Issue 4 –July 2008

RICAFE2 Newsletter

Welcome to the fourth edition of RICAFE2 newsletter. This newsletter aims to keep you informed of the recent developments in the RICAFE2 project.

http://www.lse.ac.uk/RICAFE.htm

Contents

RICAFE2 - Regional Comparative Advantage and Knowledge Based Entrepreneurship

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Indian School of Business, ISB, India
Tilburg University, UTIL.CER, Netherlands
University of Southern Switzerland, USI, Switzerland
The Institute of Physics, IBP, Serbia

Third RICAFE2 Conference

The RICAFE2 Third Conference will be held on 9 & 10 October 2008 at the University of Amsterdam Business School. The conference will include empirical and theoretical papers on the financing of knowledge-based entrepreneurial firms, on the influence of venture capital on firms' ability to translate technological advances into successful products, and on the contribution of knowledge-based entrepreneurship to regional dynamics. The topics we are planning to discuss include, but are not limited to:

- The choice between alternative sources of financing for innovative firms and their impact on strategic decisions in entrepreneurial firms;
- The determinants of knowledge-based entrepreneurship;
- Venture capital and its contribution to the knowledge-based economy and regional development;
- Economics of intellectual property rights and its implications for knowledge-based entrepreneurship;
- The role and design of financial contracts and of the choice of organizational form in fostering knowledge-based entrepreneurship;
- Effects of regulation on venture capital investment and entrepreneurial dynamics;
- The impact of corporate governance mechanisms on the performance of entrepreneurial firms.

The Conference Programme Committee includes: Stefan Arping (Univ. Amsterdam), Amar Bhidé (Columbia Univ.), Bruno Biais (Toulouse Univ.), Patrick Bolton (Columbia Univ.), Mariassunta Gianetti (Stockholm Univ.), Thomas Hellmann (Univ. British Columbia), Gustavo Manso (MIT), William Megginson (Univ. Oklahoma), Eric Nowak (Univ. Lugano), Armin Schwienbacher (Univ. Amsterdam; Cath. Univ. Louvain; Committee Chair), Alessandro Sembenelli (Univ. Torino) and Christoph Zott (Insead).

The full prorgramme and registration details will be published on the RICAFE2 website http://www.lse.ac.uk/ricafe.

UNIVERSITEIT VAN AMSTERDAM

Amsterdam Business School

This conference is organized by the RICAFE2 partner at the University of Amsterdam, Amsterdam Business School (http://www.abs.uva.nl). For more information please contact Armin Schwienbacher (a.schwienbacher@uva.nl).

RICAFE2 Working Papers

The following working papers were included in the RICAFE2 Working Paper Series

RICAFE Working Paper No. 058

Title: The impact of Private Ownership, Incentives and Local Development Objectives on University Technology Transfer Performance

Authors: Sharon Belenzon (Nuffield College, Oxford and CEP-LSE) and Mark Schankerman (London School of Economics and CEPR)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP58-Belenzon.pdf

RICAFE Working Paper No. 057

Title: Outsourcing and Technological Innovations: A Firm-Level Analysis

Authors: Ann Bartel(Columbia University and NBER), Saul Lach(The Hebrew University and CEPR) and Nachum Sicherman(Columbia University and IZA)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP57-Bartel.pdf

RICAFE Working Paper No. 056

Title: Barriers to Exit, Experimentation and comparative advantage

Authors: Philippe Aghion (Harvard Econ Department), Eric Bartelsman (Vrije Universiteit), Enrico Perotti (UVA) and Stefano Scarpetta (OECD and IZA)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP56-Aghion.pdf

RICAFE Working Paper No. 055

Title: Private investment in human capital and Industrial development: The case of the Indian software industry

Authors: Ashish Arora(Heinz School of Public Policy and Management Carnegie Mellon University) and Surendrakumar Bagde(Heinz School of Public Policy and Management Carnegie Mellon University)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP55-Arora.pdf

RICAFE Working Paper No. 054

Title: Which Firms Benefit More from Financial Development?

