Role of Public Policy and State Capacity in Influencing Entrepreneurial Activity: A Cross Country Analysis

Saurabh Srivastava[1*], Dr. Tuheena Mukherjee[2]

[1*]Indian Institute of Foreign Trade, Delhi saurabh_phdmp20@iift.edu
[2]Indian Institute of Foreign Trade, Delhi, tuheena@iift.edu

***Corresponding author:** Saurabh Srivastava
*Indian Institute of Foreign Trade Delhi, B-21 Qutub Institutional Area, New Delhi – 110016; email: *saurabh_phdmp20@iift.edu*

1. Introduction

Entrepreneurship serves as a key catalyst of economic growth, driving innovation and creating employment opportunities across the globe. (Ács et al., 2018; Autio et al., 2014). By facilitating the creation and expansion of new ventures, entrepreneurship contributes to the dynamism and resilience of economies in an increasingly competitive and globalized environment (Sautet, 2023; Baumol, 1990). Governments and policymakers recognize entrepreneurship as a key lever for addressing structural economic challenges, including unemployment and technological disruption (Aidis et al., 2022; Bosma et al., 2024).

Startups are a key indicator of entrepreneurial activity and are commonly used to assess entrepreneurial dynamism. Unlike mature firms, startups often operate under significant uncertainty and limited resources, making their emergence a good indicator of the overall health of a country's entrepreneurial ecosystem (Henrekson & Sanandaji, 2020; Breschi & Lassébie, 2023). They are often at the forefront of innovation, driving technological advancement and disrupting established markets (Fatoki, 2024). Moreover, startups disproportionately contribute to job creation and productivity growth, especially in rapidly evolving industries (Bjørnskov & Foss, 2016). Consequently, this study employs startup density - measured as the number of startups founded in the last decade per million population - as the key dependent variable to capture entrepreneurial activity and understand the variance across modern economies.

Public policy plays a crucial role in shaping the environment in which startups emerge and scale. From simplifying business registration processes to providing financial incentives and entrepreneurial education, policy instruments influence the ease and attractiveness of startup creation (Aidis et al., 2022; Baumol, 1990). Yet, the impact of such policies varies widely across countries, raising questions about the conditions under which they effectively foster entrepreneurial activity (Sautet, 2023).

Further, state capacity could play a significant moderating role in determining the effectiveness of entrepreneurship-supporting public policy on entrepreneurial outcomes. High state capacity, characterized by efficient governance, strong institutions, and effective enforcement mechanisms, enhances the implementation and impact of policies aimed at fostering entrepreneurship (Acemoglu & Robinson, 2019). When state capacity is robust, regulatory frameworks, financial incentives, and entrepreneurial support programs are more likely to be delivered effectively, reducing barriers and uncertainties faced by entrepreneurs (North, 1990; Besley & Persson, 2011). Conversely, in contexts with weak state capacity, public policies may be poorly enforced or corrupted, limiting their positive influence on entrepreneurial activity (Khan et al., 2023). Recent empirical evidence suggests that the interaction between public policy and state capacity significantly shapes startup formation and growth, highlighting the importance of institutional quality in entrepreneurship ecosystems (Li et al., 2024). Thus, understanding state capacity's moderating effect is vital for designing context-sensitive entrepreneurship policies.

This study explores the relationship between public policy and entrepreneurial activity across the top 40 economies by GDP, focusing on how variations in governance quality - measured through state capacity - moderate this relationship. This study combines Global Entrepreneurship Monitor (GEM) policy indicators with Crunchbase data on startups to examine how institutional capacity moderates the effectiveness of entrepreneurship-support policies. Specifically, the study examines whether higher state capacity strengthens the positive impact of public policies on startup formation by ensuring better implementation and reducing bureaucratic obstacles.

These insights aim to inform policymakers on the critical role of governance quality in shaping entrepreneurial ecosystems and highlight the need for tailored policy designs that consider the institutional context to successfully stimulate startup growth. The paper contributes by combining public policy and governance quality perspectives into an integrated framework, offering a nuanced understanding of drivers of startup formation across diverse institutional contexts. The findings offer practical insights for policymakers aiming to design