

# Growth-Oriented Entrepreneurship

Global Survey and Assessment

Entrepreneurship in Developing Countries

**INTERNATIONAL CENTER FOR  
GROWTH-ORIENTED ENTREPRENEURSHIP**

2016 Edition  
Dr. Alan S. Gutterman

## **Growth-Oriented Entrepreneurship: Global Survey and Assessment**

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# PART V

# ENTREPRENEURSHIP IN

# DEVELOPING COUNTRIES

## §1:1 Introduction

While there is no universally accepted definition of a “developing country” it is acknowledged that almost two-thirds of the countries in the world are significantly challenged in their ability to provide a basic standard of living for their citizens and participate competitively in the global economy. It is common to distinguish between developed, or “advanced”, countries and developing countries by arranging all of the countries by their real income, from highest to lowest, and then drawing a dividing line that places those countries above the line into the “advanced” category and those below the line into the “developing” category. When this method is used the group referred to as “developed” typically includes the United States and Canada in North America, the countries in Western Europe and Australia, Japan, Israel and New Zealand. Developing countries can generally be found in Africa, Asia, Latin America and the Middle East; however, there are clear differences among countries that remain classified as “developing”. For example, many of the developing countries are highly industrialized and have become significant players in world trade (e.g., Brazil, Russia, India and China, which are referred to generally as the BRIC emerging markets). On the other hand, the so-called “less developed countries”, or “LDCs”, are truly poor and lag significantly behind most of the other countries in the world. From a size perspective the developing world includes China and India at one end to small and sparsely populated countries such as Samoa and St. Lucia at the other perspective. Relatively wealthy and prosperous countries such as Taiwan also share developing status in many measurements with extremely poor countries such as Haiti.

Austin prepared a summary comparison of developing and developed countries based on a list of key environmental factors—natural resources, labor, capital and infrastructure—and made the following general observations of conditions as of the last 1980s<sup>1</sup>: importance of natural resources (high in developing countries and low in developed countries); availability of natural resources (underdeveloped in developing countries and high in developed countries); availability of skilled human capital (scarce in developed countries and high in developed countries); percentage of workforce classified as unskilled, based on percentage of workforce working in agricultural sector (high in developing countries and very low in developed countries); per capita income levels (much higher in developed countries)<sup>2</sup>; savings rates as a percentage of GDP (lowest

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<sup>1</sup> J. Austin, *Managing in Developing Countries: Strategic Analysis and Operating Techniques* (New York: Free Press, 2002), 41. Development levels were based primarily on per capita GDP and high-income oil exporters were excluded.

<sup>2</sup> Income disparities remain shockingly wide and comparisons of wealth of the richest 20% of the world and the poorest 20% of the world made in 2006 revealed that while 85% of the global GDP was collected by

among low-income countries and highest among middle-income countries); income skewedness (medium among low-income countries, high among middle-income countries and low among high-income countries); financial institutions (weak among low-income countries and strong among high-income countries); capital flight (high among low-income countries and low among high-income countries which actually attract capital inflows); trade deficits (medium among low-income countries, high among middle-income countries and low among high-income countries); commodity export line (narrow among developing countries and broad among developed countries); physical infrastructure (weak among developing countries and strong among developed countries); information availability (low among developing countries and high among developed countries); technological levels (low among developing countries and high among developed countries); industry structures (dualistic among developing countries and unitary among developed countries) and technology flows (developing countries are recipients and developed countries are suppliers).

A list of common characteristics of developing countries should not lead to neglect of the substantial diversity among those countries. One finds very different levels and processes of development among developing countries and circumstances in those countries are always rapidly changing. While all of the countries included in the developing category have per capita income levels substantially lower than in the US, Japan and other industrialized countries there are vast and important gaps in income levels between upper middle-income and low-income countries and income levels in developing countries must be carefully adjusted to take into account different local costs of basic living items such as food and shelter. The size of the national economies among developing countries also differ substantially and size impacts issues such as the ability to achieve economies of scale, vulnerability to economic shocks and the need for firms to rely on export-based strategies due to limited local demand. Finally, developing countries can be distinguished by other factors such as literacy, health, demographic profile, access to natural resources and level of industrialization.<sup>3</sup>

Economists and other social scientists have suggested a number of different models of economic development, each of which carries its own assumptions about what policies should be followed by less-developed countries to achieve and sustain “a process of structural transformations’ leading to an overall higher growth trajectory”.<sup>4</sup> Among other things, countries are advised to carefully encourage and orchestrate a transition from an agricultural to a manufacturing economy and then to move further down the road toward modernization by creating a services sector. In order to accomplish all of this,

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the rich the poorest countries generated only 1% of global GDP. B. Punnett, Management in Developing Countries, [http://cavehill-uwi.academia.edu/BettyJanePunnett/Papers/181413/Managing\\_in\\_Developing\\_Countries](http://cavehill-uwi.academia.edu/BettyJanePunnett/Papers/181413/Managing_in_Developing_Countries)

<sup>3</sup> For further discussion of prospects and challenges in developing countries, particularly the role of the state in economic and social development in those countries, see “Cross-Cultural Studies: A Library of Resources for Growth-Oriented Entrepreneurs” prepared and distributed by the International Center for Growth-Oriented Entrepreneurship ([www.growthentrepreneurship.org](http://www.growthentrepreneurship.org)).

<sup>4</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, Jena Economic Research Papers, No. 2009-023, March 2009, 8 (citing R. Brinkman, “Economic Growth versus economic development: Towards a conceptual clarification”, Journal of Economic Issues, 29(4) (1995), 1171-1188, 1183).

investments must be made in the acquisition of technology and in infrastructure and trade channels must be developed to connect the local economy to the world. In addition, cultural habits must be changed in order to generate the recommended levels of national savings and ease the acceptance of new institutions that fundamentally alter the rights and responsibilities of individual citizens and firms.

The development challenges confronting most of the poorer countries of the world have their roots in the experiences of those countries during their colonial periods prior to independence. Acs and Virgill pointed out that “[c]olonial economic policies . . . set an important platform for the economic policies which followed in many developing countries” and argued that “[t]he colonial periods in Africa, Latin America, the Caribbean and Asia, generally established a center-periphery economic system of state-led extraction and primary production for export with little benefits accruing to the colonized populations”.<sup>5</sup> Moreover, not only were colonial times bad for those who were colonized, the damage continued after the end of the colonial period since many of the colonial institutions remained in place and thus contributed to a weak and unstable socio-economic base that has hampered efforts of independent states to launch development projects. In many cases, in fact, the former colonial masters have been replaced by a local “ruling elite” that has simply continued practices such as extraction of natural resources for their own benefit.<sup>6</sup>

The first attempts at economic development policy implemented by developing countries once they had achieved independence often took the form of “import substitution”, which focused on reducing dependence on imports, and foreign involvement in the local economy, by producing imported goods locally.<sup>7</sup> Proponents of import substitution argued that it was “the most efficient way for developing countries to achieve industrialization and income growth”<sup>8</sup> and that developing countries “would find it initially easier to produce for an existing and known domestic market than for an unknown global market”.<sup>9</sup> Import substitution required a plethora of laws and policies to protect the new “infant industries” in developing countries such as high tariffs, export taxes and production subsidies to domestic producers.<sup>10</sup> However, these measures were thought to be necessary in order for developing countries to survive in a global economy—as explained by Bruton: “To industrialize, given the existence of already industrialized and highly productive economies (the North), the countries of the South must protect their economies from imports from the North and concentrate on putting in

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<sup>5</sup> Id. at 10 and 12 (citing R. Prebisch, “Commercial Policy in the Underdeveloped Countries”, *The American Economic Review*, 49(2) (1959), 251-273, 251).

<sup>6</sup> Id. at 12 (citing D. Acemoglu, S. Johnson and J. Robinson, “The Colonial Origins of Economic Development: An Empirical Investigation”, *American Economic Review*, 91(5) (2001), 1369-1401, 1376).

<sup>7</sup> Id.

<sup>8</sup> Id. at 13 (citing R. Prebisch, “Commercial Policy in the Underdeveloped Countries”, *The American Economic Review*, 49(2) (1959), 251-273, 253-254).

<sup>9</sup> Id. at 14 (citing H. Singer, “Beyond terms of trade-convergence and divergence”, *Journal of International Development*, 11(6) (1999), 911-916, 911).

