Entrepreneurship Practice in Developing Countries: A look at some Distinctive Attributes

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Abstract

The Global Entrepreneurship Monitor (GEM) has set the agenda for researching the differences between entrepreneurship in developed and developing countries. Particularly significant has been the emergence of the GEM 2003 Executive report (Reynolds et al 2004) that has helped us understand the diversity in the formation of new firms in developed and developing countries. Entrepreneurship in developing countries is distinctive from that practised in more developed countries. A better understanding of these distinctions is critical to policy formulation and private sector development in developing countries. Of particular interest are new and growth-oriented enterprises, which have a greater capacity to create sustainable economic growth than micro enterprises or long-established SMEs with limited growth prospects. The purpose of this paper is to identify some of the distinctive attributes of entrepreneurship in developing countries that either help to improve the probability of success or hold back growth-oriented firms.

Introduction

Entrepreneurship is considered a crucial mechanism of economic development. The centrality of entrepreneurship in the current economy, or even society, is expressed as such in scientific and policy discourses as 'the entrepreneurial economy' and 'the entrepreneurial society' (Ministerie van Economische Zaken 1999a; Von Bargen et al. 2003). At the macro level entrepreneurship is seen as a driver of structural change and job creation. At the micro level entrepreneurship is the engine behind the formation and subsequent growth of new firms. The wealth and poverty of developing countries has been linked in modern times to the entrepreneurial nature of their economies. In countries where entrepreneurship exists in high proportions it has played an important role in economic growth, innovation, and competitiveness and it may also play a role over time in poverty alleviation.

Yet, entrepreneurship in developing countries is arguably the least studied significant entrepreneurship economic and social phenomenon in the world today. Over 400 million individuals in developing countries are owners or managers of new firms. Of these, over 200 million are found in China and India alone compared with just 18 million entrepreneurs in the United States. Yet, in one of the best general books on the state of research on entrepreneurship, China is mentioned on two pages and India is not mentioned at all (Bhidé 2000).

Existing specialist literature has focused on describing the attributes of entrepreneurship in developing countries, rather than providing a framework in which entrepreneurs and policy makers alike can more rationally plan and execute innovative business models. Existing models of entrepreneurship, (such as Bhidé's uncertainty-/investment/profit diagram), are based largely on research conducted in the United States and other developed countries and do not adequately describe how entrepreneurship is carried out in developing countries. Not much literature exists on

entrepreneurship in developing countries, particularly the characteristics of new and growth-oriented firms. Scholars and practitioners alike have implicitly assumed that entrepreneurship was largely the same the world over and driven by the same impulses or factors.

More recent empirical researchmost notably based on the World Business Environment Survey (WBES) and the Global Entrepreneurship Monitor (GEM) projecthave brought to the fore the diversity, if not the dynamics, of new firm formation in developing countries. Even though methodological weaknesses may limit the robustness of the GEM data, they offer the first broad cross-country comparisons of entrepreneurship and, in particular, allow comparisons of the levels and possible drivers of opportunity-based entrepreneurship. Recent research has suggested that new firms are more likely to grow. Whilst growth-oriented firms, are more likely to create new employment opportunities than stagnant ones. Reviewing available literature by specialists and the outcomes of recent research by the Global Entrepreneurship Monitor (GEM), gives the notion that entrepreneurship in developing countries, is distinctive from that practiced in developed countries, and that understanding these distinctions is critical to private sector development in developing countries. This paper seeks to illustrate what some of these distinctions might be and their implications on new and growth oriented firms, which recent research strongly suggests are more likely to contribute to economic growth and provide important new sources of higher quality employment.

What is Entrepreneurship?

While it has become widely acknowledged that entrepreneurship is a vital force in the economies of developed countries, there is little consensus about what actually constitutes entrepreneurial activity. Scholars have proposed a broad array of definitions, which when operationalised, have generated a number of different measures in the development of the entrepreneurship literature. There is no generally accepted definition of entrepreneurship for the developed countries of the OECD. The failure of a single definition of entrepreneurship to emerge undoubtedly reflects the fact that it is a multidimensional concept. The actual definition used to study or classify entrepreneurial activities reflects a particular perspective or emphasis. For example, definitions of entrepreneurship typically vary between the economic and management perspectives.

