



Entrepreneurship and Local Economic Growth in Emerging Markets

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Abstract:

The relationship between entrepreneurship and economic growth is well studied. Also among policymakers worldwide, the growth of indigenous enterprises is nowadays increasingly considered as an engine for long lasting local economic growth, rather than attracting large firms as they have done in the previous decades. However, the focus of research is mostly on the effects of entrepreneurship on economic growth (e.g. innovation, competition, productivity, job generation, agents of change), not so much on the mechanisms how to create an environment for successful entrepreneurial activity. This question is particularly relevant for emerging markets, which generally have a high incidence of entrepreneurship, but a limited (visible) contribution to GDP. This paper addresses the more complex realities of entrepreneurship in emerging markets, and how to facilitate entrepreneurship in such a way that it can contribute to local economic growth more effectively.

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JEL classification: L26, O17, O31, I25

1. Introduction

The relationship between entrepreneurship and economic growth is well studied. Although entrepreneurs act in pursuit of their own profits, they may generate benefits to the broader society in the process, for instance in terms of creating new jobs, intensifying competition, introducing innovation, and increasing productivity. Also among policymakers worldwide, growing indigenous enterprises has gained increasing popularity as an engine for sustainable local

economic growth (cf. Thurik, 2013; Naudé, 2011; Szirmai et al., 2011; Carree and Thurik, 2010; Acs, 2006; Van Stel et al., 2005).

Although fostering entrepreneurship is not new, it represents a shift away from the macro-economic interventions that dominated among (local) policymakers in previous decades, when it was most common to try and attract large firms by providing substantial incentives (Chatterji et al., 2013). Unfortunately, many of these top-down policy interventions have not been able to address immediate and short-term local economic problems. Instead, entrepreneurship is now promoted as a bottom-up, 'low cost-high impact' approach, which can address individual-level needs related to income and employment, and can work with minimal infrastructure and resources (Desai, 2009).

However, most research focuses on the effects of entrepreneurship on economic growth, not so much on the mechanisms to create an environment for successful entrepreneurial activity that can contribute to local economic growth. This question is particularly relevant for emerging markets, which have a high incidence of entrepreneurship, but only a limited (visible) contribution to gross domestic product (Xavier et al., 2013). To explain this apparent paradox, this paper analyses the more complex realities of entrepreneurship in emerging markets, and addresses the question how to facilitate entrepreneurship in such a way that it can contribute more effectively to local economic growth.

In the first part, the different types of entrepreneurship that prevail in emerging markets will be discussed, including the challenges and

opportunities for each type, and their respective contributions to economic growth. The second part focuses on the challenges and opportunities for innovation in the specific context of emerging markets, while the final discussion provides several policy recommendations on how to create an environment that encourages productive and innovative entrepreneurship, which can contribute to local economic growth more effectively.

2. Types of entrepreneurship

One of the most positive contributions of entrepreneurship to the economy, as described by Schumpeter (1934), is the recognition and utilization of opportunities in such a way that it provides 'new combinations' (e.g. products, markets, organization), which constitute better ways to meet existing demand. However, Baumol (1990) convincingly argued that not all opportunity exploitation will necessarily contribute to the good of society. Depending on the 'rules of the game' in the economy, which may change from one time and place to another, entrepreneurship can sometimes be unproductive, and even destructive (Baumol, 1990). Unproductive firms are often replicative, as opposed to innovative, and take a share of the other's pie instead of increasing the size of the pie itself.

The multi-country surveys conducted under the Global Entrepreneurship Monitor (GEM) research program have contributed strongly to understanding how different types of entrepreneurship affect economic growth across countries and regions (Xavier et al., 2013). An important distinction within entrepreneurship research that was introduced by the GEM consortium, and which is particularly relevant in emerging markets since it is related to the level of economic development, is between opportunity-driven and necessity-driven entrepreneurship (cf. Acs, 2006; Desai, 2009). Another common distinction when researching entrepreneurship in emerging markets, related to the institutional context, is between formal and informal entrepreneurship (cf. Williams and Nadin, 2010; OECD, 2009). In many cases, both distinctions are interdependent.

3. Opportunity-driven vs. necessity-driven entrepreneurship

The distinction between opportunity-driven and necessity-driven entrepreneurs originates from the fact that most emerging markets have high levels of entrepreneurship, but these firms only have a limited (visible) contribution to economic growth. Whereas the opportunity-driven entrepreneur, in line with Schumpeter (1934), makes an active choice to start a business to take advantage of an unexploited or underexploited business opportunity, the necessity-driven entrepreneur has no better options at finding a (satisfactory) job (cf. Acs, 2006; Desai, 2009). This apparent paradox confirms the ideas of Baumol (1990) that not all entrepreneurship is necessarily productive.