Authors: Jan Bena(LSE) and Štepán Jurajda(CERGE-EI)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP54-Bena.pdf

RICAFE Working Paper No. 053

Title: Firm entry dynamics and the taxation of corporate profits: Evidence from firm-level data

Authors: Marco Da Rin(Tilburg University, ECGI, and IGIER), Marina Di Giacomo(Università di Torino) and Alessandro Sembenelli(Università di Torino and Collegio Carlo Alberto)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP53-DaRin.pdf

RICAFE Working Paper No. 052

Title: Financially Constrained Innovation, Patent Protection, and Industry Dynamics

Authors: Gerard Llobet(CEMFI) and Javier Suarez(CEMFI, CEPR, and ECGI)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP52-Llobet.pdf

RICAFE Working Paper No. 051

Title: New Business Law and Innovation A Comparative Analysis

Authors: Joseph A. McCahery(Faculty of Economics and Econometrics, University of Amsterdam; Faculty of Law, Tilburg Law and Economics Center, Tilburg University; and ECGI) and Erik P.M. Vermeulen(Faculty of Law, Tilburg University, Tillberg Law and Economics Center; and Philips International B.V)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP51-McCahery.pdf

RICAFE Working Paper No. 050

Title: The Contractual Structure and Regulation of Private Equity Funds and Hedge Funds

Authors: Joseph A. McCahery(Faculty of Economics and Econometrics, University of Amsterdam; Faculty of Law, Tilburg Law and Economics Center, Tilburg University; and ECGI) and Erik P.M. Vermeulen(Faculty of Law, Tilburg University, Tillberg Law and Economics Center; and Philips International B.V)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP50-McCahery.pdf

RICAFE Working Paper No. 049

Title: Leverage and Firm Scope

Authors: Elisa Luciano(Università di Torino and Collegio Carlo Alberto) and Giovanna Nicodano(Università di Torino and Collegio Carlo Alberto)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP49-Luciano.pdf

RICAFE Working Paper No. 048

Title: Technology adoption with exit in imperfectly informed equity markets

Authors: Katrin Tinn(Stockholm School of Economics)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP48-Tinn.pdf

RICAFE Working Paper No. 047

Title: Social Interactions and Entrepreneurial Activity

Authors: Mariassunta Giannetti (Department of Finance, Stockholm School of Economics, CEPR, and ECGI) and Andrei Simonov(Department of Finance, Stockholm School of Economics and CEPR)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP47-Giannetti.pdf

RICAFE Working Paper No. 046

Title: Innovation and the Performance of Technology Firms

Authors: Wolfgang Bessler(Center for Finance and Banking, Justus-Liebig-University Giessen) and Claudia Bittelmeyer(Center for Finance and Banking, Justus-Liebig-University Giessen)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP46-Bessler.pdf

Policy Workshop

A workshop on the overall policy relevant conclusions of the RICAFE2 research will take place in Brussels on the 28th of January 2009. More information will be published soon in the RICAFE2 website. The workshop aims to engage in a dialogue over the main results of our research with those policy groups primarily involved in this field. Representatives of policy making and professional associations are welcome to participate. For more information please contact Maria Komninou (m.komninou@lse.ac.uk)

Presentations of RICAFE2 research

The members of our nodes presented their research under RICAFE2 at the following meetings:

Title: Financially Constrained Innovation, Patent Protection, and Industry Dynamics
Date: April 3, 2008
Author: Javier Suarez & Gerard Llobet
Where: Universitat Autònoma de Barcelona

Title: Financially Constrained Innovation, Patent Protection, and Industry Dynamics
Date: April 7, 2008
Author: Javier Suarez & Gerard Llobet
Where: Universidad de Málaga

Title: Financially Constrained Innovation, Patent Protection, and Industry Dynamics
Date: April 11, 2008
Author: Gerard Llobet
Where: Universitat de València

Title: Financially Constrained Innovation, Patent Protection, and Industry Dynamics
Date: 8 February 2008
Author: Javier Suarez & Gerard Llobet
Where: ISCTE Business School, Lisbon

Title: Barriers to Exit, Experimentation and comparative advantage
Date: March 17 & 18 2008
Author: Eric Bartelsman, Enrico Perotti and Stefano Scarpetta
Where: Workshop on Experimentation, Innovation and Resistance to Change, The Hague

