FUNDING INNOVATIONS IN GLOBALIZED WORLD: THE CZECH APPROACH

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ABSTRACT
Motivation: The Czech government considers innovation policy a key component of the effort to improve the business environment. Globalization and support of competition keeps prices low and output high. In the Czech Republic the relevance of good general business conditions in encouraging research and ensuring that the economy benefits from the international diffusion of innovation.

Problem statement: There is a fundamentals question about the relationship between competition and innovation which it has been subject of many theoretical debates. Timely implementation of innovations helps the county to reach the necessary competitive advantage and create and maintain competitive position in today’s demanding international environment.

Approach: This research work uses different research strategies to explore the current competitive position and innovation potential of companies in the Czech Republic. It examines the institutional setup and financial background of innovation generators. It explores the official administrative and financial support of innovations. Impact of globalization on innovative activities is highlighted. In the regional context an important role is represented by some specific interests and local assignments.

Results and conclusion: The results of this study bring the characteristics of innovation environment and innovation potential of the Czech Republic, which can be used as a base for decision making on governmental, regional and professional levels.

JEL CLASSIFICATION & KEYWORDS
D40  L40  O30  INNOVATIONS  GLOBALIZATION  CASE STUDY  CZECH REPUBLIC

INTRODUCTION
The claim that market concentration helps innovation does not appear to be supported by recent empirical findings. (Ahn, 2002) Motivated by the Schumpeter’s assumption that large firms in concentrated markets have advantage in innovation, many empirical studies have investigated the relation between market concentration and innovation. On the whole, however, there is little empirical support for the view that large firm size or high concentration is strongly associated with a higher level of innovative activity. Increased efficiency and productivity can result from economies of scale and increased economy due to synergies and major cost cutting and outsourcing activities. Another explanation of increased productivity apart from competition on the product market can be brought by competitive pressures coming from corporate governance. Recently we have witnessed some attempts to increase efficiency by regulatory reforms in different sectors - increased openness to global competition, introduction of competition into non-profit sectors etc. It was observed that that competition brings productivity gains and long-run economic growth. Some studies suggest that it could sometimes take a long time for the producers and consumers to adjust themselves to the new environment with increased competition and to fully experience efficiency gains. (Ahn, 2002)

Competition and support of competition keeps prices low and output high. However we need to explore the relation to innovation. There is a fundamentals question about the relationship between competition and innovation because the relationship between competition and innovation is controversial and has been subject of theoretical debates whether competition is supportive to innovation. Different positions have been taken by representatives of two camps: Joseph Schumpeter (1883-1950) and Kenneth Arrow (*1921), who are authors of important theoretical schools of thoughts. (Baker, 2007)

Brief Theoretical and Methodological Background
An important premise of discussion
Before we approach this discussion on innovation and competition in the context of globalization one needs to keep in mind that an important underlying presumption of this discourse is that more innovation is good for society because innovation is undoubtedly one of the key determinants of the welfare of humankind. (Baker, 2007, p. 4) Furthermore the benefits of innovation to society as a whole greatly exceed the benefits to the firms that originally develop the innovation.

Each firm needs to react to competition. The result of competition is cheaper and better products and greater production. Competition is good because it leads firms to make more and/or higher quality goods and sell them for less. A firm can reduce its price after a close rival cuts price – so can be expected to lower price in response. Or the firm can attract buyers by making improvements in product attributes closely related to price and valued by consumers, like providing more rapid delivery, offering higher quality, offering more colours or styles or other additions to product variety, or by providing additional post-sale services. It can also alter its financial conditions.

There are distinctions between so called static and dynamic competition. Firm dynamics during their life cycle make an integral part of dynamic competition. Dynamic competition selects out less efficient firms from more efficient ones and reallocates productive resources. New features of dynamic competition (or, competition between different systems to become the standard in a new market based on new technology) raise new challenges to policymakers. Policymakers should aim at insuring dynamic efficiency, not just static efficiency in the present. In this context, well-functioning labour markets and capital markets are very important. (Ahn, 2002, p. 8)

Competition rings in efficiency and forces price to converge to marginal cost. These days we can often see an argument that the primary generation of innovative ideas and patents...
remains in the domain of small and medium sized firms (SMEs). SMEs need to keep pace with competition which is severe in their market segments and therefore they must be innovative to maintain their market share and keep pace with competing enterprises. However, historically there was a different argument, about who is the main generator of innovation.