From the economic perspective, entrepreneurship is distinguished between the supply of financial capital, innovation, allocation of resources among alternative uses and decision-making. Thus, an entrepreneur is someone encompassing the entire spectrum of these functions: "The entrepreneur is someone who specializes in taking responsibility for and making judgmental decisions that affect the location, form, and the use of goods, resources or institutions" (Hebert and Link, 1989, p. 213). By contrast, from the management perspective, "entrepreneurship is a way of managing that involves pursuing opportunity without regard to the resources currently controlled. Entrepreneurs identify opportunities, assemble required resources, implementation of practical action plan, and harvest the reward in a timely, flexible way," (Sahlman and Stevenson, 1991, p.1). The most prevalent and compelling views of entrepreneurship focus on the perception of new economic opportunities and the subsequent introduction of new ideas in the market. As Audretsch (1995) argues, entrepreneurship is about change, just as entrepreneurs are agents of change; entrepreneurship is thus about the process of change. This corresponds to the definition of entrepreneurship proposed by the OECD, "Entrepreneurs are agents of change and growth in a market economy and they can act to accelerate the generation, dissemination and application of innovative ideas....Entrepreneurs not only seek out and identify potentially profitable economic opportunities but are also willing to take risks to see if their hunches are right" (OECD, 1998, p. 11).

While the simplicity of defining entrepreneurship as an activity fostering innovative change has its attraction, such simplicity also masks considerable complexity. Entrepreneurship is shrouded is complexity for at least two reasons. The first reason emerges because entrepreneurship is an activity crossing multiple organizational forms. Does entrepreneurship refer to the change inducing

activities of individuals, groups of individuals such as networks, projects, lines of business, firms, and even entire industries, or even for geographic units of observation, such as agglomerations, clusters, and regions? Part of the complexity involved in entrepreneurship is that it involves all of these types of organizational forms. No single organizational form can claim a monopoly on entrepreneurship.

The second source of complexity is that the concept of change is relative to some benchmarks. What may be perceived as change to an individual or enterprise may not involve any new practice for the industry. Or, it may represent change for the domestic industry, but not for the global industry. Thus, the concept of entrepreneurship is embedded in the local context. At the same time, the value of entrepreneurship is likely to be shaped by the relevant benchmark. Entrepreneurial activity that is new to the individual but not the firm or industry may be of limited value. Entrepreneurial activity that is new to the region or country may be significant but ultimately limited. By contrast, it is entrepreneurial activity that is new across all organizational forms, all the way up to the global, that carries the greatest potential value. Thus, one of the most striking features of entrepreneurship is that it crosses a number of key units of analysis. At one level, entrepreneurship involves the decisions and actions of individuals. These individuals may act alone or within the context of a group. At another level, entrepreneurship involves units of analysis at the levels of the industry, as well as at spatial levels, such as cities, regions and countries. The function of entrepreneurs is to reform or revolutionize the pattern of production by exploiting an invention, or more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way...To undertake such new things is difficult and constitutes a distinct economic function, first because they lie outside of the routine tasks which everybody understand, and secondly, because the environment resists in many ways."

Economists have long believed that entrepreneurs push back the business frontier by challenging existing practices and technologies. The role isn't necessarily glamorous, but it's extremely valuable. And it is often the missing performance factor in poor countries, where economies are stagnant or regressing. Developing countries trapped in economic droughts need to be irrigated by the entrepreneurial spirit. As IMF analyst Philippe Beaugrand points out, being an entrepreneur essentially comes down to "doing new things" or "doing things differently" .Entrepreneurship, then, basically means thinking outside of the box, which is exactly what participants in the economies of developing countries need to do in order to improve their situation.

Entrepreneurship is not a well-developed component of modern economic theory. Many neoclassical economists find it difficult to reconcile the requirements of rational decision-making with the functions ascribed to entrepreneurshipcoor-dination, arbitrage, innovation, and uncertainty bearing (Barreto 1989). Entrepreneurs have been described variously as bearers of risk, agents that bring together the factors of production, or organizers of innovation. However, none of these thinkers distinguished between entrepreneurs operating in different business environments or considered differences between entrepreneurship in wealthy and poor countries at various stages in economic history.

Academic interest in entrepreneurs in developing countries began in the wake of decolonization, with interest until recently concentrating mainly on small-scale industrialization and microenterprises. Four types of entrepreneurial firms have been identified in developing countries: newly established, established but not growing, established but growing slowly, and graduates to a larger size (Liedholm and Mead 1999). With respect to the study of the subset of new and growth-oriented firms in developing countries, an important step forward has been the rich output of the GEM project.

Some distinctive attributes of entrepreneurship in developing countries

Some distinctive attributes of entrepreneurship in developing countries appear to improve the probability of success for growth-oriented firms, while others appear to hold back these firms.

