

Innovation, Spillovers and Venture Capital Contracts

Roberta Dessí*

Toulouse School of Economics (GREMAQ and IDEI) and CEPR+.

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Abstract

Innovative start-ups and venture capitalists are highly clustered, benefiting from localized spillovers: Silicon Valley is perhaps the best example.

There is also substantial geographical variation in venture capital contracts: California contracts are more "incomplete". This paper proposes an economic explanation for these observations, often attributed to regional cultural differences. In the presence of significant spillovers, it becomes optimal for an innovative start-up and its financier to adopt contracts with fewer contingencies: these contracts maximize their ability to extract (part of) the surplus they generate through positive spillovers. This relaxes ex-ante financing constraints and makes it possible to induce higher innovative effort.

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