The basic essence of this argument starts with Joseph Schumpeter, who argues that monopolies favour innovation. An opposite view, often associated with Kenneth Arrow, argues that competition favours innovation. Schumpeter (1934) speaks about different quality of innovation generated by big companies and monopolies. Competition also helps to solve agency problem. Under competition management performance is better monitored. There are also other views on competition. The probability of bankruptcy is likely to be higher in a more competitive environment. This will force managers to work harder to avoid bankruptcy. Cost-reducing improvements in productivity could generate larger revenues and profits. So called “static efficiency” implies better allocation of resources and more efficient generation of resulting revenues and profits. In dynamic industries (e.g. telecommunication or ITC) the efficiency is gained through new modes of competition. This subsequently creates greater welfare gains. The potential trade-off between static and dynamic efficiency deserves special attention in considering the links between competition and innovation.

Classification of Innovations

The exact notion of innovation is not unambiguous. A plethora of definitions for innovation types has resulted in an ambiguity in the way the terms ‘innovation’ and ‘innovativeness’ are operationalized and utilized in the new product development literature. The terms radical, really-new, incremental and discontinuous are used ubiquitously to identify innovations. One must question, what is the difference between these different classifications? “(Garcia & Calantone, 2002, p. 110) From another standpoint the innovations are understood as not only a new product offered to customer it concerns also processes and organisational innovations and more broadly also “non-technical” innovations. The classification is broader. The degree of innovation also depends on particular discipline.

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<tr>
<th>Construct</th>
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<td>Product innovativeness</td>
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<td>Radialness (discontinuous)</td>
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<td>Newness to customer</td>
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<td>Product uniqueness</td>
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<td>Product (superiority)</td>
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Very frequently and more elaborated classification of innovation was put together by OECD in so called “Oslo Manual” published by OECD recommending ways of measurement of scientific and technological activities. Oslo manual, however, does not limit its attention to technological, technical, product and process innovations only. It provides guidelines to non-technical innovations, mainly in the area of marketing innovations and organisational innovations and it provides guidance to diffusion of innovation. (Oslo Manual, 2005, p. 88 and following). In the Czech Republic classification of innovations and research on innovation activity is exercised by Czech Statistical Office using questionnaires that are based on Oslo manual and harmonised by Eurostat.

Relation between Competition and Innovation

Research and development are key factors of production and growth. Now, starting from Schumpeterian argumentation, big firms and monopolies are traditionally originators and promoters of innovations, because they are able to finance innovation from their own funds. Starting from this argument Schumpeter suggests that large firms and monopolists may be more innovative than firms in competitive markets. The reasons are that “large firms might be better able to fund large research and development (R&D) projects than firms in competitive markets”, the small ones (Baker, 2007, p. 5). Moreover, it may be easier for big successful firms to explain to the suppliers of financial capital why research and development projects have potential, because the major part of needed financing lies within the organization itself. This helps to overcome agency problem and information asymmetry. It is easier for the big firm to obtain necessary resources because the big firm can easily put forward arguments to capital market participants and to venture funds specialists. Furthermore, as we can observe in today’s practice, there is also a considerable discrepancy in funding innovations in the US and in Europe (i).

In contrast to this theory, Kenneth Arrow emphasized a competing logic by which competition rather than monopoly promotes innovation. Small and medium sized companies are principal originators of innovations. Big companies will innovate less because there will be a big need funding of substantial improvement of production and technology. Therefore it is reasonable to ban the innovation and prevent the competition to bring in a new enhancement or improvement that could be reached for example by cost reduction or quality increasing or by bringing in entirely new product.

Putting it simply, monopolist might innovate less than competitive firms because a monopolist has more to lose. “A monopolist could spend a great deal of money to make a dramatic improvement — whether by lowering cost, improving quality or creating a new product — and take over the market, only to find that it does not get much additional business because it already has most of the business there is to get.” (Baker, 2007, p. 6). This limitation of the monopolist to innovate is often termed the “Arrow effect” or the “replacement effect”.