<sup>10</sup> Id. at 13 (citing R. Prebisch, “Commercial Policy in the Underdeveloped Countries”, *The American Economic Review*, 49(2) (1959), 251-273, 256-257).

place new activities that will produce an array of manufactured products currently imported”.<sup>11</sup>

While import substitution became a fairly common development strategy around the world, it eventually became apparent that this approach was not successful and that, like practices during the colonial times, it created deep problems for markets and institutions in developing countries that added to the challenges that policymakers faced as they looked for new solutions. Acs and Virgill recited a long list of problems created by import substitution including overvalued exchange rates, import and foreign exchange controls, large inefficient monopolies, complex business regulations (i.e., import licenses) and corruption. In addition, the strong government intervention in the marketplace required in order for import substitution to be implemented severely limited the role of local entrepreneurs and the fate of the economy was generally left in the hands of “bureaucrats with little market experience”.<sup>12</sup> In fact, Acs and Virgill conclude that “[g]iven the inefficiency of the import substitution strategy and the complexity of the bureaucracy created by import substitution ... entrepreneurs would be more likely to engage in rent-seeking, evasive and ‘unproductive’ entrepreneurial activities rather than in socially ‘productive’ entrepreneurship”.<sup>13</sup>

As enthusiasm for import substitution faded the surprising and impressive successes of the newly industrialized Asian economies led to a decisive change in the prescription for development that called for developing countries to embrace an “outward orientation” and implement policies that promoted exports and engagement in the global trading community. Economists were quick to line up with evidence that an export orientation and “openness” to trade was the preferred path to growth.<sup>14</sup> Specific policies and experiences of various Asian economies, notably Japan and Korea, are discussed elsewhere in this publication and the evidence in favor of export promotion strategies is quite impressive; however, many also cautioned that “trade liberalization must be accompanied by a milieu of other policies to ensure that a country is successful in integrating more intensively with the world in a manner that is favorable to growth and poverty reduction”.<sup>15</sup> Moreover, implementing export oriented policies successfully was far from easy and countries needed to overcome a number of difficult hurdles including high levels of protection within developed economies, the additional transportation costs

<sup>11</sup> Id. at 14 (citing H. Bruton, “A Reconsideration of Import Substitution”, *Journal of Economic Literature*, 36(2) (1998), 903-936, 904).

<sup>12</sup> Id. at 15 (citing W. Baumol, R. Litan and C. Schramm, “Unleashing Entrepreneurship in Less Developed Economies, in *Good Capitalism Bad Capitalism*” (New Haven, CT: Yale University Press (mimeo), 2006), 24).

<sup>13</sup> Id. at 18 (citing W. Baumol, “Entrepreneurship: Productive, Unproductive, and Destructive”, *The Journal of Political Economy*, 98(5) (1980), 893-921).

<sup>14</sup> Id. at 19 (citing, e.g., A. Krueger, “Why Trade Liberalization is Good for Growth”, *The Economic Journal*, 108(450) (1998), 1513-1522, 1514; B. Balassa, “Trade Policies in Developing Countries”, *The American Economic Review*, 61(2) (1971), 178-187; B. Balassa, “The Lessons of East Asian Development: An Overview”, *Economic Development and Cultural Change*, 36(3) (1988), S273-S290; and J. Sachs and A. Warner, “Economic Reform and the Process of Global Integration”, *Brookings Papers on Economic Activity*, 1995(1) (2005), 1-118, 22 and 36).

<sup>15</sup> Id. (citing R. Rajan, *Trade Liberalisation and Poverty: Revisiting the Age-Old Debate* (Adelaide, Australia: School of Economics, University of Adelaide, 2002).

associated with producing offshore, the effects of political instability on production and, at least in the case of Africa, lack of technology, training and experience in marketing products in overseas markets.<sup>16</sup> In fact, the enormity of these challenges often led to calls for pursuing export orientation by allowing foreign investors interested in expanding production into overseas markets to come in and setting up the manufacturing and marketing systems needed for successful exporting.<sup>17</sup>

Acs and Virgill point out that export oriented strategies had several positive influences on growth and development. For example, they noted that export orientation would, hopefully, generate foreign exchange earnings that could be used to finance additional capital investments and reduce the excessive levels of government intervention associated with import substitution policies.<sup>18</sup> In addition, the larger export market associated with “[o]utward oriented trade policies . . . allowed for the generation of scale economies, without the use of monopolies”<sup>19</sup>, an important consideration for smaller countries with limited domestic markets that would prevent them from exploiting economies of scale and fully utilizing their capacities.<sup>20</sup> It has also been argued that exporting is the best way to increase the efficiency of resource usage in developing countries by exposing them to larger and more competitive markets and thus encouraging them to continuously pursue productivity improvements and focus production into areas where they have a comparative advantage.<sup>21</sup> Finally, “export promotion was associated with less distortionary and bureaucratic policies compared to import substitution which could have a positive effect on growth”.<sup>22</sup>

There is no question that countries have been able to achieve striking and sustained growth and development following export oriented strategies and many of the specific tools and policies associated with export orientated, particularly those related to expanding economic freedom, have become standard entries on the prescriptions of policymakers and scholars. However, while exporting generates revenues it does not necessarily follow that the country will continue down a road to development that includes appropriation of the technologies and human capital necessary for sustained

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<sup>16</sup> Id. at 20 and 21 (citing G. Helleiner, “Manufactured Exports from Less-Developed Countries and Multinational Firms”, *The Economic Journal*, 83(329) (1973), 21-47, 35, 36 and 40; and L. Kinunda-Rutashobya, “Exploring the potentialities of export processing free zones (EPZs) for economic development in Africa: lessons from Mauritius”, *Management Decision*, 41(3) (2003), 226-232, 226-227).

<sup>17</sup> Id. at 21 (citing E. Penrose, “Foreign Investment and the Growth of the Firm”, *The Economic Journal*, 66(262) (1956), 220-235).

<sup>18</sup> Id. at 21 (citing A. Krueger, “Why Trade Liberalization is Good for Growth”, *The Economic Journal*, 108(450) (1998), 1513-1522, 1516).

<sup>19</sup> Id. at 22 (citing A. Krueger, “Why Trade Liberalization is Good for Growth”, *The Economic Journal*, 108(450) (1998), 1513-1522, 1515).

<sup>20</sup> Id. at 22 (citing B. Balassa, “The Lessons of East Asian Development: An Overview”, *Economic Development and Cultural Change*, 36(3) (1988), S273-S290, S280).

<sup>21</sup> Id. at 24 (citing B. Balassa, “Trade Policies in Developing Countries”, *The American Economic Review*, 61(2) (1971), 178-187, 180-181; and B. Balassa, “The Lessons of East Asian Development: An Overview”, *Economic Development and Cultural Change*, 36(3) (1988), S273-S290, S281).

<sup>22</sup> Id. (citing A. Krueger, “Trade Policy as an Input to Development”, *The American Economic Review*, 70(2) (1980), 288-292, 291 and A. Krueger, “Virtuous and Vicious Circles in Economic Development”, *The American Economic Review*, 83(2) (1993), 351-355, 352).

progress. Export orientation also has one of the main difficulties associated with import substitution: governments are heavily involved in the selection of those firms and industries that they believe will be “winners” and governments, staffed by bureaucrats with little or no market experience, are often wrong. All of this has contributed to what often has been a poor experience with export promotion and has led countries to “examine the role of entrepreneurship in development” and adopt policies that place “a greater focus on the role of the private sector as an important engine for economic growth and a de-emphasis on the role of government planning”.<sup>23</sup>

## §1:2 Definitions and types of entrepreneurship in developing countries

Acs and Virgill observed that the term “entrepreneurship” is often used in several different ways when discussed in connection with developing countries.<sup>24</sup> For example, studies of entrepreneurship in developing countries often focus explicitly and primarily on “small- and medium-sized enterprises” (“SMEs”). In other cases, discussions of entrepreneurial activities in developing countries include persons and firms found in the “informal sector” as well as those engaged in “petty capitalism”.<sup>25</sup> In many cases, combining firms in the informal sector with SMEs in developing regions such as Africa results in a large group of small traders which is collectively responsible for 65%-70% of total GDP<sup>26</sup> and this means that efforts to study and incentivize entrepreneurial activities in developing countries must take into account firms operating both inside and outside the formal institutional framework. Petty capitalism can be found in many forms and has been described as including “small businesses which employ relatively few employees and rely heavily on their owner’s and owner’s family’s labor”.<sup>27</sup> Acs and Virgill cited several examples of petty capitalism including the numerous export enterprises of Hong Kong, the maquila workshops in Mexico and furniture manufacturers in Italy.<sup>28</sup> The terminology landscape in developing countries clearly contrasts with the approach taken by scholars of entrepreneurship in the US and other developed countries—they make a strong distinction between entrepreneurship and SMEs based on their intentions with respect to growth<sup>29</sup>; however, in developing countries it is generally advisable to adopt a broader definition of entrepreneurship that includes SMEs, the informal sector, petty

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<sup>23</sup> Id. at 26.

