Institutional Determinants of Venture Capital Activity

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Synonyms

Institutional drivers of Venture Capital; Cultural determinants of Venture Capital activity; Laws which favour the Venture Capital industry.

Definition/Description

Venture capital (VC) is a form of private equity financing in which specialised investment companies provide capital to early-stage, high-growth companies with promising business models and innovative ideas, in exchange for an equity stake in those companies, with the aim of achieving significant financial returns upon growth and eventual exit. Like any other economic activity is reputed to be influenced by the institutional context where it takes place. By institutional context, we refer to the set of formal and informal institutions, what North (1990) called the 'institutional matrix': the set of formal rules, laws, on the one hand, and the set of social and cultural norms, unwritten codes of behaviour and conventions, on the other, that characterise a society and shape its economic (and other) activities.

Introduction

The analysis of which formal and informal institutions may have an impact on the ability of an economic system to generate a thriving venture capital industry was addressed along two main lines of enquiry. These two are summarized below.

In search for the institutional roots of the American success

VC was born in the United States (U.S.) after the II World War, i.e. it is an 'American invention'. In the U.S., it has experienced most of its success, while 'replicas' of (or rather, attempts to replicate) the same financing model in other institutional contexts have produced, on the whole and with few exceptions, relatively more modest results, or at any rate results that were not comparable to those consistently achieved by the U.S. Without claiming that this was the sole reason for their extraordinary commercial success, it should suffice to recall here that all of the so-called GAFAM companies (i.e. Google, Amazon, Facebook, Apple and Microsoft), all of which were obviously born in the U.S., were all supported by VCs in their early stages of development.

Accordingly, one line of research sought to investigate what is so special about the U.S. or, given that the VC industry is typically very geographically localised, what is so special about the three U.S. areas where it has historically developed most, namely California, Massachusetts and New York.

This interesting line of research, not necessarily grounded on the institutional field, mostly conducted on a qualitative ground and from an historical or sociological perspective, probably culminates (at the moment of writing) with *VC: An American History* appeared in 2019. In this book the author Tom Nicholas of Harvard University (simplifying) individuates as one of the primary reason for explaining the VC success in the U.S. an affinity for particularly skewed and long-tailed payoffs that distinguishes the American culture and that it is rooted in peculiar historical events occurred there. More specific determinants are advocated towards the VC development in the Silicon Valley rather than other U.S. areas, including the presence of important sources of academic knowledge and the undertaking of large public investments in that specific territory. But these (as well as similar) views, about the ultimate, historically-based and institutionally-related reasons argued to explain the U.S. success in VC are far from being considered definitive (e.g. Korteweg and Sensoy, 2023), since similar features also characterize other geographical areas.

Thus, taking a panoramic view, which also embrace other important contributions in this field, the success of (some areas in) the U.S, appears largely governed by serendipitous dynamics and highly path-dependent processes, in which it is difficult to ascertain beyond doubt what was really important in the early stages.

Empirically-driven inquires on the institutional determinants of VC activity

A second line of enquiry, more grounded in the institutional economics domain, is empirically-driven and largely based on econometric analyses (for a more complete review of this literature, see Grilli et al., 2019).

First looking at the formal institutions, we can say that the legal framework of a country or region sets the stage for venture capital activity by defining the rights and responsibilities of investors and entrepreneurs. A robust legal framework that ensures contract enforceability, protects intellectual property rights, and provides investor protections is found crucial for fostering a conducive environment for venture capital (La Porta et al., 1997). More generally, other regulatory aspects such as tolerant bankruptcy laws (Armour and Cumming, 2016) and flexible labor markets (Bonini and Alkan, 2012; Bozkaya and Kerr, 2014) are deemed important drivers of VC activity.

One other important formal institution which is found to matter is represented by fiscal policy. In particular, low capital gains taxes should increase the supply of venture capital funds by increasing the after-tax returns obtainable from this type of investment relative to alternatives. Similarly, an alteration of the relative tax burdens on wages and capital gains in favour of the latter may also have significant effects on the demand for VC, pushing more talented individuals to opt for entrepreneurial careers. Empirical evidence generally corroborates this view (e.g. Gompers and Lerner, 1999; Da Rin et al., 2006; Cumming and Li, 2016), even if exceptions do exist (for example, Jeng and Wells, 2000). Similar lines of reasoning and similar empirical results on the beneficial effects on VC activity of low taxation levels also apply to corporate income taxes (e.g. Romain and van Pottelsberghe, 2004; Bonini and Alkan, 2012).

Lastly, efficient and well-developed financial markets are essential for the functioning of the venture capital industry. In fact, VC activity is a process that eventually requires an exit from investment. Besides Merger & Acquisition (M&A), the favourite exit route through which venture capitalists cash in their investments is the initial public offering (IPO). Thus, a particularly lively IPO market enhances the liquidity of venture capital investments, with mutual benefits for investors and entrepreneurs (see e.g. Black and Gilson, 1998; Fleming, 2004; Cumming et al., 2006).

Turning to informal institutions, the presence of a vibrant entrepreneurial culture contributes to the growth of venture capital activity (Gompers and Lerner, 1999). Other cultural factors, such as attitudes towards risk-taking and uncertainty-tolerance are found to positively influence venture capital activity. More specifically, in economic systems characterised by a high degree of uncertainty avoidance and a great bulk of collectivism, VC activity is less reactive to formal regulations (Li and Zhara, 2012). Then, another critical informal institutional driver which is often reputed (and found) to exert a crucial role for VC activity is the tendency of a society to trust one another (Bottazzi et al., 2016). Among other possible reasons, VC often involves long-term partnerships between investors and entrepreneurs. These partnerships require trust to build strong relationships based on mutual respect and shared goals. Trust enables effective communication, cooperation, and support, which are essential for the success of early-stage companies, and the sooner trust is developed between the parties the higher is the probability these activities take place in an efficient manner.

Conclusions

Research on the institutional determinants of venture capital offers interesting evidence that can serve as interesting levers on which to act to stimulate the VC industry. But there are still quite a few obscure or otherwise not fully explored points on the topic. An area of great interest (and one that could actually reconcile at least some of the not-so-clear evidence that emerges on the influence of certain factors) is an approach to consider not only the direct effects of the various (formal and informal) determinants but also their interaction, under the hypothesis, dear to North (1900) and to the framework on 'varieties of capitalism' (Hall and Soskice, 2001), that the same institutions (and institutional changes) can produce very different effects depending on a different institutional set-up in place. In this regard, it is also worth asking whether and to what extent the recent trend toward internationalization (and cross-border syndication dynamics) of the VC industry may in some way mitigate the need to find the 'right' institutional mix in each specific context. In turn, all these issues call into question the role of public policy in the VC sector, and the actual need to devote substantial public resources with the goal of creating a thriving VC market, where this has not emerged rather endogenously. Indeed, while VC is an 'U.S. invention', as mentioned before, 'replicas' in other geographical contexts have been far from reaching the heights of the original (with few exceptions), despite the many institutional changes often brought about in an economic system by finalized policy making or direct government involvement in VC funds (see Grilli and Murtinu, 2014; 2015 or the contribution "Governmental Venture Capital Funds" in this Encyclopedia). In this regard, the debate is wide open, as the new alternative modes of entrepreneurial financing that already exist (e.g., see "Crowdfunding" in this volume) or the 'next big thing' might better serve to finance and nurture promising start-ups than VC in institutional settings where the VC industry has always struggled to fully develop.

Cross References

Crowdfunding

Government Venture Capital Funds

Internationalization of Venture Capital

Silicon Valley

Venture Capital and Private Equity Country Attractiveness Index

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