arrangements to create access for the hard to classify self-employed and freelance workers that are making up a growing share of the modern labor force. When some basic level for a decent living is taken care of as a collective responsibility, unemployment benefits, disability and illness insurance and pension systems go from being essential to being nice-to-have and can arguably be left (more) to private initiative or self-insurance. With some basic income to fall back on, even a(n income) risk averse entrepreneur may not need expensive insurance for temporary involuntary unemployment or illness and compete on merit rather than risk appetite.

Imagine smarter IPR…

For knowledge institutions I propose we reform the system of intellectual property rights protection. The problem with the current system is that legal ownership to knowledge is awarded exclusively to the creator of the knowledge. This ignores the crucial importance of actually making the knowledge useful in practice. That is, it denies the importance of entrepreneurship and favors the inventor over the innovator. That is not a problem if inventors also innovate. But the modern innovation model rarely operates in that way. From entrepreneurship research we know that the best, most creative inventors are rarely the best and most successful entrepreneurs. A few super-entrepreneurs make the headlines and catch the spotlight. But most successful innovation is a team effort where many people play small but essential parts. In addition, also established firms increasingly choose to spin out and repurchase to develop risky projects at arms length and off the mother company balance sheet. Trying to incentivize knowledge creation by first creating a temporary monopoly and then having the rents from that monopoly reward the inventor fits the "geek tinkering in the garage" model of innovation, but is a roundabout and inefficient way to try and internalize the positive externalities of knowledge creation. Moreover, by entitling the knowledge owner to claim realized profits from commercial products that embody (part of) his knowledge ex post, we put a risk on entrepreneurship and commercialization that should not be there. Direct subsidization of knowledge creation combined with an open source patent that needs to be cited but need not be bought, would come closest to truly internalizing the positive externalities at hand. The marginal social costs of using knowledge that already exists are zero. Efficient allocation then requires that such knowledge is used up to the point where private marginal benefits are zero. Hence the use of knowledge should be priced at 0. It fits the European model to then compensate the knowledge creators with a decent reward from public sources. We do this for arts, where the benefits are much harder to quantify and our largely public universities are perfectly positioned to take on that role. Alternatively, if we want the users/beneficiaries of the knowledge and not the general public to pay for the creation of the knowledge, intellectual property should be priced and marketed as any other good. That is, the creator of the knowledge should be required to not only disclose the knowledge (so others can build on it), but also the price he/she charges for the use of that knowledge ex ante. And maintaining the monopoly rights to the use of some piece of knowledge should be made costly in proportion to the price that is charged. Then if an inventor wants to price a patent or license high, the fee he pays for getting that right awarded should also be high. That way inventors can charge a price that covers their costs and includes a reasonable and healthy return on their investment, whereas potential users (entrepreneurs) can evaluate if the knowledge offers value for money. They then remain full and complete residual claimant to the profits of their venture. As they should be.

With patent registration and holding fees depending on this pre-set licence fee, inventors can charge a fair reward to recover the costs of generating knowledge, while innovators need not worry about unexpected claims on their profits. After paying a fair price for the invention, the residual rents to innovation accrue to the entrepreneur for coming up with a commercial application of the idea. Taking a more extreme position on the issue, some have argued that IPR is simply not the right tool to mobilize resources for knowledge generation and allocation in a knowledge intensive, entrepreneurial economy. They have gone as far as to suggest we abandon the system of patent protection and intellectual property altogether (e.g. Boldrin and Levine 2013; Lobel 2013), as it simply fails to deliver the desired results. Patent protection historically emerged in Medieval Italy and only gradually evolved into the instrument for incentivizing knowledge creation for commercial purposes it is (perceived to be) today. Consequently: "What one is faced with is the mixture or intended and unintended consequences of an undirected historical process on which the varied interests of different parties (some widely separated in time and space) have left an enduring mark." (David 1993, p. 21). Boldrin and Levine (2013) present empirical evidence to support their case, showing strong patent protection is not promoting innovation. In the absence of patents, knowledge generation could alternatively be funded through patronage or procurement (David 1993) and commercialization would be motivated by profit but not by legally enforceable monopoly rents. Such drastic reforms, however, would involve backing out of complex and encompassing treaties and implies withdrawing for example from the WTO altogether. Obviously, such drastic steps would cause large collateral damage. Moreover, due to historical co-evolution and complementarities among interacting institutions, radical institutional reform inevitably spills over in other domains. Patents, and IPR in general are for example also deemed important for entrepreneurs as signals of quality and potential financiers look for IPR in new ventures (e.g. Hsu and Ziedonis 2008) as patents serve as a proxy for innovativeness, quality and give some collateral, where uncertainty reigns. The patent registry serves as a repository of knowledge that tracks the origin of ideas and can be consulted for commercial and policy purposes. And finally, the role of and therefore total abolishment of patent protection would work out very differently in different sectors. In some there is no problem achieving the same results with trade secrets (e.g. software), whereas in others (e.g. medicines), mandatory and highly uncertain certification procedures make it difficult to conceive of efficient alternatives. Given the legal complexities and institutional complementarities I propose a cautious approach of experiments that retain the system's benefits while increasing the free flow of knowledge because the monopoly rents that patent holders can now extract ex post reduce the ex ante private incentives to commercialize and serve as a tax on consumers (Acs and Sanders 2012). Because everybody, not only the buyers of the patented good or service, benefits from the knowledge spillovers that widely diffused knowledge generates (Acs et al. 2012; Braunerhjelm et al. 2010), it is more efficient to incentivize and finance knowledge generation (and documentation) out of general tax revenue. And I would agree with Verspagen (2007) that policy makers in this area must be entrepreneurs themselves. Ready to implement reforms in this general direction, take the risk of failure and learn from their mistakes when that happens.

…it's easy if you try

With the above reforms, entrepreneurs have access to a reliable payment system, fairly priced capital, relevant knowledge at known costs, a skilled labor force and are ensured of the basics in life. That provides a firm foundation for new ventures, allowing them to take economic risks by challenging the status quo in capitalist markets. In open market-capitalism such challenges will then be judged in globalizing markets in fair and open competition. Some will hit the jackpot, many more will fail. But that is how an economy at the global frontier progresses. If entrepreneurs create value to their (global) customers, they will thrive and pay a fair share of their gains to the knowledge creators that enabled them (but who did not do the hard work of finding and bringing the knowledge to the markets at their own risk). If the venture fails, they can easily rebound and try something else without creating large negative externalities on their employees and financiers. Financiers, in turn, are true intermediaries that will charge a fair price for the risks their investees take. And such intermediation may come from traditional banking, innovative forms of finance, including traditional US style venture capital and private equity as well as more novel platform based intermediation methods. Employees are ensured the basic minimum level and can sort into risky, early stage ventures or more established mature employers according to risk preferences and appetites while entrepreneurs and their employees need not fear destitution or stigma from business failure.

The proposed reforms above are particularly suited for European countries. In Europe's bank based financial systems and deeply entrenched social-democratic traditions of well developed welfare states, these reform respect the need and desire to provide for a basic quality of life to all while keeping open the opportunity to rise above the mean. Europe owes it to its history and traditions to try and combine social justice and inclusive security with fair and open competition that rewards real value creation and true merit.

I congratulate David on his 65th birthday and wish he sees his vision realized. To do so we, academics, need to help policy makers to align our institutions across the board to entrench contestability and defeat the enemies of the Entrepreneurial Society in the twenty-first century.

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