<sup>24</sup> Id. at 31. For detailed discussion of definitions and types of entrepreneurship, see the chapter on “Definitions and Types of Entrepreneurship” in this Survey.

<sup>25</sup> Id. at 31 (citing A. Smart and J. Smart, *Petty Capitalists and Globalization: Flexibility, Entrepreneurship, and Economic Development* (Albany, NY: State University of New York Press, 2005)).

<sup>26</sup> Id. at 31 (citing M. Ayyagari, T. Beck and A. Demirgüç-Kunt, *Small and Medium Enterprises Across the Globe*. (Washington DC: World Bank Policy Research Working Paper No. 3127, 2003)). With regard to the “entrepreneurial landscape in Africa”, which includes informal and formal sector businesses, traditional and modern, indigenous and foreign-owned enterprises geographically dispersed in rural and urban areas, see B. McDade and A. Spring, “The ‘New Generation of African Entrepreneurs’: Networking to Change the Climate for Business and Private Sector-Led Development”, *Entrepreneurship and Regional Development*, 17 (January 2005), 17–42.

<sup>27</sup> Id.

<sup>28</sup> Id.

<sup>29</sup> Id. (citing J.W. Carland, F. Hoy, W. Boulton and J.C. Carland., “Differentiating Entrepreneurs from Small Business Owners: A Conceptualization”, *The Academy of Management Review*, 9(2) (1984), 354-359, 357).

capitalists and the relatively rare dynamic entrepreneur given that each of these actors is capable of generating something that is “new” in what Schumpeter probably meant when he referred to “the humblest levels of the business world”.<sup>30</sup>

Studies of entrepreneurship in developing countries have often focused extensively on distinctions between “necessity-based” and “opportunity-based” entrepreneurs, which is often viewed as a distinction between proprietors who start their own businesses when no other options are available in order to find a way to sustain their families and persons who start businesses with the intent of not only bringing in sufficient income to support themselves and their families but also to generate excess capital that can be reinvested in order to underwrite business growth and development.<sup>31</sup> The lack of institutions in many developing countries, which is discussed in great detail elsewhere in this chapter, often results in a shortage of formal employment opportunities in those countries and leaves substantial portions of the population with little choice but to set out on own. So-called “reluctant entrepreneurship” of this type also follows loss of employment, which may be caused by one of the frequent economic shocks that developing countries are prone to suffer. Several extensive studies of global entrepreneurship, including the Global Entrepreneurship Monitor, commonly referred to as the “GEM”, and the Global Entrepreneurship and Development Index, have provided additional information on entrepreneurial types in developing countries, the factors that have motivated them to choose and pursue entrepreneurship and the impact that economic development is likely to have on the face of entrepreneurship in those countries.<sup>32</sup>

Lingelbach et al. explored some of the factors that they perceived as making entrepreneurs in developing countries “different”.<sup>33</sup> They first noted that researchers had identified several categories of entrepreneurial firms in developing countries including “newly established”, “established but not growing”, “established but growing slowly”, “graduates of a larger size” and, a somewhat recent phenomenon, “new and growth-oriented firms” (similar to “opportunity-based entrepreneurs” mentioned above).<sup>34</sup> Turning their attention to the specifics of building successful growth-oriented firms in

<sup>30</sup> Id. (citing J. Schumpeter, *The Creative Response in Economic History*, *The Journal of Economic History*, 7(2) (1947), 149-159, 151). Notice should be taken that there is also debate as to which firms in developing countries are most effective at driving innovation. Amsden, for example, has argued that large privately-owned enterprises are the innovative firms in developing countries since they are more flexible and innovative than subsidiaries of foreign multinationals or state-owned enterprises. See A. Amsden, “Firm Ownership and Entrepreneurship” in A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 65-77.

<sup>31</sup> R. Scase, “The Role of Small Businesses in the Economic Transformation of Eastern Europe: Real but Relatively Unimportant” *International Small Business Journal*, 16 (1997), 113-121; R. Scase, “Entrepreneurship and proprietorship in transition: policy implications for the SME sector”, in R. McIntyre, R. Dallago and B. Houndsmill (Eds.) *Small and Medium Enterprises in Transitional Economies* (Basingstoke: Palgrave Macmillan, 2003), 64-77.

<sup>32</sup> For further discussion of both the GEM and the Global Entrepreneurship and Development Index, see the chapter on “Research on Entrepreneurship” in this Survey.

<sup>33</sup> D. Lingelbach, L. De La Vina and P. Asel, *What's Distinctive about Growth-Oriented Entrepreneurship in Developing Countries?* (San Antonio, TX: UTSA College of Business Center for Global Entrepreneurship Working Paper No. 1, March 2005).

<sup>34</sup> Id. at 3 (citing C. Liedholm and D. Mead, *Small Enterprises and Economic Development: The Dynamic Role of Micro and Small Enterprises* (London: Routledge, 1999).

developing countries, Lingelbach et al. mentioned the following “distinctive attributes of entrepreneurship in developing countries”:

- Since developing countries lack a “stable of mature markets”, entrepreneurs in those countries have a broader range of opportunities available to them than their counterparts in developed countries. In other words, while entrepreneurs in developed countries generally operate on the fringes of the economy, developing country entrepreneurs can, if they wish, place themselves in the core of their economies pursuing solutions for needs and opportunities that are more widespread.
- The fragmented and immature markets in developing countries reduce the threat of well-established incumbents; however, entrepreneurs must contend with the much higher levels of risk associated with the economic, political and regulatory uncertainties that generally exist in developing countries. Lingelbach et al. suggested that entrepreneurs in developing countries cope with these risks by operating a portfolio of businesses to manage risks through diversification. Capital raised in one business can be used to providing financing for other businesses and Lingelbach et al. suggested that “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”.<sup>35</sup>
- Entrepreneurs in developing countries face significant challenges with obtaining the necessary financial resources and use several strategies to overcome those problems. They typically start downstream businesses to reduce initial capital requirements and gain access to customers and information flow. They also rely on informal funding provided through well-developed family networks rooted in both urban and rural areas—Lingelbach et al. noted that there are “greater pools of private saving in the countryside”.<sup>36</sup>
- Family-owned and –operated businesses remain more common in emerging markets than in developed countries since entrepreneurs in developing countries still lack mentorship and apprenticeship opportunities that can expose them to the skills and experiences needed to launch and expand businesses in challenging environments. Developing country entrepreneurs must have different skills including the ability to “see through the fog of politics and economics in crisis-prone developing countries” and to be perceived as “trustworthy” in a situation where transactions are most often based on trust rather than formal contracting rules.<sup>37</sup>

### §1.3 Entrepreneurship and economic development

Many commentators, beginning with Schumpeter, have argued that entrepreneurship is crucial for understanding economic development.<sup>38</sup> Acs and Virgill noted that “[t]he

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<sup>35</sup> Id. at 4.

<sup>36</sup> Id. at 5.

<sup>37</sup> Id. at 7.

<sup>38</sup> Z. Acs and L. Szerb, “The Global Entrepreneurship and Development Index (GEDI)” (Paper presented at Summer Conference 2010 on “Opening Up Innovation: Strategy, Organization and Technology”, Imperial College London Business School, June 2010). A review of the literature regarding the relationship of entrepreneurship to economic development appeared in Z. Acs and N. Virgill, “Entrepreneurship in developing countries”, *Foundations and Trends in Entrepreneurship*, 2009.

empirical evidence is . . . strong in support of a link between entrepreneurship and economic growth” and that [s]tudies have found that regional differences in economic growth are correlated to levels of entrepreneurship”.<sup>39</sup> They explained that entrepreneurs in developing countries play a key role in “fill[ing] in important gaps left by incomplete and underdeveloped markets” and referred also to Leff’s explanation that “a key function of entrepreneurship in developing countries is . . . to mobilize factors such as capital and specialized labor which, being imperfectly marketed, might otherwise not be supplied or allocated to the activities where there productivity is the greatest”.<sup>40</sup> According to Acs and Virgill, recognition of the unique value of entrepreneurship in developing countries has led policymakers in those countries to “begin to work on perfecting their markets by eliminating barriers to entrepreneurship and other market failures”,<sup>41</sup> a trend which can be seen in the increased interest of policymakers and researchers in the role that institutions play in promoting entrepreneurship that can lead to economic development.