This argumentation has lead to important discussion relating competition and innovation. Several theoretical presumptions have been formulated and discussed in economic literature:

1. Competition in innovation itself — that is, competition among firms seeking to develop the same new product or process — encourages innovation, i.e. patent races,
2. competition among rivals producing an existing product encourages those firms to find ways to lower costs, improve
quality, or develop better products. Firms engage in research and development because innovation may allow them to escape competition.

3. another presumption is that, firms that expect to face more product market competition after innovating have less incentive to invest in R&D. If innovation would not allow a firm to escape competition, the firm would anticipate profiting less from R&D.

4. and at last, a firm will have an extra incentive to innovate if in doing so it can discourage potential rivals from investing in R&D. If a monopolist can make investments that guarantee that it will quickly emulate any innovation introduced by a new entrant – those investments will discourage potential rivals from innovating in ways that compete with the monopolist without reducing the monopolist’s own incentives to innovate.

Following a more recent view on innovation we observe understanding of innovation and different classification. The concept is not understood as one case of innovation or one isolated new product but as different innovation strategy. Very important progress in theory of innovation was made by Eric von Hippel (”1941) who is specializing in the nature and economics of distribution and in so called “open innovations”. The new term that he coined is the “user innovation”. That is, it has been originally assumed that most important designs for innovations would originate from producers and be supplied to consumers via goods and services produced. This view seemed reasonable – producer-innovators generally profit from many users purchasing and using a single, producer-developed innovation design. Von Hippel introduced the concept of “open innovation”, which is a paradigm that assumes that firms can and should use external ideas for creating and developing better products or processes. “External ideas” are then used together with “internal ideas”, and internal and external routed to market, as the firm looks to improve its technology. The concept of open innovation diminishes the boundaries between firm and its client, between supplier and customers and competitors etc. In this way the inspiration and other sources of innovation can be easily interchanged between all subjects within given environment. Von Hippel’s concept assumes a world of widely distributed knowledge where firms can not rely only on their in-house research, but should instead buy or licence processes or inventions (patents) from other subjects within given environment. (Von Hippel, 2005)

Contrary to the concept of open innovation is closed innovation that is based on paradigm that successful innovation is prepared completely under control of one subject (one company) along the whole chain i.e. generation of ideas, production, marketing and distribution. The outputs of internal research that are not being used elsewhere should be according to concept of open innovation distributed and utilized outside the company (e.g. via licensing, joint-ventures and spin-offs). Particular types of industries are suitable for this type of innovation. Here we have in mind mainly IT and communication technology. It is important to stress that his type of innovation flourishes in supportive environment. Prior to this concept Von Hippel also developed the term user innovation (Von Hippel, 1986). The idea of user innovation is based on argument that end-users not producers are responsible for significant portion of new innovation. In this context Von Hippel introduced the term “lead user”.

With increasing globalization more contemporary thoughts on innovation are also pointing out the fact that there is significant shift in “value proposition” or how innovations (especially those from product area) are perceived by customers. In the past the innovation usually meant delivery of better product that somehow naturally costs more, but nowadays in most cases it means to deliver better and also cheaper product. Value proposition is one of the core ideas of modern marketing; it is describing how much value the customer can expect from the goods or service. This concept is relevant today in the era of globalization and cost cutting justified by economic crisis, even though the original ideas of “better and cheaper” product, better organization of work and improvement in production technology started with Japanese miracle during the period of record economic growth following the World War II.

**Funding Innovations in the US and in Europe**

There is different tradition in funding innovations in the US and in Europe. The US is more open to new things and promotes innovative sectors, which determine the leadership in innovation overall. The major industries by newly created jobs in 2010 were Software (90%), Biotechnology (74%), Semiconductors/Electronics (72%), Computers (54%), and Telecom (48%).

Over the last few decades, venture-backed innovations have consistently spread about entire new industries and not only on new techologies. These included semiconductors, biotechnology, medical device, the internet and clean technology included new sub-sectors e.g. energy efficiency, energy storage, earth mineral mining, pollution control, alternative energy generation, and natural gas; and information technology covering computer software, internet, communications. Such evolutions create virtuous circles of innovation, job creation and revenue growth that benefit the whole country.

