Does quality of governance affect the returns of policy for entrepreneurship? Evidence from European regions

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Abstract

Absorbing about one third of the EU's total budget, the European Cohesion policy is one of the most important policies of the European Union. The purpose of this policy is that of promoting a balanced and harmonious development of the EU through the strengthening of the economic, social and territorial cohesion, as stated in the Treaty of the European Union. After practically three decades of actions, regional disparities in economic development, especially those within countries, remain large and have been increasing in the last decades. The absence of convergence in GDP per capita, however, is not necessarily matched in terms of social welfare, as previous works showed that welfare levels have converged significantly across European regions also thanks to a progressive alignment of structural and institutional factors (Rodriguez-Pose and Tselios, 2015). Within this debate, the effectiveness of Cohesion policy in achieving convergence objectives has been increasingly questioned. A growing number of works on the evaluation of Cohesion Policy has been produced in the literature, most of which focus on the capacity of this policy to foster economic development in the lagging regions, thus favouring a convergence in terms of GDP per capita. Since the last decade, Cohesion Policy has been increasingly relying on the role of a "smart specialisation" strategy, according to which essential conditions to economic development are innovation, entrepreneurship and risk-taking (McCann and Ortega-Argilés, 2013; Romero and Fernández-Serrano, 2014).

Entrepreneurship represents a crucial factor for any sustainable process of economic development. From a theoretical point of view, new business formation can drive economic growth not only through its direct effects on the economic activities and production, but in large part through the indirect effects that new firms generate in the economic environment and in the existing population of firms. More specifically, new firms creation fosters the diffusion of knowledge and innovation and introduces higher variety and quality of input. The increased competition between new firms and the incumbents has been found to be a strong and long lasting mechanism through which entrepreneurship drives economic development (Fritsch, 2013). In this context, this paper focuses on the role of cohesion policy to promote entrepreneurship. The latter can be measured in a fairly straightforward way, also across European regions, thanks to the Business demography database provided by Eurostat. So far, not much research has been devoted to assess the actual effect of Cohesion policy on entrepreneurship in European regions and to identify the factors that can drive or mediate such effects. This paper aims to fill this gap and to investigate the effect of the funds for enterprise support.

Specifically, we study whether and how the quota of EU cohesion Funds specifically designed to support entrepreneurship affect business demography in EU regions. Using a quasi-experimental approach, we find that regions that exogenously received more funds had increased business

creation and survival rates. However, similar policies (i.e. a similar amount of funds) may have heterogeneous effects across regions, depending on local characteristics. In particular, regional governance – and the quality of institutions more in general – have a very important role in ensuring that the funds are absorbed in an efficient way and, above all, in ensuring that all the conditions to favour and promoting entrepreneurship, from law enforcement to impartiality, from quality of services to education, are put in place. For this reason, we evaluate how the quality of regional governance (measured by Charron et al., 2015) mediates the effects of EU Cohesion funds on outcomes such as business creation and survival rates. We find that a similar amount of funds in support of entrepreneurship becomes substantially more valuable in regions with better "absorptive capacity", or better regional governance.

One of the main methodological challenges in the context of the empirical literature on the effectiveness of EU Funds is that of isolating the actual impact of policy from that of other factors that might confuse the interpretation of the analysis (Pellegrini et al., 2012) as well as that of tackling reverse causality issues. Particularly, the amount of funds received by a given region is a function of a number of unobservable characteristics of a given region which might simultaneously affect outcomes. For this reason, we study the effectiveness of Cohesion funds by adopting a regression discontinuity design, to evaluate the effects of the quota of Objective1 EU funds for entrepreneurship on business demography in European regions for the 2007-13 programming period. Based on the application rules of Cohesion policy, regions are assigned to two groups – treated and non-treated regions – based on whether they received (and spent) or not the funds of enterprise support. The assignment is based on a "forcing variable", which consists in having a level of GDP per capita below or above the threshold of 75% of average EU GDP per capita. The idea of the regression discontinuity approach is that regions just above and below the threshold can be compared before and after receiving the treatment. At the point of the threshold, the discontinuity in the conditional expected outcome (i.e. new business formation) would constitute an evidence of a causal effect of the policy. The underlying idea is that when regions are close enough to the cut-off point, the treatment variable (being below or above the cut-off point) should not affect the outcome variable (i.e. business creation) if not through the effect of funds.

The literature on the effectiveness of EU funds is vast. However, existing works rarely focuses on actual disbursed amounts, and very rarely distinguishes between different categories of funds. We address the role of a specific typology of public fund towards a specific outcome variable: business creation and survival. This adds to the literature also along the dimension of outcome variables, since the studies on the topic typically focus on the effect of funds on GDP growth. Being able to distinguish the channels through which EU Cohesion Funds work, we are also capable of disentangling the intermediate objectives towards GDP creation (e.g. business creation). With respect to the studies that assess the impact of Cohesion policy on GDP per capita using regional growth regressions, the choice of our dependent variables (i.e. new business creation rates) is likely to be less sensitive to the biases that might emerge due to leakage or spillover effects from neighbouring well-performing regions and the measurement error at regional level should be limited (firms counts come from business registers). Quality of government was accounted for through the indicators provided by the University of Gothenburg through the Quality of Government EU Regional Dataset (Charron et al., 2015).

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