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Entrepreneurship and labor market institutions

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Abstract

The paper introduces a model of enterprise formation in a unionized economy with labor protection and wage bargaining. Enterprise formation is subject to market risk and is shaped by the unemployment compensation and redundancy pay to labor in the post-entry stage with firing. Private contracts cannot undo the policy-determined labor market regulation as the insurance elements created by those regulations raise the union bargaining power. This reduces entrepreneurship ex ante. The predictions of the model are tested in cross-section OECD data on 19 economies over 1978–1998. Empirical support is found for the view that enterprise formation is affected by economic risks, unemployment compensation, union power, and labor protection variables.

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1. Introduction

Understanding the determinants of entrepreneurship and enterprise formation is the key to understanding and predicting the future performance of different economies.

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Empirical data indicates that the rate of entrepreneurship differs substantially across OECD countries (Fig. 1). Unfortunately, only a few tentative explanations are available to explain such a finding. Fölster and Trofimov (1997) explain the cross-country differences in entrepreneurship in terms of a political economy equilibrium. A related study by Fehn and Meier (2001) also suggests that the economic performance is linked to the institutional setups on labor and capital markets, intertwined by politoeconomic forces. They derive and test cross-country relationship between different measures of labor market rigidities and of competition in capital markets. Ilmakunnas and Kannianen (2001) find statistical evidence that national macroeconomic risks, social risk insurance, the size of the public sector and differing labor market structures shape enterprise creation across countries. Kannianen and Leppämäki (2000) suggest that labor market institutions, particularly the nature of wage bargaining interact with the entry threshold. Apart from these studies, very little is known of the impact of labor market institutions on enterprise formation. The focus has been rather different, i.e. in the impact of labor market institutions on employment, not on the market entry of firms which create the jobs.

Existing labor market institutions serve a well-understood social purpose. Risk averse individuals with firm-specific human capital need protection in conditions where markets do not provide such an insurance. As shown by Booth (1996), efficient outcome can be obtained in conditions where incumbent workers and firms bargain over wages and redundancy pay simultaneously. The bargaining surplus is maximized and the wage equals the opportunity cost of labor. The political reality has, however, taken a different path and perhaps for good reasons. Several job security provisions were introduced, especially in most Western European countries from the late 1950s through the early 1970s (cf. Emerson, 1988). While such measures cannot have any impact on employment in perfect markets, they do have when markets are not perfect. Analytic work (Lindbeck and Snower, 1987; Bentolila and Bertola, 1990; Bertola, 1990; Risager and Sorensen, 1997) has suggested that job provisions have stabilizing effects in labor

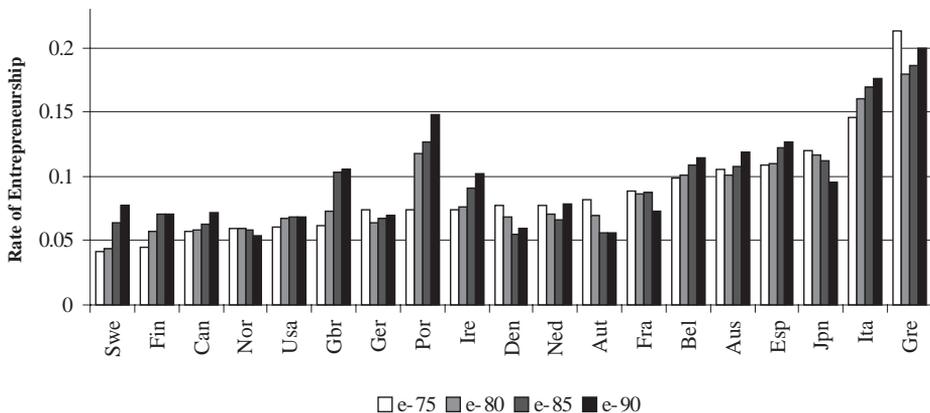


Fig. 1. Development of entrepreneurship in OECD countries.

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