Venture-backed companies typically fuel these new industries in terms of employment and revenue creation. With their focus on innovation, high-growth potential and entrepreneurial spirit, these companies set themselves in a unique position that prevails long after the venture capitalist leaves the investment and goes on supporting a new venture.

In the US the data bout the venture funding are collected by NVCA – National Venture Capital Association, who follows the indicators of U.S. new job creation and economic growth. In spite of the overall economic crisis the employment generated by newly established companies has risen. The percentage of total U.S. private sector employment generated by venture capital-backed companies grew as well as their percentage of overall U.S. revenue.

This shows the importance of venture capital to the US economy. Venture capital investors undertake high risk and spend more sources working closely with entrepreneurs to bring new ideas and technologies to the market. Over the last four decades, these products have changed the way of our lives and work conditions in profound ways, e.g. in electronic and communication.

“…such innovations drive the U.S. economy’s evolution by spawning new high-growth companies and, in many cases, entire new industries. Here, venture capitalists play a lead role by persistently identifying and funding only those ideas with transformative potential — in good economic times and bad. Venture has proven itself to be the most effective mechanism for rapidly deploying capital to the most promising emerging technologies and industries — moving nimbly to where the future opportunities lie. The result has been millions of jobs, trillions of dollars in revenue, and...
immeasurable economic value that otherwise might never have come into being had these bright ideas not been initially funded and nurtured to sustainability.” (iii)

That’s why the policy makers must continue to recognize this aspect of venture capital’s impact when tackling critical economic and public policy issues. When policy-makers support venture capital the U.S. venture capital community will continue to drive the US economy toward to a more prosperous future. Recently it seems that even the US funding of innovations slowed down. In private sector innovations continued to be funded by various venture funds, but the money invested in venture funds have decreased in total as described on Figure 1. This can be attributed to the worldwide economic crisis that started with the collapse of the US mortgage system. To these days European countries are fighting with the consequences of economic crisis which has later on affected almost all European countries. Nowadays, heads of state or government of the euro area have agreed on their summit on comprehensive measures to safeguard the financial stability.

The developmental pattern of venture capital funds has been modified and the industry spectrum has also modified. Given the tremendous impact that venture capital has on company creation, it is easy to forget that the industry is small and highly susceptible to the many market forces presently at work. Venture funds are prepared to provide more funding to new entrants and help with the exit phase, but the choice is more selective. The perceived risk has increased and there are big investments funded by mature companies in the sector.

"Initial public offerings in 2010 picked up considerably from the minimal levels of the prior two years. While this provided some relief for the backlog of mature companies waiting for an opportunity to go public, totals have to increase far beyond 2010 levels for a sustainable industry. A record number of venture-backed companies were acquired, but the total proceeds from those purchases were far from a record.

The lack of distributions to the institutional investors who provide the capital to the industry has left these professional money managers with little capital to recycle back to the industry. Thus, 2010 remained a difficult year for many venture capital firms to raise money.

A healthy venture capital ecosystem requires its metrics to be in balance. And while the quality of new business opportunities, known as deal flow, remains very high and the best opportunities are getting funded, stresses remain.” (NVCA Yearbook, 2011, pp. 9-10)

The development of finance flowing into venture capital industry since 1995 can be observed on the following chart.

There is big difference between the venture capital industry in the US and in Europe. One must appreciate, that in the US there is a long tradition of venture capital funding starting with the American Research and Development Corporation funded in 1948. The firm was originally founded to encourage private sector investments in businesses run by soldiers who were returning from World War II. ARDC’s was the first institutional private equity investment firm. (Kirsner, 2008)

Up until the early 1990s, venture capital remained essentially an American phenomenon (Botazzi and Da Rin, 2001). Compared to the US market, venture capital industry in Europe is rather slow-moving and immature and European stock exchanges are perceived as rather hostile towards young firms. This has been found as a major obstacle to innovation. In general on one side, entrepreneurial firms are viewed as major contributors to economic growth and to the creation of new jobs and venture capital as an important tool for job creation, technological innovation, export growth, and regional development. There is a feeling that Europe’s growth problems may be caused not as much by rigidities in labour markets, as by weaknesses in capital markets, in the access to risk capital in particular.