While focusing on and describing the “economics of innovation”, Porter suggested that countries go through three stages of economic development: a factor-driven stage; an efficiency-driven stage; and, finally, an innovation-driven stage.<sup>42</sup> Acs and Szerb provided the following brief description of each of these stages<sup>43</sup>:

- The factor-driven stage is marked by high rates of agricultural self-employment and countries in this stage generally compete based on low-cost efficiencies in the production of commodities or low value-added products. Countries in this stage do not create knowledge that can be used for innovation nor do they use knowledge to engage in exporting activities.
- The efficiency-driven stage requires that countries engage in efficient productive practices in large markets so that firms are achieve and exploit economies of scale. Industries in this stage are generally manufacturing-based and focused on the production and distribution of basic goods and services. Self-employment declines during this stage and capital, labor and technology become the key drivers of productivity.
- In the innovation-driven stage, the key input is “knowledge” and decisions about embarking on new projects are based on primarily on expected net returns and the likelihood that economic activities can generate high value added products and services.

Acs and Szerb discussed the relative importance of institutions and innovation as countries moved through the various stages and noted that while “[i]nstitutions dominate the first two stages of development”, innovation spurred by entrepreneurship plays an

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<sup>39</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, Jena Economic Research Papers, No. 2009-023, March 2009, 26.

<sup>40</sup> Id. at 26 (citing N. Leff, “Entrepreneurship and Economic Development: The Problem Revisited”, *Journal of Economic Literature*, 17(1) (1979), 46-64, 48).

<sup>41</sup> Id. at 26.

<sup>42</sup> M. Porter, *Global Competitiveness Report* (Geneva: World Economic Forum, 2002).

<sup>43</sup> Z. Acs and L. Szerb, “The Global Entrepreneurship and Development Index (GEDDI)” (Paper presented at Summer Conference 2010 on “Opening Up Innovation: Strategy, Organization and Technology”, Imperial College London Business School, June 2010).

increasingly important role in economic activity “in the innovation-driven stage when opportunities have been exhausted in factors and efficiency”.<sup>44</sup> The institutional emphasis as the beginning of the continuum is illustrated by the need to increase production efficiency and the education level of the workforce in order to transition from the first stage to the second stage and its increased emphasis on technology. In contrast, the activity of individual agents in possession of new technology (i.e., “entrepreneurs”) plays a bigger role in traveling the road from the second to third stage.<sup>45</sup>

The notion of “stages” of economic development has also been embraced and explained by other scholars. For Brinkman, economic development is “a process of structural transformations” that ultimately leads to an overall higher growth trajectory.<sup>46</sup> Liebenstein explained that “per capita income growth requires shifts from less productive to more productive techniques per worker, the creation or adoption of new commodities, new materials, new markets, new organizational forms, the creation of new skill, and the accumulation of new knowledge”.<sup>47</sup> As noted elsewhere in this publication, the role of the entrepreneur has often been neglected in economic theory, including various “stages of development” models; however, Liebenstein explicitly and celebrated the entrepreneur as “gap filler and input-completer . . . [and] . . . probably the prime mover of the capacity creation part of [the] elements in the growth process” that occurs during the aforementioned processes of change as economies shift to higher productivity.<sup>48</sup>

All in all, entrepreneurship plays a big role throughout the process of economic development, not just at the innovation-driven stage, and entrepreneurship makes a continuing contribution in various forms such as employment, innovation and welfare. Acs and Szerb argued that relationship between entrepreneurship and economic development was “S-shaped”: during the first transition—factor-driven stage to efficiency-driven stage—entrepreneurship plays a minimum role in productive entrepreneurship; however, entrepreneurship become increasingly important during the efficiency-driven stage and throughout the transition to the innovation-driven stage. Acs and Szerb also made the interesting observation that “economic activity” can be characterized as a societal “resource” that is capable of increasing and expanding over time as institutional support strengthens and the society learns how to use entrepreneurship in productive, rather than unproductive and destructive, ways.<sup>49</sup>

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<sup>44</sup> Id.

<sup>45</sup> Z. Acs and S. Laszlo, “The global entrepreneurship Index (GEINDEX), Foundations and Trends in entrepreneurship”, 5(5) (2009), 341-435.

<sup>46</sup> R. Brinkman, “Economic Growth versus economic development: Towards a conceptual clarification”, *Journal of Economic Issues*, 29(4) (1995), 1171-1188, 1183.

<sup>47</sup> H. Liebenstein, “Entrepreneurship and Development”, *The American Economic Review*, 58(2) (1968), 72-83, 77.

<sup>48</sup> Id.

<sup>49</sup> Z. Acs and L. Szerb, “The Global Entrepreneurship and Development Index (GEDI)” (Paper presented at Summer Conference 2010 on “Opening Up Innovation: Strategy, Organization and Technology”, Imperial College London Business School, June 2010) (citing W. Baumol, “Entrepreneurship: Productive, unproductive and destructive”, *Journal of Political Economy*, 98 (1990), 893-921; and D. Acemoglu, S. Johnson and J. Robinson, “The colonial origins of comparative development: An empirical investigation”, *American Economic Review*, 91(5) (2001), 1369-1401). For further discussion of the Global

Naude et al. acknowledged the utility of the model created by Acs and Szerb but also argued that it tends to “understate the importance of innovation by entrepreneurial innovation in the early stage of [economic] development”.<sup>50</sup> Naude et al. believed that it was important to distinguish between “incremental” and “radical” innovations and focus on the impact that a particularly type of innovation has on the local economy. Using this criterion, innovations that might not be that important in developed countries can, in fact, be quite significant in developing countries that are embarking on “catch-up change”. For example, entrepreneurs in developing countries engage in innovation when they imitate products or processes originally developed in other parts of the world and adapt them for use in their local economies. This type of “innovation” serves an essential function with respect to technology upgrading and increasing production efficiency. Developing countries can also benefit from another type of “innovation”: development of the capacity to “absorb and creatively adapt international technological knowledge . . . [to] . . . achieve accelerated growth”<sup>51</sup>, skills that served countries such as Chile, China, Korea and Taiwan well. Finally, the “mere” exploitation of new markets and development of new ways to organize businesses, each somewhat commonplace in developed countries, is a key method of innovation in developing countries. Naude et al. concisely described the important role of “innovation” at the earlier stages of development as follows:

“Entrepreneurs in low-income developing countries provide innovations that are important for firm and country growth, even if they are incremental in nature. Innovation in developing countries involves the process by which firms master and implement the design and production of goods and services that are new to them. Many small improvements in product design and quality, changes in the way production is organized, creativity in marketing and modifications in production processes and techniques reduce costs, increase efficiency and flexibility to respond to changes in competitive conditions and enhance productivity and employment growth. In emerging economies innovation involves upgrading and shifting to higher levels of technological sophistication. . . . Innovation plays an important role in catch-up and growth in a globalized economy.”<sup>52</sup>

While on the face of it one might assume that entrepreneurship would have a positive impact on economic and social development, there are those that have questioned this proposition. Baumol, for example, has observed that “entrepreneurship can take various forms, and not everything labeled as ‘entrepreneurial’ might be desirable from a macroeconomic and societal perspective”.<sup>53</sup> If this is true, policymakers developing tools

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Entrepreneurship and Development Index, see the chapter on “Research on Entrepreneurship” in this Survey.

<sup>50</sup> W. Naude, A. Szirmai and M. Goedhuys, Policy Brief: Innovation and Entrepreneurship in Developing Countries (Helsinki, Finland: United Nations University-World Institute for Development Economics Research, November 1, 2011), 3.

<sup>51</sup> Id.

<sup>52</sup> A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 26-27.

<sup>53</sup> W. Baumol, “Entrepreneurship - Productive, Unproductive, and Destructive” *Journal of Political Economy*, 98(5) (1990), 893-921 (as cited in F. Welter, “Entrepreneurship and development—Do we really

to encourage and support “entrepreneurism” need to have a better understanding of just what types of entrepreneurial activities are likely to have the most positive impact on economic development. Baumol distinguished between “productive” and “unproductive” entrepreneurship while commenting that “. . . there are a variety of roles among which the entrepreneur’s efforts can be allocated, and some of those roles do not following the constructive and innovative script that is conventionally attributed to that person. Indeed, at times the entrepreneur may even lead a parasitical existence that is actually damaging to the economy. How the entrepreneur acts at a given time and place depends heavily on the rules of the game—the reward structure in the economy—that happen to prevail.”<sup>54</sup> Welter explained that “[p]roductive entrepreneurship includes any activity that indirectly or directly contribute to economic output or the capacity of the economy to produce additional output”, while unproductive, or “destructive” entrepreneurship “includes, but is not limited to, rent seeking, illegal activities and shadow activities or different forms of corruption”.<sup>55</sup> This distinction is sometimes simplified by assuming that the activities of legal, registered businesses are productive and that the activities of illegal, informal businesses are unproductive and, in fact, destructive in those instances where they attracts followers that engage in wholesale circumvention and defiance of the legal and normative framework of the society.<sup>56</sup> Assuming all of this is true, policymakers developing tools to encourage and support “entrepreneurship” need to have a good understanding of just what types of entrepreneurial activities are likely to have the most positive impact on economic development.