Title: Family Interactions in the Making of Entrepreneurs in Latvia
Date: January 2008
Author: Vyacheslav Dombrovsky & Olga Rastrigina
Where: Annual Global Entrepreneurship Monitor 2008 Planning Meeting (US, Boston)

Title: Leverage and Firm Scope
Date: January 2008
Author: Giovanna Nicodano
Where: Norwegian School of Management

Title: Leverage and Firm Scope
Date: February 2008
Author: Giovanna Nicodano
Where: the European Winter Finance Conference

Title: Entry Dynamics and the Taxation of Corporate Profits: Evidence from Firm-level Data
Date: March 2008
Author: Marco Da Rin, Marina Di Giacomo and Alessandro Sembenelli
Where: Tilec, Tilburg University

In March 2008 RICAFE2 completed the second year of its research activities and submitted the project's second annual report to the European Commission for evaluation.
The main objective of our research continues to be the development of a comprehensive report on how societal, legal and economic factors affect the patterns of regional economic growth and how KBE contributes to shifting patterns of regional comparative advantage and to regional growth and social cohesion. The question we are addressing is an important one especially given the current state-of-the-art where governments across the world have tried to emulate the American experience in Silicon Valley in California. To replicate the Silicon Valley experience current research in KBEs is trying to understand the factors responsible for its success.

Our strategy to understand these factors has been two-fold. Firstly, by doing research using European datasets we have fine-tuned our understanding of the factors driving success of KBEs in Europe. Secondly, by inviting eminent researchers from the US to our two RICAFE2 conferences we have acquired insights into the American experience. The below summarizes the research progress and major results from those over the first two years of the RICAFE2 project.

1. We explore the role of over-confidence in entrepreneurship. Entrepreneurial projects are typically highly uncertain because of their novelty. Our conceptualization of the entrepreneurial process and the ensuing empirical analysis – based on French data - show that the strongest source of entrepreneurial optimism is selection: people do not become entrepreneurs by accident but because they perceive that they have a project that dominates their other career choices. Experimental psychologists have shown that in such situations people tend to rely on crude heuristics and that these heuristics may give rise to incorrect decisions. Comparing entrepreneurs' expectations with actual performance, we find that many of them indeed fail to predict the future correctly. Two characteristics of entrepreneurs, higher education and novelty of the project, are particularly conducive to being over-optimistic. We also predict that optimistic entrepreneurs make more use of short term debt, and find supporting evidence for this in the data.

2. We analyse using a simple framework the development and financing structure of projects when potential entrepreneurs are risk averse. We study the impact of job-guarantees on the entrepreneurial process. Risk-averse individuals leaving their job to become entrepreneurs naturally seek some insurance from (financing) partners. This is clearly most relevant in the European context, where 'failed' entrepreneurs often pay a large cost in terms of a 'stigma of failure'. In this context, we analyze the offer of a job-back guarantee as a form of insurance that may facilitate the decision to start

a business. This suggests that whenever it is not credit constraints but aversion to risk that thwarts entrepreneurship, then job-back-guarantees can have a positive effect on the efficiency of labour markets. Moreover, whenever the project has positive spillovers towards the rest of society, which is likely to the case for innovative firms, a mandatory job-back guarantee can also enhance social welfare.

3. We also analyse an additional effect of risk-aversion as an obstacle to becoming entrepreneur, and explore which other institutions may stimulate risk-averse individuals, and particularly creative workers, to engage in entrepreneurship. We observe that in the US in the 1990s talented workers began to spurn secure jobs in large and stable organizations, formerly considered prestigious. In other words, "willingness to roll the dice for a big reward" by MBAs increased, showing a diminished importance of job security. Similar tendencies were observed in European countries such as the U.K. We study the possibility that this was stimulated by a relaxation of the liquidity constraints. Our conceptualization points to the fact that the ability of small firms to compete for talent depends on institutions that reduce income risks. We find this to be reflected using the data on employment of creative workers from the US 2001 Survey of Consumer Finance. Individuals with less tight credit constraints are more likely to be self-employed or employed in small firms, confirming that financial development is important to the competitiveness of small firms and proclivity of talented workers to take on the risks to develop their ideas in small firms. This highlights an important role of the financial system in stimulating innovations: the provision of a ‘safety cushion’ that enterprising individuals can fall back on if their idea is not successful in the market. It also points to the importance of flexible and well-functioning labour markets, which would make it easier for an unsuccessful entrepreneur to reintegrate into the labour market – thus showing that labour and financial markets may play a similar role in providing implicit job-back guarantees.