Opportunity

Opportunities for entrepreneurs in developing countries are broader in scope than in developed markets, allowing firms to pursue a portfolio approach to strategy that can efficiently manage the higher levels of business and market risk. Entrepreneurs in developing countries face a different set of circumstances than their counterparts in developed economies. These differences are rooted in the underlying economies in which they operate. Emerging markets lack the stableness of mature markets and the consistency that such markets offer. Consequently, the opportunity for entrepreneurship in emerging markets is pervasive. While Western entrepreneurs operate at the fringes of the economy, emerging market entrepreneurs operate closer to the core the needs and opportunities are more widespread. While the competitive threat to these entrepreneurs from well-established incumbents is reduced, the risks posed by economic, political and regulatory uncertainty is heightened often outweighing direct competitive threats.

The rational, though counter intuitive, response (especially for those trained in Western business strategy) is for entrepreneurs in developing countries to spread resources across several separate but related businesses in order to mitigate systematic risk. In effect, the entrepreneur operating in segmented markets (a feature of many developing countries) often plays a surrogate role as a financial investor who manages risk through portfolio diversification. He manages portfolio risk by operating several diverse businesses in lieu of investors who might otherwise do the same. Lacking alternative sources of financing, the successful entrepreneur may use internally generated cash flow from one business to fund his other businesses. The keiretsu system in Japan and *chaebols* in Korea are examples of highly developed conglomerates with interlocking ownerships and business partnerships that developed in this manner. In addition to risk mitigation and a source of funding, interlocking businesses provide a source of informal information flow, access to a broader pool of skills and resources, and, when well implemented, a brand name that can be leveraged across all businesses. If interlocking business conglomerates are common in emerging markets, how do they start? Inadequate access to capital and fragmented retail and distribution often require entrepreneurs to begin businesses downstream with direct access to the end customer.

Starting downstream businesses reduces initial capital requirements as working capital is much reduced and permits access to customers and information flow that is frequently lacking. Access to such information is often overlooked as a key success factor. Lack of access to the end customer is a primary reason for the failure of South American businesses to move beyond commodity markets into higher value added activities (Fairbanks and Lindsay 1997). Having achieved success in retail and distribution, successful entrepreneurs often leverage the domain experience, information flow, and cash flow generated to vertically integrate and move into upstream businesses.

Financial Resources

While entrepreneurial opportunities are broader and resultant strategies are naturally self-hedging in developed countries, limited personal and family savings and an absence of financial innovation severely limits the growth prospects of promising startups in developing countries. The nature of entrepreneurial opportunities in developing countries plays a critical role in the market for entrepreneurial finance in these countries. To a greater extent than in developed countries, new entrant entrepreneurs must answer the following fundamental financial questions: if the odds of a new enterprise surviving its first five years are less than 50%, is it rational for an entrepreneur to commit financial resources (her own or others) to a new firm? If not, how can we understand the persistent tendency of entrepreneurs to start new businesses? Reflecting the unpromising odds of entrepreneurial success, internal finance comprises the majority of financing for small and medium enterprises in most developing countries. Entrepreneurs in emerging markets rely very heavily on informal sources of finance to start their businesses; these sources provided between 87% and 100% of the outside capital raised by entrepreneurs (Bygrave 2003). Other sources of financing typically targeted by development finance institutions interested in

improving access to finance in the emerging marketsbank lending and venture capitalplay a very limited role at present in financing entrepreneurs, at least in the startup stage.

Very little is understood about the mechanisms by which potential entrepreneurs in developing countries gather the capital necessary to start a business. How do entrepreneurs save funds from their own sources of income in order to start a business? Recent evidence suggests that startup capital requirements could be quite modest in developing countries (for example, Bhidé 2004 and Johnston et al. 2004). There are two issues here: sources of income, and appropriate depositories for savings until the new business is started. Sources of income can include retained earnings from a previous business, often in the retail or distribution sector. In countries where well-paid government positions are still available (such as the Middle East), some potential entrepreneurs are able to save start up capital from their salaries. Research on the determinants of private savings in developing countries suggest that countries that have experienced economic instability are more likely to have higher rates of private saving, maintained as an insurance mechanism (Loayza, Schmidt-Hebbel, and Servén 2000). Crisis represents opportunity; at least as far as forming the pools of private capital necessary for startup finance is concerned. Moreover, while successful entrepreneurship is correlated with urbanization, urbanization also results in an increase in individual consumption and a concomitant decrease in private savings. Thus, successful entrepreneurs are likely to find ways to access the greater pools of private saving in the countryside in order to start their businesses. This highlights the possible importance of well-developed family networks that span both urban and rural areas. How such private rural savings are intermediated into urban entrepreneurship is not at present well understood and almost certainly will vary by country.