While much of the research regarding entrepreneurship and economic development assumes that there is a direct correlation between the success of the entrepreneurial activities at the “micro”, or venture, level and the contribution of those activities to society at the “macro” level, it is useful to analyze a particular set of activities using the model developed by Davidsson and Wiklund which allows for the fact that entrepreneurial activities may have either positive or negative outcomes at both the venture (i.e., micro) and societal (i.e., macro) levels.<sup>57</sup> The result is a typology of four different enterprises that can be described as follows:

- “Hero” or “success” enterprises, which have positive societal and venture level outcomes, generally as a result of introducing new products or services and creating personal income and wealth.
- “Robber” or “re-distributive” enterprises, which are successful at the venture level, yet contribute nothing at the societal level since their success is tied to the use of strategies that Baumol would classify as “unproductive”.
- “Catalyst” enterprises, which may not be successful at the venture level, yet do make a positive contribution at the societal level. An example would be a venture that

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know which entrepreneurship types contribute (most)?” Strategic Entrepreneurship—The Promise for Future Entrepreneurship, Family Business and SME Research?, Papers presented to the Beitrage zu den Rencontres de St-Gall 2010 (St. Gallen: KMU-Verlag HSG, 2010)).

<sup>54</sup> Id.

<sup>55</sup> Id.

<sup>56</sup> Id..

<sup>57</sup> P. Davidsson and J. Wiklund, “Levels of Analysis in Entrepreneurship Research: Current Research Practice and Suggestions for the Future” *Entrepreneurship: Theory & Practice*, 25(4) (2001), 81.

develops ideas and methods that do not generate profit for that venture but which eventually are successfully imitated and productively exploited by others in the future.

- “Failed” enterprises, which are unsuccessful at both the venture and societal levels.

However, this model does not fully explain how things work in the “real economy”. For example, Davidsson pointed out that “. . . we have to live with the fact that in real economies ‘legal, yet re-distributive’ and ‘illegal, yet societal beneficial’ are both possible”.<sup>58</sup> In addition, even enterprises that eventually are found to fall within the “hero” category may sometimes engaged in activities generally thought to be “unproductive” from a societal level at some point during their development. Even “failed” enterprises cannot be totally dismissed since it is feasible to imagine that the entrepreneurs involved with these enterprises may have learned from their failures and applied this knowledge to new enterprises that were more successful.<sup>59</sup>

Other researchers have found evidence that entrepreneurs “switch” between “proprietorship” behavior, which focuses primarily on income and survival for the individual entrepreneur and his or her family, and so-called “opportunity-based” or “dynamic” entrepreneurship that is more focused on growth and business development and discussed elsewhere in this chapter. For example, while entrepreneurs may have the skills and desire to oversee growth-oriented ventures, their initial goals may be largely necessity-based as they struggle to create a basic income for themselves and limit their activities to satisfying local demand. As time goes by, however, and they are more confident in the sustainability of their venture they may shift toward strategies that are most consistent with opportunity-based entrepreneurship. In addition, researchers analyzing entrepreneurship in the transitional economies of the former socialist countries in Eastern Europe have concluded that most new and small companies are engaged in both productive and unproductive activities at the same time, a situation that the researchers attribute to the lack of formal laws and regulations in those countries and the corresponding need of entrepreneurs to engage in “defiance and avoidance strategies”, particularly rent seeking, in order to simply survive in a turbulent, ambiguous and uncertain environment.<sup>60</sup> Welter concluded that analyzing entrepreneurship using just

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<sup>58</sup> P. Davidsson, *Researching Entrepreneurship* (New York: Springer, 2004).

<sup>59</sup> A. Sauka and F. Welter, “Productive, unproductive and destructive entrepreneurship in an advanced transition setting: The example of Latvian small enterprises” in M. Dowling and J. Schmude (Eds.), *Empirical Entrepreneurship in Europe: New Perspectives* (Cheltenham, UK, Northampton, MA: Elgar, 2007), 87-105.

<sup>60</sup> F. Welter, “Entrepreneurship and development—Do we really know which entrepreneurship types contribute (most)?” *Strategic Entrepreneurship—The Promise for Future Entrepreneurship, Family Business and SME Research?*, Papers presented to the Beirtrage zu den Rencontres de St-Gall 2010 (St. Gallen: KMU-Verlag HSG, 2010) (citing T. Manolova and A. Yan, “Institutional Constraints and Entrepreneurial Responses in a Transforming Economy: The Case of Bulgaria”, *International Small Business Journal*, 20(2) (2002), 163-184; A. Rehn and S. Taalas, “Znakomstva I Svyazi’ - (Acquaintances and connections)-Blat, the Soviet Union, and mundane entrepreneurship”, *Entrepreneurship and Regional Development*, 16(3) (2004), 235-250; D. Smallbone and F. Welter, “The distinctiveness of entrepreneurship in transition economies”, *Small Business Economics*, 16(4) (2001), 249-262; D. Smallbone and F. Welter, *Entrepreneurship and small business development in post-socialist economies* (London: Routledge, 2009); F. Welter and D. Smallbone, “The emergence of entrepreneurial potential in

assessments of “activities” (i.e., productive or unproductive) or measures of output provides an incomplete picture and that it is necessary to take into account both activities and output in a non-judgmental fashion and consider the environment in which the entrepreneur is operating and the likelihood that strategies may change over time.<sup>61</sup>

#### §1:4 Research on entrepreneurship in developing countries

Entrepreneurship has been continuously linked to economic development of countries and has often been championed as a key path for transforming developing countries toward greater economic growth, innovation, competitiveness and alleviation of poverty.<sup>62</sup> However, researchers have bemoaned the fact that, as described by Lingelbach et al., “. . . entrepreneurship in developing countries is arguably the least studied significant economic and social phenomenon in the world today”.<sup>63</sup> For example, while as of 2004 there were literally hundreds of millions of “entrepreneurs”, generally defined as owners or managers of new firms, in developing countries as opposed to just under 18 million entrepreneurs in the US<sup>64</sup>, leading books on entrepreneurship research often had no more than a handful of pages on entrepreneurship in important developing countries such as China and India.<sup>65</sup> Research on entrepreneurship in developing countries is important for a number of reasons, not the least of which is providing policymakers with a better idea of how to encourage entrepreneurship as part of an overall strategy for private sector development in developing countries. A strictly Western model of entrepreneurship is not apt to work well in developing countries due not only to differences in societal culture but also the distinctive nature of entrepreneurship in emerging markets where resources readily available in developed countries are scarce or even non-existent.<sup>66</sup>

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transition environments : a challenge for entrepreneurship theory or a developmental perspective?’, in D. Mallbone, L. Hans and D. Jones-Evans (Eds), *Entrepreneurship and Growth in Local, Regional and National Economies: Frontiers in European Entrepreneurship Research* (Cheltenham, UK, Northampton, MA: Edward Elgar, 2009), 339-353; A. Yan and T. Manolova, “New and Small Players on Shaky Ground: a multi-case study of emerging entrepreneurial firms in a transforming economy”, *Journal of Applied Management Studies*, 7 (1) (1998), 139-143). Welter points out that it could reasonably be assumed that once entrepreneurs in these economies have survived the initial stages of formation and organization using any means possible some of them may “develop their activities from simply trading towards more substantial businesses”.

<sup>61</sup> F. Welter, “Entrepreneurship and development—Do we really know which entrepreneurship types contribute (most)?” *Strategic Entrepreneurship—The Promise for Future Entrepreneurship, Family Business and SME Research?*, Papers presented to the *Beitrage zu den Rencontres de St-Gall 2010* (St. Gallen: KMU-Verlag HSG, 2010).

<sup>62</sup> D. Landes, *The Wealth and Poverty of Nations* (New York: W.W. Norton, 1998).

<sup>63</sup> D. Lingelbach, L. De La Vina and P. Asel, *What's Distinctive about Growth-Oriented Entrepreneurship in Developing Countries?* (San Antonio, TX: UTSA College of Business Center for Global Entrepreneurship Working Paper No. 1, March 2005), 1. For detailed discussion of the scope of research conducted in the field of international entrepreneurship, see the chapter on “Research on Entrepreneurship” in this Survey.

<sup>64</sup> P. Reynolds, W. Bygrave and E. Autio, *Global Entrepreneurship Monitor: 2003 Executive Report*, 2004.

<sup>65</sup> A. Bhidé, *The Origin and Evolution of New Businesses* (New York: Oxford University, 2000).

<sup>66</sup> For discussion of the influence of societal culture on entrepreneurship see the chapter on “Societal Culture and Entrepreneurship” in this Survey.

