Investor protection and business creation

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A B S T R A C T

We study the effects of investor protection on the cost of external finance, entrepreneurship, and creation of new firms in an equilibrium search model of private capital markets. Besides search frictions, we emphasize moral hazard problems that stem from entrepreneurs’ possibilities to expropriate financiers. Investor protection reduces the scope for moral hazard. However, it also constrains the freedom of entrepreneurs to choose projects and to run their own firms. Strengthening investor protection does not therefore always enhance business creation: the results indicate that only when investor protection has a sufficiently large impact on financiers’ monitoring cost relative to entrepreneurial freedom does strengthening investor protection enhance start-up creation. We also find a general equilibrium effect, since search frictions amplify the adverse effect of investor protection on business creation.

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1. Introduction

Becoming an entrepreneur and creating a new firm typically calls for external finance. Especially wealth-constrained entrepreneurs require external finance, because they rarely can afford to cover the costs of entry and other miscellaneous outlays, such as initial working capital, needed to establish a new firm. However, tapping the market for external finance is not easy: both academics and policymakers regard the high cost and unavailability of external capital as crucial impediments to entrepreneurship and small business growth.2

The findings of the influential law and finance literature, initiated by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998), suggests a means to lower the cost of capital and enhance its availability: improving the legal protection of outside financiers should make them less vulnerable to the opportunistic behavior by corporate insiders and hence increase the willingness to pour resources into the smallest companies. This has led to the notion (see, e.g. Beck, Demirgüç-Kunt, Laeven, & Maksimovic, 2006; Rajan & Zingales, 2003) that stronger investor protection stimulates business creation through improved access to external finance.3 What has not been recognized as clearly is that strong investor protection also constrains the freedom of entrepreneurs to run their own firms. Such reduced entrepreneurial freedom can severely discourage entrepreneurship because of its important non-pecuniary benefits, such as opportunities to “be one’s own boss” (Hamilton, 2000; Moskowitz & Vissing-Jørgensen, 2002). This potential trade-off raises the central question of our study: how does investor protection affect entrepreneurship and business creation?

Traditional analyses of public policy on entrepreneurship have not addressed this question, as they focus on the effects of taxation, subsidies, and governmental services such as entrepreneurial training and provision of social insurance, on risk taking and occupational choice (e.g. Black & de Meza, 1997; Boudway, Marchand, & Pestieau, 1991; Poterba, 1989). Some studies, such as Keuschnigg and Nielsen (2003), Inderst and Müller (2004) and Michelacci and Suarez (2004), seek to clarify the effects of public policy measures on venture capital finance and entrepreneurship, but notably do not address investor protection.

Investor protection and decisions of entrepreneurs to go public is considered by Shleifer and Wolfenzon (2002). Following them, we construct an equilibrium model of corporate finance and investor

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protection but, instead of frictionless equity markets and firms going public, we focus on the private equity and debt markets. These markets are typically fragmented and characterized by imperfections (Berger & Udell, 1998), making the search for capital costly and time-consuming. The more significant these search frictions, the more difficult it is to raise external financing for a start-up.4

Search frictions of capital markets are also emphasized in Inderst and Müller (2004) and Michelacci and Suarez (2004). Much as in labor market searches (Mortensen & Pissarides, 1999; Pissarides, 2000), the central problem of capital market search is the creation of cooperating coalitions of entrepreneurs without financial resources and financiers with idle capital. A basic property of the search models is that, when an entrepreneur and a financier meet, they will find a way to exploit gains from trade, if the match surplus is fully transferable and positive. The crux of our model is that besides search frictions, there are contract frictions that constrain the transferable match surplus. They, together with search frictions, hinder business creation.

The contract frictions arise, because closely held firms – which start-ups are almost by definition – tend to be controlled by their few founders who remain the principal owners and managers. After outside financiers have invested in the firm, they, even upon receiving a minority stake in exchange for the finance, are exposed to opportunistic behavior by those in control, i.e. the founder–manager–owners. The ways to transfer value from the firm to them are multitude. Well-known examples include looting (Akerlof & Romer, 1993), tunneling (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000) and self-dealing via selling assets to the firm or buying assets from it at non-market prices (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2005). More straightforward means to expropriate the financiers of small businesses are excessive salaries, unjust payments of bonuses, and outright withdrawals of cash that can be accumulated by settling transactions frequently in cash without a receipt. The fear of such expropriation renders financiers reluctant to fund new business ideas even if they could be certain of their commercial viability.