In theory, microenterprises could also play a role in creating a pool of savings from which a larger, more sophisticated enterprise might be launched. However, a shortage of attractive savings mechanisms (including negative real interest rates on bank deposits) in the formal and informal financial sectors and the difficulties associated with investing in land or real estate as a savings vehicle (including land tenure issues) have severely limited savings. Other forms of de facto savings, such as inventory accumulation, are also limited by the absence of secure premises .These are some of the many reasons why microenterprises have not generally served as launching pads for growth-oriented entrepreneurship in developing countries.

Finally, an important, but overlooked and undocumented, development is the increasingly consumerist nature of developing country economies, which has caused personal savings rates to fall and personal consumer-related indebtedness to grow. Anecdotal evidence from regions such as the Middle East and North Africa suggest that inappropriate levels of personal indebtedness may severely constrain an entrepreneur's willingness and capability to start a new firm. Once established, new firms use a wide variety of unconventional techniques and strategies to obtain finance. Given the underdeveloped nature of financial markets in many developing countries, bootstrap financing may have become the predominant form of early stage financing in these countries. For example, small-scale Chinese entrepreneurs have designed a wide variety of techniques and institutions to provide informal finance (Tsai 2002).

Why have outside, formal sources of financing, particularly forms of risk capital finance required by growth-oriented entrepreneurs in emerging markets, failed to materialize in substantial quantities? One major reason is that the macroeconomic conditions in many emerging markets militate against the high IRRs that investors require in order to compensate them for their risk (Leeds and Sunderland 2003). As a result, while there are no industry-wide statistics on private equity investing in emerging markets, it is estimated that realized IRRs are roughly breakeven for the first generation of such funds (those started in the early 1990s). It goes without saying that such returns are insufficient to attract large amounts of new investment into the next generation of risk capital vehicles.

Risk capital finance is particularly important for growth-oriented entrepreneurs in the developing world, because it aligns the incentives of entrepreneurs and outside investors. Each is properly motivated to maximize economic value of the enterprise, rather than playing zero-sum games designed to benefit at the expense of the other. Such zero-sum games are typical of commercial bank lending to entrepreneurs in developing countries. In addition, properly designed and staffed fund management organizations can add substantial post-investment value to the growth-oriented entrepreneurial enterprise. Lenders do not have incentives to provide such post-investment assistance. Post-investment value creation is often a key to the development of growth-oriented entrepreneurial enterprises.

While risk capital finance has been an important component of the entrepreneurial process in a number of developed countries, it has not realized its promise in the developing world. The American model of venture capital has had limited applicability in these markets, but has often been the first approach taken by fund managers focused on developing countries. Venture capital funds are able to work with only small numbers of companies, limiting their development impact. Venture capital and private equity funds have been unable to exit many of their investments, due to the illiquidity of local stock markets in developing countries. Successful venture capitalists possess relatively rare skills that can generally be acquired only through experience, rather than through education and training, thus limiting the number of risk capital organizations that can be organized. Current forms of risk capital finance require the setup of new institutions (usually both a fund and a fund management company) before commencement of investment operations, thus slowing the investment process and causing funds to invest too late in the investment cycle in many cases. How might some of these hurdles be overcome? Surprisingly, despite the revolution in finance that has swept through developed capital markets over the past fifty years, little financial innovation has made its way to entrepreneurial firms in developing countries. As one example, income-linked loans (loans, the repayment of which is tied to a borrower's future income) were first introduced to finance higher education in the United States (Shiller 2003), but could be applied to other classes of borrowers, including entrepreneurial firms in developing countries.

Lenders (commercial banks, non-bank financial institutions, fund managers, and others) could offer long-term (10 years or more) loans to entrepreneurial borrowers. The repayment terms of these loans would be tied to both the firm's future income and some index of aggregate incomes. This index of aggregate incomes might include borrowers from the same sector throughout a region (for example, all garment manufacturers in Indonesia), corporate borrowers from any sector but in the same geographic region (for example, all corporate borrowers in Brazil), or a combination of the two.

Apprenticeship and Human Resources

Technical, industry-specific training is an important component in the creation of globally competitive firms. These firms often form into geographically focused industrial clusters (Porter 1998). Indeed, this has been found to be a powerful model that can be extended to the emergence of globally competitive industries in developing countries. The software cluster in India, the animation outsourcing cluster in the Philippines, and the wireless market in China each conform to varying degrees with the specifications of clustering.