Decolonization was the trigger for the first attempts to study entrepreneurship in developing countries and most researchers have, until recently, focused their attention on small-scale industrialization<sup>67</sup> and microenterprises.<sup>68</sup> As time has gone by, and initiatives such as the GEM were launched, the analysis of entrepreneurship in developing countries has become more nuanced and it is now recognized that entrepreneurial firms in those countries can fall into one of several different categories such as newly established, established by not growing, established but growing slowly, and graduates to a larger size.<sup>69</sup> This movement has opened the door for studying a small, yet very important, subset of businesses in developing countries: new firms formed with a growth-orientation and strategies tied to entry into global markets. It is apparent that there are now a number of promising areas for further research with respect to entrepreneurship in developing countries, all with important policy implications for governments looking to stimulate economic growth and development.<sup>70</sup> Lingelbach et al., for example, offered up the following list as a suggested research agenda for entrepreneurship in developing countries<sup>71</sup>:

- Increased focus on new and growth-oriented firms in developing countries, which are important given that these firms are most likely to contribute to economic growth and provide new sources of higher quality employment in developing countries;
- Analysis of the dynamics of firm creation and destruction in developing countries;
- Analysis of the strategies used by entrepreneurs in developing countries to overcome poor access to finance including the use of funds provided by personal savings and intra-familial financial linkages;
- Further exploration of the link, if any, between the general business environment and the level of entrepreneurial activities in poorer countries;
- Development of more information on “models of success” among entrepreneurs in developing countries in order to provide a better picture of the common features of successful entrepreneurship in developing countries and the extent to which those

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<sup>67</sup> See, e.g., H. Schmitz, “Growth Constraints on Small-scale Manufacturing in Developing Countries: A Critical Review,” *World Development*, 10(6) (1992), 429-450.

<sup>68</sup> See, e.g., M. Robinson, *The Microfinance Revolution* (Washington: World Bank, 2001-2).

<sup>69</sup> C. Liedholm and D. Mead, *Small Enterprises and Economic Development* (London: Routledge, 1999).

<sup>70</sup> See, e.g., M. Harper, “The role of enterprise in poor countries”, *Entrepreneurship Theory and Practice*, 15(4) (1991), 7–11; A. Gibb, “Small business development in Central and Eastern Europe—Opportunity for a rethink?”, *Journal of Business Venturing*, 8 (1993), 461–486; D. Audretsch, *The role of small business in restructuring Eastern Europe* (Vaxjo, Sweden: 5th Workshop for Research in Entrepreneurship, 1991). Other studies that have identified entrepreneurship as a critical factor in national economic development include S. Birley, “New ventures and employment growth”, *Journal of Business Venturing*, 2(2) (1987), 155-165; P. Reynolds, “New firms: Societal contributions versus survival potential”, *Journal of Business Venturing*, 2(3) (1987), 231-246; M. Morris and P. Lewis, “Entrepreneurship as a significant factor in societal quality of life”, *Journal of Business Research*, 23(1) (1991), 21-36; and S. Shane, L. Kolvereid and P. Westhead, “An exploratory examination of the reasons leading to new firm formation across country and gender (Part 1)”, *Journal of Business Venturing*, 6(6) (1991), 431-446. For further discussion of research activities relating to entrepreneurship see the chapter on “Research on Entrepreneurship” in this Survey.

<sup>71</sup> D. Lingelbach, L. De La Vina and P. Asel, *What's Distinctive about Growth-Oriented Entrepreneurship in Developing Countries?* (San Antonio, TX: UTSA College of Business Center for Global Entrepreneurship Working Paper No. 1, March 2005), 7-8.

features differ from successful entrepreneurship in the US and other developed countries;

- Development of strategies for designing markets for entrepreneurial finance in developing countries including introduction of various methods for managing risk such as hedging and insurance;
- Application of behavioral economics and finance to entrepreneurship in developing countries to determine how cognitive biases identified by researchers in those fields vary in entrepreneurs in developing countries; and
- Development of models of entrepreneurship that adequately take into account how entrepreneurship is carried out in developing countries.<sup>72</sup>

### **§1:5 Institutional environment and entrepreneurship in developing countries**

There has been growing interest in the relationship between the institutional framework that exists in a country and the level and type of entrepreneurship practiced in that country.<sup>73</sup> For example, when discussing the important and fundamental role that institutions play with respect to economic development, Acemoglu began by referring to the evidence from economic analysis that has confirmed that differences between countries with respect to prosperity and per capita income are strongly related to differences in the traditional factors of production: human capital, physical capital and technology.<sup>74</sup> He went on to argue that these findings raised a fundamental question for researchers: why is it that some countries have less human capital, physical capital and technology than other countries and/or make worse use of these factors than other countries (i.e., failure to identify and/or exploit entrepreneurial opportunities effectively)? Certainly some of the differences can be attributed to geographical differences or cultural factors; however, Acemoglu observed that “[i]nstitutions have emerged as a potential fundamental cause”.<sup>75</sup> In the same vein, Chu argued that countries that have achieved relative affluence in relation to others have done so in large part because they were able to establish and maintain “efficient” institutions while countries that have remained undeveloped have suffered from the lack of efficient institutions.<sup>76</sup> Milo described and analyzed several different institutional indicators and concluded that there was a positive relationship between economic performance and institutional quality among member countries of the ASEAN and noted, in particular, that the strong relative economic

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<sup>72</sup> Lingelbach et al. commented that most of the models of entrepreneurship, such as the uncertainty/investment/profit diagram developed by Bhidé, are based primarily on research conducted in the US and other developed countries. *Id.* at 2 (citing A. Bhidé, *The Origin and Evolution of New Businesses* (New York: Oxford University, 2000)).

<sup>73</sup> For further discussion of the influence of institutions on entrepreneurship see the chapter on “Institutional Environment and Entrepreneurship” in this Survey.

<sup>74</sup> D. Acemoglu, *Challenges for social sciences: institutions and economic development*, [http://www.aeaweb.org/econwhitepapers/white\\_papers/Daron\\_Acemoglu.pdf](http://www.aeaweb.org/econwhitepapers/white_papers/Daron_Acemoglu.pdf)

<sup>75</sup> *Id.*

<sup>76</sup> K. Chu, “Collective Values, Behavioural Norms and Rules: Building Institutions for Economic Growth and Poverty Reduction” in R. van der Hoeven and A. Shorrocks (Eds.), *Perspectives on Growth and Poverty* (Tokyo: United Nations University Press, 2003).

performance of countries such as Malaysia, Singapore and Thailand was consistent with their high scores on measures of institutional quality.<sup>77</sup>

Other scholars, while often using different definitions of “institutions”, have reached similar conclusions: “institutions explain economically and statistically significant differences in per capita incomes across countries”.<sup>78</sup> Olson tackled the question of why there continued to be widely differing standards of living around the world if, in fact, markets everywhere were working efficiently.<sup>79</sup> He first investigated whether the variations among countries might be attributable to different resource endowments (i.e., poorer countries have problems with economic growth and social development because “they lack land and natural resources, physical and human capital, or access to the latest technology”<sup>80</sup>). He systematically dismissed this proposition noting, for example, that there was evidence showing that knowledge was and is equally available to all countries at a reasonable cost, population density does not explain economic performance, capital flows are driven by the quality of institutions and there was no basis for assuming that citizens of richer countries were innately “smarter” than citizens of poorer countries. Olson thus concluded that “the large differences in per capita income across countries cannot be explained by differences in access to the world’s stock of productive knowledge or to its capital markets, by differences in the quality of marketable human capital or personal culture”.<sup>81</sup> Assuming this to be true, “[t]he only plausible explanation left is that differing performances are caused by differences in the quality of countries’ institutions and policies”.<sup>82</sup> Olson predicted that poorer countries that elect to adopt better economic policies and institutions would enjoy higher rates of growth in per capita incomes in relation to richer countries because they were so far short of their potential prior to the adoption of the new policies and there was such a huge gap to close between actual and potential income in those countries.<sup>83</sup>

Holcombe took a different approach by arguing that differences in economic performance of countries could be explained by the “entrepreneurial opportunities” that are available

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<sup>77</sup> M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 23-29.

<sup>78</sup> Id. at 20 (citing T. Eicher and A. Leukert, “Institutions and Economic Performance: Endogeneity and Parameter Heterogeneity”, Paper presented at the European Economic Association and Econometric Society Parallel Meetings, Vienna, 24–28 August 2006, 2).

<sup>79</sup> M. Olson, “Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 25-53.

<sup>80</sup> B. Powell, “Introduction” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 1-22, 3.

<sup>81</sup> M. Olson, “Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 25-53, 44.

<sup>82</sup> Id. Olson’s article also includes citations to other studies that he and other conducted that provide “direct evidence of the linkage between better economic policies and institutions and better economic performance”. Id. at 47.