Since opportunity-driven entrepreneurs are 'pulled' into entrepreneurial activities, they are generally better motivated, and often also more skilled at running a business. As a result, they are able to operate more efficient and be more productive. Because of this, they are also more likely to get access to external finance, and, consequently, their firms tend to grow faster and larger (Acs, 2006). For necessity-driven entrepreneurs, the underlying motivation for starting a business is quite different. Since these entrepreneurs are generally 'pushed' into self-employment for subsistence reasons, they usually operate on a small scale, involving simple business activities. Their entrepreneurial skills may not matter much to the functioning of their businesses. They only have limited personal or family savings, and lack access to external finance, which severely hampers the growth prospects of their firms (Desai, 2009).

Other than providing an income to a family, necessity-driven entrepreneurship generally has little or no effect on economic growth, while opportunity-driven entrepreneurship can indeed have significant positive effects (e.g. employment, competition, innovation). However, a relatively high share of the entrepreneurship rates in emerging markets is primarily driven by necessity motives. As such, high levels of entrepreneurship may be an indicator of low levels of development rather than a potential engine for economic growth. This corresponds

with the idea that the relationship between entrepreneurial activity and economic development is U-shaped (Wennekers et al., 2010). According to this model, self-employment declines as economies become more efficient, and alternative wage-earning job opportunities are created, only to increase again when economies reach the even more advanced innovation-driven stage (Porter, 1990). The major difference, however, is that these entrepreneurs are predominantly characterized as ambitious, innovative, opportunity-driven entrepreneurs.

4. Formal vs. informal entrepreneurship

It is well known that a substantial proportion of economic activity in emerging markets takes place in the informal sector. The most obvious distinction with a formal entrepreneur is that an informal entrepreneur operates a business without registration. However, firms may show different degrees of informality. Even registered firms may occasionally resort to informal operations, for instance by charging without invoice, or providing casual services to friends and relatives. Apart from completely 'hidden' firms, the informal sector also includes (partially) 'hidden' output (Williams and Nadin, 2010). Because informal firms operate (largely) outside the legal framework of an economy, one of the biggest problems when studying informal entrepreneurship is the lack of reliable data. Worldwide, estimates measuring informality (or self-employment) range from 30% in Eastern European economies, up to almost 60% in Sub-Saharan countries (cf. WBES, 2013; OECD, 2009; ILO, 2009). It is widely assumed that having a large informal sector is undesirable and potentially harmful to the economy. Informal firms may produce unfair competition to formal firms, and deprive governments of potential revenue through income and labor tax (cf. González and Lamanna, 2007; Lewis, 2004).

Others oppose this 'parasite view' by arguing that excess regulation and a high cost of operating a formal business is driving potential entrepreneurs into informality. According to this 'legalist view', informal businesses may lift individuals or families out of poverty and may therefore also contribute to economic growth (Bennet and Estrin, 2007; De Soto, 2000). Finally, the so-

called 'dual view' stresses the co-existence between formal and informal firms. According to these authors, informal firms represent little threat to formal firms since they generally operate on different markets, with different customers, but also contribute little to economic growth because they are often highly inefficient (La Porta and Shleifer, 2008).

Evidence indeed suggests that informal entrepreneurs generally tend to start out, and stay smaller than formal firms, employ fewer workers, and have less access to business financing than their formal sector counterparts (Amin, 2009). The vast majority of informal entrepreneurs are in fact necessity-driven entrepreneurs, starting their businesses because of lack of alternative employment opportunities (Autio and Fu, 2013). From more than one point of view, it seems desirable to stimulate businesses to register as formal firms, because it could lead to substantial efficiency gains (Klapper and Love, 2010). However, there is very little evidence that formal firms have previously operated informally (La Porta and Shleifer, 2008).

The choice, as far as possible, between formal or informal entrepreneurship is often based on a calculation of relative costs and benefits within a specific institutional environment. Most firms in emerging markets are confronted with many costly and time consuming regulatory and administrative barriers when registering (WB/IFC, 2013). Add to this the many indirect costs, such as bribes and service fees for processing business permits without excessive delay (Autio and Fu, 2013). Consequently, in countries with difficult entry regulations, a weak rule of law, and weak protection of property, many entrepreneurs will probably prefer to remain informal (Gelb et al., 2009).

5. Innovation in emerging markets

In the Schumpeterian definition, entrepreneurship is almost synonymous to innovation. In a process of 'creative destruction', entrepreneurs challenge existing firms by introducing new combinations that make current technologies and products obsolete (Schumpeter, 1934). A somewhat broader approach refers to innovation not only as the development of new products or

(technological) processes, but also as the exploitation of new markets and the development of new ways to organize business. Also relevant in this discussion is the distinction between innovations that are 'new to the world', innovations that are 'new to the domestic market', or innovations that are 'new to the firm' (cf. Szirmai et al., 2011; Aulet and Murray, 2013).