4. In a further study we provide evidence (based on survey data from the Netherlands) that small business performance is affected by the human capital of the entrepreneur. We find that human capital as measured by number of years of education, increases entrepreneur’s earnings by a direct 13% for each additional year of education whereas the indirect effect of education on earnings, via the capital constraint is another 4%. Thus, the power of extra education to improve entrepreneur’s performance seems to be greater when capital constraints exist, because education helps to relax these constraints as well as having a direct effect on performance.

5. We further explore the characteristics of entrepreneurs and question as to why entrepreneurs start new businesses? Surprisingly, we find that entrepreneurs do not start new businesses because it is profitable, but because they wrongly believe it is. In other words, entrepreneurs are typically over-optimistic about the success of their venture. We corroborate the analysis by using data from two waves of survey conducted by the French statistical office on a population of entrepreneurs the very year their business was started. We find that indeed the data supports our contention. In particular, we find that entrepreneurs with higher education and those who are developing their “own idea” tend to be more optimistic, whereas entrepreneurs who take the business over from someone else tend to be less optimistic.

6. Using a theoretical model we explore the role of favoritism and connections in entrepreneur's ability to raise capital. We find that if the pool of savings is small, favoritism can lead to an efficient allocation of investment. As the economy develops and its pool of saving increases, information production and the identification of distant investment opportunities become crucial for efficient investment decisions. Nevertheless, even in such an economy favoritism can emerge and investors may find it optimal to fund low quality entrepreneurs if they are familiar with them. One way to mitigate favoritism and improve the efficiency of capital allocation is to increase the amount of disclosure by firms.

7. We undertake an empirical investigation of the role played by social networks in emergence of regional disparities in entrepreneurship. Social networks may affect individual decisions to become entrepreneurs through social interactions between members of the same network – for example by observing peers or by creating role models and social norms. Using an unusually detailed individual-level dataset on individual socio-economic characteristics from Sweden we are able to overcome methodological roadblocks and provide a convincing analysis. Our analysis, which analyses differences across municipalities, documents that social interactions are important in explaining the entrepreneurship choices of individuals. In particular, peer effects seem to matter because they increase entrepreneurial private benefits from conformity with the social norms, and not because, they increase productivity in the entrepreneurial activity. Together, our findings indicate that cultural values may have an indirect effect on economic decisions, which may produce persistent inequalities across different regions with different cultural values.

8. The work performed so far furthers our understanding of the entrepreneurial process and based on our studies we have very interesting results to report. Based on a two-year inductive field study we find that entrepreneurs are more likely to acquire resources for new ventures if they perform symbolic actions. The data shows that entrepreneurs who perform a variety of symbolic actions skillfully and frequently obtain more resources that those who do not. In particular, we identify four symbolic action categories that facilitate resource acquisition: conveying the entrepreneur's personal credibility, professional organising, organisational achievement and the quality of stakeholder relationships.

9. An important question related to KBE is what kind of organisation is better suited for innovation firms or markets. We find that markets are better in developing ideas and leading to their commercial exploitation. However, in markets it is easier to steal ideas and they may deny the inventor a sufficient reward for invention. On the other hand firms can ensure that ideas are not stolen and the inventor is suitably rewarded for his invention, but keeps the idea within the firm and thus establishes a firm's trade secret. Thus both firms and markets truly complement each other, each compensating for the inefficiency of the other. Firms incubate ideas, while markets increase their chances of elaboration. This complementarity suggests a natural symbiosis of open firms and markets.