<sup>83</sup> Id. at 45-46. Olson noted during the 1970s the fastest growing countries in the world (apart from the oil-exporting countries) were poorer countries that grew at rates that far exceeded the growth achieved by the US economy during that period. Id. A similar spree of spectacular growth rates, relative to industrialized countries, has been achieved in countries such as China and India in recent years.

in those countries and that decentralized free economies are the ones that do the best job of generating more opportunities that can be seized for their profitability and which also continuously generate new opportunities that ultimately will create an “endogenous engine of economic growth”.<sup>84</sup> He placed so much importance on the availability of entrepreneurial opportunities that he argued that often-used techniques for launching economic development such as encouraging investment in industrial activities and research and development, calling for increased savings and funding education would not, in and of themselves, be successful unless and until fundamental market reforms, including the creation and support of appropriate institutions, were made to facilitate creation of entrepreneurial opportunities. As an example, Holcombe pointed out that when developing countries have educated their citizens they often migrate to other countries due to lack of entrepreneurial opportunities in their homelands and pointed out that this sort of “brain drain” will continue until governments in those countries create and support institutions that are conducive to entrepreneurship.<sup>85</sup>

It should be noted that there are some who have questioned the relationship between institutional development and entrepreneurship in developing countries. Lingelbach et al., whose studies of “what makes entrepreneurs in developing countries different” are described elsewhere in this chapter, argued that the data collected from studies of new- and growth-oriented firms in developing countries suggested “several important, but counterintuitive findings: freer, more competitive, poor countries are not correlated in a statistically significant way with higher levels of opportunity entrepreneurs; recent economic growth in a poor country is not correlated in a statistically significant way with higher levels of opportunity entrepreneurship; and protection of property rights and levels of corruption don’t seem to matter either”.<sup>86</sup> In spite of these assessments of the data, the general consensus appears to be that institutions do matter; however, as they await institutional improvements small but growing numbers of entrepreneurs in developing countries are developing and implementing strategies to create successful businesses in spite of higher risks and uncertainties, difficulties in accessing financial and human capital and the absence of mentors and role models.

### **§1:6 --Institutional weaknesses in developing countries**

When discussing the relationship of institutions to entrepreneurship in developing countries it is important to emphasize that developing countries do not lack institutions—each of those societies have certain “rules of the game” that economic actors are expected to follow; however, according to North, in many instances the institutional frameworks found in developing countries do not reward production and exchange but rather provide incentives for expropriation and redistribution of a static stockpile of economic-based resources. In North’s own words, institutions in developing countries “overwhelmingly

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<sup>84</sup> R. Holcombe, “Entrepreneurship and Economic Growth” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 54-78.

<sup>85</sup> *Id.* at 71.

<sup>86</sup> D. Lingelbach, L. De La Vina and P. Asel, *What's Distinctive about Growth-Oriented Entrepreneurship in Developing Countries?* (San Antonio, TX: UTSA College of Business Center for Global Entrepreneurship Working Paper No. 1, March 2005), 3.

favor activities that promote redistributive rather than productive activity, that create monopolies rather than competitive conditions, and that restrict opportunities rather than expand them”.<sup>87</sup> While this may be somewhat of an overgeneralization, there is credence to the conclusion when one reviews the evidence in those developed countries where larger percentages of the population appear to be mired in hopelessness and poverty while small groups control resources, appropriate rents and manipulate the rules in a manner favorable to them.

Baumol identified a set of entrepreneurial activities that appear in all countries and argued that divergent economic performance among countries can be explained by the allocation of entrepreneurial efforts among these activities rather than by the total supply of entrepreneurial activities in those countries. Specifically, Baumol identified the following six types of entrepreneurial activities, the first five of which were based on the prior of Schumpeter: introduction of new goods; introduction of new methods of production; identification and opening of new markets; discovery and exploitation of new sources of supply for needed raw materials or intermediate goods; new organization of industries (i.e., creation or destruction of a monopoly position); and, finally, “rent seeking” (e.g., legal and illegal lobbying of regulators and politicians for favors, commencing legal actions to impede the progress of competitors, engaging in military activities to achieve and/or maintain power and imposing taxes that impact incentives to engage in certain activities).<sup>88</sup> Activities constituting “rent seeking” are considered to be unproductive, or even destructive, entrepreneurship and Baumol concluded that countries with cultures, policies and/or institutions that incentivize rent seeking (or lack of institutions that encourage entrepreneurial activities other than rent seeking) are likely to have poor performing economies.<sup>89</sup>

Evidence to support Baumol’s arguments can be found when examining the situation of Romania following the collapse of the Communist regime in that country in 1989. Boettke et al. attributed Romania’s difficulties in transitioning to a market economy on policies and environmental conditions that tended to incentive unproductive entrepreneurship.<sup>90</sup> They cited a World Bank survey of Romanian respondents that concluded that “constant changes in the laws and regulations are a main obstacle to doing business”<sup>91</sup>, particularly executive decrees referred to as “emergency ordinances” that

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<sup>87</sup> D. North, *Institutions, institutional change, and economic performance* (New York: Norton, 1990), 9.

<sup>88</sup> W. Baumol, “Entrepreneurship: Productive, Unproductive, and Destructive” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 79-111, 82-83 (citing and quoting J. Schumpeter, *The Theory of Economic Development* (Cambridge, MA: Harvard University Press, 1912/1934), 66).

<sup>89</sup> It should be noted that what Baumol might consider “unproductive” avenues for entrepreneurs can also be found in industrialized countries such as the US if one considers the potentially adverse consequences of expensive and time-consuming litigation as a competitive tool and/or financial incentives that divert highly-educated young professional toward jobs in the financial sector rather than launching and building new and dynamic businesses.

<sup>90</sup> P. Boettke, C. Coyne and P. Leeson, “Entrepreneurship or Entremanureship? Digging Through Romania’s Institutional Environment for Transition Lessons” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 223-249.

<sup>91</sup> *Id.* at 229 and 231.

announced substantial legal changes without warning and made it difficult for businesses to engage in long-term planning. Romania also suffered from widespread corruption by government administrators and judicial officials. As a result, “a large amount of resources [in Romania] is dedicated to rent seeking in order to obtain privileges from those in positions of power” and one Romanian entrepreneur commented that “[t]he sole profitable business in this environment is to have a connection in the government and make money from cheating and stealing”.<sup>92</sup> Poorly functioning land and capital markets and weak formal property rights were cited as additional problems and contributed to the emergence of a large, and inefficient, informal sector in Romania. Boettke et al. concluded that substantial reforms would be needed in Romanian institutions in order to provide a stable environment for entrepreneurship to flourish.

### **§1:7 --Institutional requirements for productive entrepreneurship**

In order to understand how policy makers in developing countries might address shortcomings in their institutional frameworks that might be impeding productive entrepreneurship it is first necessary to identify the institutions that are related to economic performance. A number of studies have attempted to do this very thing<sup>93</sup> and Milo reported that “[t]he consensus institutions that have been associated with economic performance commonly relate to measures of government risk of expropriation, rule of law, bureaucratic quality, corruption, government repudiation of contracts, civil liberties, and openness to trade”.<sup>94</sup> For example, an index developed by the Frasier Institute and published in *Economic Freedom of the World* is based on the proposition that development requires “economic freedom” and that economic freedom can be measured and compared by analyzing five areas: (1) size of government; (2) legal structure and security of property rights; (3) access to sound money; (4) freedom to trade internationally; and (5) regulation of credit, labor and business.<sup>95</sup> The Heritage Foundation/Wall Street Journal announced an Index of Economic Freedom with ten variables: (i) trade policy, (ii) fiscal burden of government, (iii) government intervention in the economy, (iv) monetary policy, (v) capital flows and foreign investment, (vi) banking and finance, (vii) wages and prices, (viii) property rights, (ix) regulation, and (x) informal market activity.<sup>96</sup>

The World Bank, which has been a forceful advocate for institutional development and reform in developing countries in the course of its financial and technical assistance efforts to those countries, developed its own measures of “governance indicators” based

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<sup>92</sup> Id. at 233.

<sup>93</sup> J. Aron, “Growth and Institutions: A Review of the Evidence”, *The World Bank Research Observer*, 15(1) (2000), 99–135.

<sup>94</sup> M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 20 (citing T. Eicher and A. Leukert, “Institutions and Economic Performance: Endogeneity and Parameter Heterogeneity”, Paper presented at the European Economic Association and Econometric Society Parallel Meetings, Vienna, 24–28 August 2006).

<sup>95</sup> Id. at 25 (see Appendix 1 of Milo’s paper for further elaboration of each of the areas).