Market conditions, policies, and the institutional environment can promote or hinder innovative behavior. In emerging markets, the incentive for entrepreneurs to innovate is often limited, because the risks posed by economic, political and regulatory uncertainty are often high. Markets are often imperfect, and inappropriate property rights and weak contract enforcement make returns on innovations risky, while deficient infrastructure, low per capita incomes, and institutional barriers make it difficult for innovations to spread (Szirmai et al., 2011). Most innovation, will therefore, at best, take place at the firm level, since only few entrepreneurs are able to successfully compete at national levels, let alone global levels.

Nevertheless, in dealing with both market and government deficiencies, entrepreneurs in emerging economies often resort to a wide variety of unconventional techniques and strategies, for example to obtain finance (Lingelbach et al., 2005). Even technological backwardness is not necessarily a disadvantage as long as the absorptive capacity and creativity of entrepreneurs with respect to new technologies is sufficiently developed. This absorptive capacity goes beyond mere imitation, and may result in new, and even disruptive, innovations without having to bear all the costs and risks of investing in developing new knowledge (Szirmai et al., 2011).

Evidence shows that the process of economic development is not linear, neatly following certain stages of development, but may also involve 'leapfrogging' (cf. Goedhuys and Sleuwaegen, 2009; UNCTAD, 2004). Entrepreneurs may even benefit from market and government deficiencies because the needs, and therefore new business opportunities, are

widespread. Since competitive threats are also more limited, opportunities for entrepreneurs in emerging markets are also broader in scope, allowing firms to pursue a portfolio approach. This strategy can also efficiently manage the higher levels of business and market risk.

6. Discussion

Over the past decade, both academics and policymakers have demonstrated renewed interest in entrepreneurship as an engine for local economic growth, in particular in emerging markets. Although it is often considered as a 'low cost-high impact' approach, its contribution to economic growth has, by no means, achieved its potential yet. Due to the often challenging entrepreneurial environment with regard to levels of development and institutional context, the numbers of small-scale, informal, self-employed, and often unproductive entrepreneurs outweigh the number of productive, innovative, opportunity-driven entrepreneurs.

In order to create an environment that encourages productive and innovative entrepreneurship in such a way that it can contribute more effectively to local economic growth, a broad and integrated approach is essential, since it is influenced by many determinants (e.g. education levels, business climate, legal and political conditions). Efforts to promote entrepreneurship as an engine for economic growth should therefore include the three most important stakeholders involved: the public sector, the private sector, and knowledge institutions. All stakeholders should thereby share a clear and exclusive focus on fostering ambitious, innovative and high growth-oriented firms (Stam and Van Stel, 2009).

As for the role of the government, in most emerging markets there still is a lot of ground to be gained to improve the business climate, and make it easier and less costly to start and run a business (WB/IFC, 2013). In addition, addressing other market deficiencies (e.g. access to finance, infrastructure, labor markets) also falls within the responsibility of the public domain. The engagement of the (local) private sector in fostering innovative and productive entrepreneurship may be multi-faceted. The minimal level of engagement may be in sharing

best practices, offering apprenticeships, and coaching start-up firms, but it may also include investing in promising firms and establishing (more) formal partnerships. Perhaps the most important responsibility lies with knowledge institutions. Education and the development of entrepreneurial skills play an important role in increasing the likelihood of survival of new firms, and in improving their economic performance. Since knowledge institutions traditionally play an important role in new value creation, they are the most appropriate stakeholder in taking the initiative in promoting innovative business solutions, and change the mindset with regard to entrepreneurial attitudes (e.g. opportunity perception), abilities (e.g. start-up skills), and aspirations (e.g. innovation, high-growth)(Acs et al., 2013).

If successful, innovative firms have the potential to grow exponentially, but at the same time these firms generally also need more investment in capital, time, and effort before they will bring returns (Aulet and Murray, 2013). Since many firms are doomed to early failure when they are most vulnerable, educational efforts should be combined with other initiatives, such as setting up business incubators that offer start-up support to promising entrepreneurial ideas. By linking technology, capital and know-how within a protected and enabling environment, the process of business creation can be speeded up, while the probability of failure can be reduced (De Bell, 2012). From the point of view of local economic growth, one of the long-term objectives may be the formation of a cluster of innovative firms, with a pool of well-trained and like-minded entrepreneurs, and a culture that encourages innovation and new businesses (Chatterji et al., 2013). The process of implementing such an integrated approach, with a clear and strong focus and involving all relevant stakeholders, will be long and undoubtedly littered with numerous setbacks and pitfalls, but it will eventually also benefit those groups of society that still rely on necessity-driven entrepreneurial activities.

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