However, the clustering model is of limited value for the vast majority of entrepreneurial opportunities and those involved with public policy in markets where essential preconditions do not yet exist and may not be construed. It is not clear that clustering is a precondition for the creation of globally competitive firms in developing countriesJollibee and Cemex are examples to the contrary. In addition, what is to be done about industries in which the market size is national and sub-national and business conditions are essentially homogenous? How does one operate in emerging markets without the normal avenues of preparation and mentorship? What does one do when in mal-developed or corrupt economies where leading companies do not necessarily serve as the best guides for new businesses? How do businesses achieve scale in the

absence of certain skill sets domestically such as financial management?

Entrepreneurship is a lonely profession rendered more difficult without the benefit of mentorship and apprenticeship. Leading hotspots of innovation such as Silicon Valley have a broad pool of well-trained talent, a culture that encourages innovation and new businesses, and marquee companies that serve as informal finishing schools for entrepreneurs. Even in the absence of these ideal situations, apprenticeship and entrepreneurship may be developed in tandem. At the most rudimentary level, micro lending organizations have found that repayment and business success rates increase markedly with even the most basic business training and local support groups of like-minded entrepreneurs. Unfortunately, few of these enterprises scale to regionally competitive levels, let alone national or global levels. At a higher level, multinationals have played a leading role as training grounds for prospective entrepreneurs. Given that foreign direct investment by multinationals is often directly related to the general business environment, and that apprenticeship in these firms can be an important road to entrepreneurship, we shall need to reconcile these observations with the lack of correlation of levels of entrepreneurship with the general business environment. In those markets where entrepreneurship has flourished, successful local businessmen may serve as mentors and outside advisors.

As a business expands, corporate governance supersedes mentorship as requisite guidance and oversight; a mix of savvy local businessmen and industry experts, even if attracted from abroad, play an important role during this expansion stage. Emerging markets require revolutionary change but have few people with the requisite skills and experience to effect such change. High potential businesses in developed economies assemble executive teams with common experiences but diverse, complementary skills. Potential stakeholders look for thoughtfully selected, complete teams that include experienced executives in sales, marketing, finance and operations. In emerging markets, these skills are equally valid but often in short supply. As a result, entrepreneurs look for other characteristics that are pertinent to the local market environment, including the ability to see through the fog of politics and economics in crisis-prone developing countries. Trust is even more highly regarded in these situations than in developed markets where arms-length transactions are well established. Family owned and operated businesses are even more common in emerging markets than in Western economies.

Conclusion

It is generally acknowledged that there are differences in the distribution of entrepreneurship across countries. Studies exploring differences in entrepreneurship across countries often focus on the incidence of new firm registration or self-employment which may not be reliable indicators when applied to developing countries with significant informal economies and fewer alternatives to self-employment. The contribution of entrepreneurial activity to economic growth has been found to be stronger for highly developed countries as compared to developing countries. This may be due to the distinct differences between the two in relation to availability of financial resources, apprenticeship and skilled human resource and an appropriate legal frame work that support new firm formation and growth oriented firms.

Due to the important economic, social, and political roles new and small firms play in most economies, governments at all levels federal, state/regional, and local especially those in developing countries must design strategies to support entrepreneurial activity. One of the most important questions regarding entrepreneurship policy is whether to stimulate new firm formation, to help existing firms survive, or to focus on (potentially) growing firms (cf. Reynolds et al. 1994). Next, it is also important to decide on whether to aim for generic policy or to focus on particular regions or industries (cf. Stam 2005). Of course prior to any public policy should be the establishment of a legal framework, a "rule of law" (cf. De Soto 2001). This legal foundation is often taken for granted, but is often not in place in developing and transition countries. Perhaps the first question must be whether governments should be involved in supporting entrepreneurs at all. Why should governments do more than enhancing the

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general investment climate? So-called market failures are often used to legitimize entrepreneurship policy.

Entrepreneurs may not undertake projects which, whilst in the interest of society as a whole, yield the firm insufficient returns. The role of public policy (e.g. subsidy) is to make it privately worthwhile for the firm to undertake the project, enabling society as a whole to benefit. In the context of high growth firms, it might be that entrepreneurs do not pursue certain projects, because the risks are too high (new technology), or because they cannot fully appropriate the returns (innovation). Public policy could raise the private benefits of these projects in order to produce the social benefits, e.g. job creation and improved national productivity.

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