This raises important policy issues. It is crucial to understand whether any industrial policy and regulation can actually contribute to the growth of a dynamic venture capital industry in Europe. European official documents, and also industry reports like the White Paper of the European Venture Capital Association (EVCA, 1998), focus on the supply of funds and on the creation of favourable structural conditions for entrepreneurs. But it is not clear which policy would be most appropriate to support venture capital in Europe.

In the paper of Bottazzi and Da Rin (2002) the authors develop a systematic analysis of venture capital in Europe. To get around the shortage of data on European venture capital, the authors have exploited a new market Euro.nm. This was established in 1997 as an alliance of Europe’s ‘new’ stock markets for innovative companies in high-growth industries – an analogy to the US Nasdaq. Euro.nm represented the ‘new’ markets of Amsterdam, Brussels, Frankfurt, Paris, and later also Milan. Unfortunately this market disentangled as an alliance in December 2000, but its five members have continued to operate independently. Over its short life span, Euro.nm has allowed nearly 600 companies to list on public markets and raise over 40 billion euros of equity capital. (Bottazzi and Da Rin, 2002)

This has been found as a major obstacle to innovation. On one hand entrepreneurial firms are viewed as major contributors to economic growth and to the creation of new jobs. This implies that venture capital as an important tool for technological innovation, job creation and regional development and growth of national export. However European Investment Bank identified that Europe’s growth problems may be caused by weaknesses in capital markets and smaller access to risk capital, rather than by rigidities in labour markets. This raises important policy issues. It is crucial to understand whether any industrial policy and regulation can actually contribute to the growth of a dynamic venture capital industry in Europe. European official documents focus on the supply of funds and on the creation
of favourable structural conditions for entrepreneurs, but it is not clear which policy would be most appropriate to support venture capital in Europe.

We then look at the involvement of venture capital with some of Europe’s most innovative and successful companies: Those listed on Europe’s ‘new’ stock markets. Venture capital is effective in helping these firms overcome credit constraints, and thus to be born in the first place. Its success in supporting dynamic companies which create jobs and wealth brought many governments to look for ways to support a national venture capital industry. At the same time, the high returns enjoyed by US venture capital firms induced venture funds to become active also in other countries. Venture capital is by now a sizeable industry also in Europe and Asia. In Europe the innovative start-ups were usually financed by banks and government funds. Banks are less flexible and more conservative in their policies. Furthermore the regulation in Europe is more restrictive and more limiting, which is probably given by inherent bureaucracy in all EU systems.

The Czech Approach to Funding Innovation and Impact of Globalization

Nowadays, globalisation plays a key role in the Czech economy, which is very open. According to OECD statistics the share of international trade in national GDP has been more than 70% in recent 5 years. Structurally, it represents predominately trade and cross-border movement of goods and also active participation in production chains especially in car industry and other machinery. The core attraction of the Czech Republic is favourable location and relatively low labour costs. The setting up of international production plants has accounted for a large share of the Czech Republic’s substantial foreign-direct investment.

Globalisation is affecting the economy also on other fronts. Multinational companies play an important role in retailing and international mobility of labour is increasing. The Czech authorities need to concentrate on important issues to help the country to profit from globalization - healthy macroeconomic conditions and proactive structural policy in terms of improving the business environment. This concerns mainly simplification of business legislation and taxation and engaging in of innovation policy.

Because of the nature of the Czech economy as a very open economy with high dependence on international markets, there is need to support the small and medium sized companies in access to international markets where there is very often lack of finances. This area is a domain of active state agencies Czech Invest and Czech Trade. The country also needs to put in order good transport infrastructure as this is one of the few key factors in firms' location decisions where investment policy plays a direct role. In particular, increased attention needs to be paid to the efficiency of public supportive activities.