10. A related question is whether innovation is better performed in a large or small firm. The discovery of recombinant DNA was thought to have heralded the era of biotechnology in the pharmaceutical industry. Many thought this would lead to a spate of entry which would unleash widespread changes in the structure of the pharmaceutical industry. Though much has

changed in the pharmaceutical industry, entrants have been a breath of fresh air rather than the gale of creative destruction that some foresaw. Using the pharmaceutical industry as a test ground we find that overall research scale (or size) at the firm level increases the likelihood of success though the effect at the firm level is negligible in magnitude. Further, existing big pharmaceutical firms are more likely to succeed in developing new drugs than new entrants. Finally, over time because of learning and other environmental factors new entrants become similar to more established firms.

11. In a separate but related set of studies we document in detail the effect of corporate governance regulations on disclosure by firms. Using the UK as a setting, since it follows the voluntary "comply or explain" approach to corporate governance we find that companies choose to comply rather than explain deviations from best practice. We further find that amongst those companies providing an explanation very few provide a good explanation related to their own circumstances. In most cases the explanations provided are standard explanations with very little information. Further analysis suggests that those companies providing good explanations out-perform all other companies and even those that comply. This suggests that indeed good firms disclose more and the same is reflected in their performance.

12. A related question is which firms benefit more from financial development. We address this using a large data set covering European firms between 1995 and 2003. We find that it is firms of median age that benefit most from financial development, consistent with very young firms having relatively little access to the financial systems – even in such industrialized economies. This result can be understood by considering that newly incorporated firms in less financially developed countries typically employ unusually high shares of equity capital, which protects these entrants from the lack of external financing implied by less developed financial systems. This has two important policy implications. First, we build a case for a re-consideration of the support for small and medium-sized enterprises (SMEs), defined as firms with fewer than 250 employees and balance sheet totals below 43 million euro, provided by the EU. Second, promoting financial development appears to offer an effective way of promoting the growth of young firms with low shares of equity capital even within a set of comparable highly developed economies.

13. Another closely related issue is how important is a better legal environment to knowledge-based businesses. We look at this by examining the listing choices of Chinese businesses on the Hong-Kong stock exchange. Interestingly, we find that the main motivation for entrepreneurial firms from emerging economies to choose a foreign listing is the search for an efficient institutional environment which will be beneficial for the long-run growth of the firm, a result of relevance for accession countries.

14. We explore the role of legal environment also from other angles. First, we study how company law affects business creation and innovations. Company law lays down the fabric of contractual relations between participants of a business, which affects the incentives of the participants as the business evolves. Using tools from comparative law, we show that the "limited liability partnership" (LLP) which emerged in Texas in 1991 and has now spread to several (but not all) European countries provides a versatile instrument for the financing of innovative companies. Second, we argue that, from a legal point of view, private equity funds play a positive role in forcing the firms

to abandon obsolete practices and become more efficient. This largely revolves about these funds providing an activist form of corporate governance.

15. Another study takes a mix of legal and economics arguments to analyze how the presence of intellectual property rights and financial constraints shape the evolution of an industry. We show that, in terms of promoting innovation, IP rights are a sword with a double-cutting edge. To the extent that they help in fighting future innovators, they prolong the expected duration of the monopoly position of successful innovators, but they also increase the hurdle for success. This raises the question whether protection of incumbents against future innovations unambiguously increases the rate at which innovations are produced and results in higher welfare for society. Our main contribution is that the protection of incumbents against future innovators has an overall negative effect on innovation. In other words, the (negative) effect channelled through the entry hurdle dominates the (positive) effect on post-entry profits.

16. The importance of physical and psychological distance for venture investing is studied in a detailed empirical analysis of cross-border European venture deals. Surprisingly, trust towards other countries is found to affect also this form of sophisticated contracting, suggesting that slow-moving preference across populations may sometime make it difficult for purely economic policies to be effective. The analysis also points out that venture investments ought to be expected mostly from countries with well established trust for the recipient country. This provides some guidance as to what countries might be the most promising targets for government that want to attract foreign venture capital investments.

17. We explore the channels through which more developed financial markets promote entrepreneurial and innovative activities and thereby long-term growth. We suggest that financial markets can stimulate adoption of technology by providing not only financing but also exit opportunities to entrepreneurs and venture capitalists that provide funding to investments in technology. The analysis provides support for the view that accession countries should only gradually move towards adopting high transparency for listed companies.