The various possibilities of investor expropriation can for our purpose be grouped into the problems of interim and ex post moral hazard. Interim moral hazard refers to the entrepreneurs’ opportunities to use funding raised from financiers for some other purpose than the productive investment the funding was granted for. This opportunity to translate corporate assets into private benefits of control instead of investing them productively limits the “pledgeable” income of entrepreneurs (Holmström & Tirole, 1997). Ex post moral hazard is about diverting corporate profits from a productive investment after it has been made (Gale & Hellwig, 1985; Townsend, 1979). As the scope for ex post moral hazard grows, curbing such misbehavior by monitoring and auditing becomes more costly. In our model, interim moral hazard reduces the transferability of match surplus between entrepreneurs and financiers, whereas ex post moral hazard reduces the gross match surplus.

A major function of corporate (and bankruptcy) laws is to constrain the value-reducing forms of opportunism by corporate insiders (Kraakman et al., 2004). Although we do not specify legal details, the laws governing investor protection empower creditors and equity investors to monitor and influence entrepreneurial decision-making both before and after a suspected act of expropriation. The laws thus have two generic effects on the match surplus in our model: the stronger the investor protection, the smaller the entrepreneurs’ private benefits and the lower the monitoring costs. These two effects lead to the trade-off between investor protection and entrepreneurship suggested in recent empirical literature. The reduction in monitoring costs expands the gross match surplus, which encourages entrepreneurship. However, the reduction in the entrepreneur’s private benefits improves transferability of utility by increasing the pledgeable income of entrepreneurs. This diminishes advantages of becoming an entrepreneur, because the threat to expropriate financiers endows entrepreneurs with bargaining power in situations where it would otherwise be weak. This trade-off emerges despite that we consider an economy with a fixed amount of private capital.

The trade-off would also emerge from a model without search but search frictions, besides adding a touch of reality, generate a general equilibrium effect by exacerbating the adverse consequences of strengthened investor protection on entrepreneurship. The effect arises, because the frictions endow financiers with some bargaining power that is further enhanced by stronger investor protection. This reallocation of bargaining power links the private benefits of control and, accordingly, investor protection to the incentives to become an entrepreneur.

Because entrepreneurship is latent in search equilibrium, the effect of investor protection on business creation is not clear a priori and, in particular, the effects of investor protection on (latent) entrepreneurship and business creation are not necessarily equivalent. The creation of a firm requires that a would-be entrepreneur seeks and finds external project finance. When the number of latent entrepreneurs grows without corresponding increase in the supply of capital, the equilibrium stock of idle capital per entrant diminishes. On the one hand, this congestion makes raising external finance harder and may reduce the rate at which new firms are created. On the other hand, the tighter the market for entrepreneurial finance, the faster the scarce capital is recycled. We show that the latter effect dominates so that latent entrepreneurship is directly related to business creation. Thus, what increases latent entrepreneurship also increases the rate of business creation.

Despite our focus on the generic effects of investor protection, we can offer some concrete policy recommendations: If we think that various transparency rules such as accounting, auditing, and disclosure affect ex post moral hazard (monitoring costs) more than interim moral hazard (project choices), our analysis suggests that strengthening such transparency rules might stimulate entrepreneurship and business creation.5 In contrast, a cautious approach is called for with regulations controlling the freedom of entrepreneurs to “be their own bosses” and to choose their projects. Many laws governing minority-shareholder protection such as low thresholds for calling extraordinary shareholders’ meetings, or qualified majority requirements for charter changes and sales of major assets, typically reduce entrepreneurial freedom.6 These rules clearly limit entrepreneurial freedom if applied to small companies. Our analysis suggests that such laws should not be applied to small companies as harshly as to large corporations. These findings are topical, for on-going reforms of corporate laws in several countries nominally seek to rebalance the trade-off between the cost of capital and the freedom of entrepreneurial decision-making.

5 To be sure, mandated disclosure also helps to constrain project choices (interim moral hazard), since it increases possibilities to seize expropriating acts (e.g. via internal corporate governance). Furthermore, the better the transparency, the more difficult it is to enjoy the private benefits of the pet project.
6 Permissible covenant rules and how they can be enforced in the court of law are other concrete examples of creditor protection that reduce corporate insiders’ possibilities to pursue pet projects.

4 We emphasize that while venture capital finance has stolen the headlines, more traditional and passive types of small business finance – such as equity finance from individuals or other firms, loans from commercial banks and finance companies and trade credit – maintain their quantitative importance (see, e.g. Berger & Udell, 1998).
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