Innovation potential and entrepreneurship in the Czech Republic is also supported on governmental level. For example, according to the Ministry of Industry and Trade there were subsidies and financial support in the volume of 13.5 bills. CZK spent in the period from 2007 to 2010 from the program “Operační program podnikání a inovace” (Operational programme enterpriseing and innovations). But there were also supports on the level of state budget with guarantees for almost 1500 SMEs enabling them to obtain loans for operational and investment purposes in the total amount of 9 bills CZK. There are also other supporting programs that are more narrowly focused on technical and non-technical innovations, for example programs “Tvarlá prosperita” (Permanent prosperity) or “TIP” that supported over 500 SME projects in the area of industrial research and development in the year 2010 with overall subsidy over 1.6 bill CZK.

The programme “Operační program podnikání a inovace” is reflecting the EU Lisbon strategy, which focuses on tools of direct and indirect support of entrepreneurship, especially in its form of small and medium enterprises. In general, the program is focused on removing the barriers to access to capital funds. The support is usually given to companies with higher innovation potential, and also to activities supporting establishment of new companies and on development of existing companies to improve their competitiveness within regions with structural problems and high unemployment. The program is funded by EU structural funds (85%) and remaining part is funded by Czech state budget. There are six main areas of focus: (1) establishment of new companies, (2) development of existing companies, (3) programme entitled effective energy (iv), (4) support of innovations, (5) creation of environment for entrepreneurship and innovations, and (6) support of services for development of entrepreneurship.

Another important aspect for the innovation potential is the level of international cooperation, export and import. As the size of the Czech market is limited and it is necessary for companies to think seriously about using innovations to go on the international market. The research made by European Commission among European SMEs showed that only 25% of SMEs are exporting their production to foreign markets, 7% is in role of supplier or customer of foreign company and only 2% is realizing foreign direct investment. These average numbers for whole EU are in case of Czech companies higher that is reflecting the openness of the Czech economy. There is relation between size of the company and the degree of international cooperation or international activities. The bigger company the more active on foreign markets is. The same applies for the size of the domestic market. There is also relation between the age of the company and their international activities – older companies are more likely to be active on international markets.

According to The Czech Ministry of Trade and Industry (MPO) there are the following priorities for future: the establishment of seed fund or fund of venture capital. That fund will be established and operated by the MPO. Its goal is to support innovation-driven start-ups via direct investment or loan guarantees etc. It is expected, that this approach brings certain advantages. It aims to provide the needed capital for start up companies with high innovation potential and it should bring a multiplication effect of invested financials. There is a relatively good experience with such approach in some countries in area of support of innovative environment and knowledge based economy.

Conclusion

Ever since Schumpeter (1934) disseminated his theory of innovation, entrepreneurship, and economic development, economists, policymakers, and business managers have assumed that the dominant mode of innovation is a “producers’ model.” That is, it has been assumed that most important designs for innovations would originate from producers and be supplied to consumers via goods and services. This view seemed reasonable – producer-innovators generally profit from many users, each purchasing and using a single producer-developed design. Different concept represented Von Hippel in 1980s. However, the producers’ model is only one mode of
innovation. Two increasingly important additional models are innovations by single user firms or individuals, and open collaborative innovation. Each of these three forms represents a different way to organize human effort and investments aimed at generating valuable new innovations. Von Hippel introduced a notion of “open innovation”, which is a paradigm that assumes that firms can use external ideas for creating and developing better products or processes. External ideas are used together with internally generated ideas as the firm strives to improve its technology. “The concept of open innovation diminishes the boundaries between a firm and its client, between supplier and customer and competitor etc. each model has a different profile that gives it economic advantages under some conditions and disadvantages in others.” (Baldwin and von Hippel, 2010, p. 2)

Globalization changes the way industries operate by decreasing the costs of production through outsourcing. The Czech Republic has a good position in today’s world with its open economy, with international trade representing more than 70% of country GDP in last 5 years. The country aspires to become a knowledge based economy. For this reason the Czech Ministry of Trade and Industry prepares different programmes to support the creation of innovation, improve infrastructure and work out less bureaucratic procedures for new entrepreneurs and companies in innovative segments. This proactive policy including creation procedures for new entrepreneurs and companies in innovative segments. This proactive policy including creation of seed fund easing access to venture capital should help innovative segments. This proactive policy including creation procedures for new entrepreneurs and companies in innovative segments.

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