18. We study the study the contractual framework in which venture capital contracts are written up, and its implications for the corporate governance of innovative firms. We conduct our analysis using a sample of nearly 500 venture capital contracts in Germany since 1990. We provide a detailed analysis of how these contracts affect investors' rights to step into firm management in case of bad firm performance. We also document that significant learning processes occurred in the German venture market, whereby elements of US-style contracts have been increasingly adopted over time,

19. We analyse how KBEs choose their innovation strategy and its interaction with the investor's exit preferences. The analysis provides key insights for the links between innovation, venture capital exits and market structure. A novel feature of the analysis is the inclusion on product market characteristics. Based on the product market strategy we study the entrepreneur's motivation to innovate so as to try and retain control of the project after the investor exits.

20. We investigate the role of business organizational structure in innovative industries. We build a conceptual model to look at whether the organizational form of entrepreneurial firms (stand-

alone vs. acquired firm) is related to innovation and how exit choices by the venture capitalist affect the entrepreneur's incentives to innovate. Our explanation for the emergence of business groups focuses on financial synergies arising from firm combinations, which arise from the possibility to deduct interests from taxes, making borrowing relatively advantageous. The fact that this structure is common in US private equity groups, provides a rationale for legally encourage this structure in European countries.

21. We analyse syndication, the joint realization of one project or one investment by several capital providers. Syndication has a long tradition in financial markets, and it is also a common trait of venture finance. We point to an economic benefit of syndication so far overlooked, the know-how transfer between syndicate partners - particularly in markets that are in the early stages of their development or that are in the process of expanding, as in the case of European venture capital markets.

22. We empirically investigate how software exports by different states in India are conditioned by local levels of human capital, as measured by the state level production of engineers. Though previous studies have noted the role of skilled labor in the growth of the Indian software industry, they have not empirically investigated its importance. We study the effect of the supply of engineers, measured by engineering baccalaureate capacity, on the regional growth of the software exports between 1990 and 2003. We find significant effect of engineering baccalaureate capacity on the growth of software exports even after controlling for other relevant factors. This conclusion is especially interesting because much of this capacity is due to private, rather than publicly supported colleges, and testifies to the private willingness to invest in human capital even in poor countries.

23. We develop a model to analyze how entrepreneurial firms' expectations on technological change influence their demand for outsourcing. Outsourcing parts of the production of a final product is costly because of the costs associated with searching and finding an appropriate input supplier and, more importantly, because contracting with outside suppliers may be imperfect if some attributes of the outsourced inputs are not verifiable by third parties. We show that outsourcing becomes more beneficial to the firm when technology is changing rapidly. The reason is that outsourcing enables the firm to purchase from suppliers that use the latest technology and avoid the sunk costs. Our model thus provides an explanation for the recent increases in outsourcing that have taken place in an environment of increased expectations for technological change. Our predictions are confirmed by a sample of Spanish firms (for the period 1990 to 2002).

24. We examine policies aimed at fostering the creation of new companies, focussing on taxation policy. We use data on European companies between 1997 and 2004 to study the effect of corporate taxation policies on incorporation and entry. We also notice that the nature of the political process affects the decision to change corporate tax rates, and we account for this in the analysis. We find an economically appreciable significant negative effect of corporate taxation on entry rates. Interestingly, the effect becomes higher at lower taxation levels. Interestingly, we find that lowering taxation is more effective in economies where the institutional and legal environment is better, where tax evasion is lower, and where accounting standards are more stringent.

25. Finally, in a related study we focus instead on the entry-deterrence effect of labor, finance, and product market regulations. We propose an interpretation for differences in firm productivity growth between the EU and the United States as the outcome of reduced firm experimentation. We draw inspirations from evidence on the firm characteristics of entrant and exiting firms and their growth patterns from firm-level data for several OECD countries drawn from business registers and enterprise surveys to model the choice for innovative firm strategies. Our conceptual model derives the effect of politically-determined costs of labor insurance on firms' comparative advantage. We also show how exit costs have a particularly damaging effect on experimentation and therefore innovation in sectors or processes close to the technological frontier.