<sup>96</sup> Id. at 27 (see Appendix 2 of Milo’s paper for further elaboration of each of the variables).

on the following six key dimensions or “Worldwide Governance Indicators” as described by Milo<sup>97</sup>:

- Voice and accountability, the extent to which a country’s citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and free media;
- Political stability and absence of violence, perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including political violence and terrorism;
- Government effectiveness, the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies;
- Regulatory quality, the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development;
- Rule of law, the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence; and
- Control of corruption, the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as “capture” of the state by elites and private interests; voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

Accepting that institutions matter and the “rules of the game” should be set to encourage productive entrepreneurship, the question becomes just what steps should be taken in developing countries to enhance their competitiveness. Lawson makes a strong case for the proposition that productive entrepreneurship requires an institutional environment grounded in economic freedom and property rights and concluded that “the empirical evidence is overwhelmingly clear: [s]ocieties that organize themselves with private property, rule of law, and free markets outperform, on almost every measurable margin, societies that are less economically free”.<sup>98</sup> In a similar vein, Olson has argued that the lack of impartial third-party enforcement of contracts causes economic actors in developing countries to lose gains that should normally be realized in economic

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<sup>97</sup> Id. at 28 (citing D. Kaufmann, A. Kray and M. Mastruzzi, *Governance Matters V: Aggregate and Individual Governance Indicators for 1996–2005* (Washington, DC: World Bank Policy Research Working Paper No. 4012, 2006)).

<sup>98</sup> R. Lawson, “Economic Freedom and Property Rights: The Institutional Environment of Productive Entrepreneurship” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 112-133, 131. Specifically, Lawson attempted to show, using data from the Economic World of Freedom Report and other empirical evidence, that “higher levels of economic freedom are associated with higher levels of per capita income, higher rates of economic growth, higher levels of entrepreneurial activity, higher rates of domestic investment, larger amounts of foreign investment attracted, longer life expectancies and better access to safe water”. B. Powell, “Introduction” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 1-22, 9.

exchanges; the failure to create institutions for recognizing and securing property rights leads to the loss of most of the potential gains from capital intensive production; private and public predation, which occurs due to a lack of institutional policing, also holds developing economies back; and, finally, the inability to create a sophisticated array of markets deprives developing countries of the potential advantages of social cooperation.<sup>99</sup>

Llosa argued that entrepreneurship in Latin America would only be successful if and when the rule of law was established and reforms were implemented that would result in “the liberation of the individual from the phenomenal accumulation of state power in Latin America”.<sup>100</sup> He suggested that substantial changes were needed across laws and regulations pertaining to business, finance, labor, social issues and justice and law and order. With respect to business laws, he advocated for the reduction of extensive and burdensome permit and licensing requirements and criticized the stifling of competition caused by “sanctioning and supporting government-owned companies”.<sup>101</sup> Also subject to criticism was the use of price controls, subsidies and tariffs and antitrust policies that hindered efforts to achieve competitiveness through economies of scale. In the finance area, Llosa criticized the lack of competition and regulation in the banking and insurance sectors, which drove up the price of services for entrepreneurs. With respect to the other categories of laws mentioned above, Llosa took particular note of shortcomings with respect to collective bargaining, excess political interference in the delivery of educational and health services and, finally, as to justice and law and order, “many laws that create special jurisdictions—and therefore privilege—as well as norms that give the political authorities a strong say in the judiciary”.<sup>102</sup>

### **§1:8 --Impediments to institutional reforms**

Once some sort of reasonable consensus has been reached on what type of institutions are needed in order for developing countries to effectively promote growth attention turns to determining the best way to develop those institutions which are lacking or “reform” existing institutions that are inefficient. Unfortunately, while the need for reform is largely recognized and has become a popular topic among scholars, reliable prescriptions for change have been hard to come by and the experiences of institutional reforms have been mixed and often dismal. Milo commented that institutional change has been “hard to accomplish . . . due in particular to the complex interactions between the different typologies of institutions (i.e., interaction between formal and informal institutions, between different levels of institutions, and between economic and political institutions), which have different horizons for change and are therefore subject to very different

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<sup>99</sup> M. Olson, “Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 25-53, 48.

<sup>100</sup> A. Llosa, “The Case of Latin America” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 189-222, 214.

<sup>101</sup> *Id.* at 215.

<sup>102</sup> *Id.*

evolutionary dynamics”.<sup>103</sup> One problem that has been consistently encountered is that the imposition of formal political and economic rules from one country, such as the US or some other developed country, to a developing country has failed to produce the “expected” results within the desired timeframe because the informal institutions in the developing country, which must legitimize any formal rules, are slow to change. Moreover, economic actors in developing countries who are benefitting from the “old rules” can be expected to resist institutional changes that may deprive them of the property and power that they possess.<sup>104</sup>

Milo analyzed the fit between policies and institutions in the Philippines and the economic performance achieved by that large developing country over the last several decades. She noted that while the policies and institutions found in the Philippines are consistent with “conventional wisdom” as to what is needed for economic growth and development (e.g., free and reasonably fair elections, more civil rights and freedom of the press), actual performance has been much poorer than expected.<sup>105</sup> She provided several explanations for this puzzle. First of all, she argued that the “Philippine state is weak” and that the effectiveness of formal institutions is severely undermined by the lack of state autonomy from “the vested interests of dominant Filipino social classes, powerful political families and clans, an influential landed elite, and wealthy Filipino capitalists”.<sup>106</sup> As a result, “politics of privilege” and “crony” capitalism became dominant themes in the Philippine economy and rent-seeking activity provides too much enticement to entrepreneurs in an environment where weak governance, corruption and mismanagement dominates. Second, while policies were adopted to liberalize the deregulate the economy and “replace the state with the private sector and markets”, the state has failed to aggressively pursue specific steps such as effective enforcement of property rights and contracts and ensuring competitive and fair market processes.<sup>107</sup> As a result, foreign investors have been reluctant to expand their participation in the Philippine economy since the political and legal system is still perceived to be run by vested interests. Milo cited de Dio and Hutchcroft for the conclusion that “the most fundamental need in the Philippines is to improve the overall performance of government, insulate it from the plunder of oligarchic groups, and promote new types of private sector initiative”.<sup>108</sup>

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<sup>103</sup> M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 20.

<sup>104</sup> M. Shirley, “Institutions and Development” in C. Menard and M. Shirley, *Handbook of New Institutional Economics* (Dordrecht, Netherlands: Kluwer Academic Publishers, 2005).

<sup>105</sup> M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 23 (citing L. Pritchett, “A Toy Collection: A Socialist Star and a Democratic Dud? (Growth Theory, Vietnam, and the Philippines)” in D. Rodrik (Ed.), *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton, NJ: Princeton University Press, 2003)).

<sup>106</sup> Id.

<sup>107</sup> Id. at 24.

<sup>108</sup> Id. at 29. See E. De Dios and P. Hutchcroft, “Political Economy” in A. Balisacan and H. Hill, *The Philippine Economy: Development, Policies and Challenges* (Quezon City: Ateneo University Press, 2003). They noted that improvements were needed with respect to the quality of the bureaucracy in the Philippines and commented that this was an area in which Singapore, a well-performing country from an economic perspective, had excelled.

Llosa described the institutional shortcomings in Latin America that have held countries in that region back in spite of lavish endowments of natural resources.<sup>109</sup> For example, he noted that land reforms that occurred after countries achieved their independence from colonial rule did not create private property rights but instead vested ownership in the government, thereby reducing the incentives for the citizens who were enlisted to work the land. Another issue was the distrust that Latin American leaders had for the richer nations and the steps that were taken to “correct” for what the Latin Americans viewed as structural disadvantages that would prevent their countries from being able to compete with the richer nations: barriers to inbound foreign investment and technology transfer; import restrictions; subsidies and nationalization of certain “key industries”. Attempts at reform occurred during the 1980s and 1990s; however, Llosa argued that they largely amount to exchanging old forms of intervention in the economy for new ones: “reform meant replacing inflation with new taxes, high tariffs with regional trading blocs, government monopolies with private monopolies, price controls with regulatory bodies”.<sup>110</sup> A related issue was the failure of the judiciary system to protect individual rights and Llosa claims that the courts of Latin America were simply corrupt arms of the ruling political groups.

After years of experimentation the general conclusion appears to be that good economic performance will not logically and automatically follow after importing formal political and economic rules from developed countries into developing countries.<sup>111</sup> As a result, policy makers have had to abandon the notion of “one-size-fits-all” with respect to programs for institutional reforms in developing countries and recognize the shortcomings of the “global standard institutions” argument which is based on the presumption that countries all over the world must adopt a prescribed menu of mostly Anglo-American institutions in order to survive and prosper in the global economy.<sup>112</sup> As Milo pointed out, “pure institutional imitation is rarely enough” and “[m]aking imported institutions work would require some degree of adaptation”.<sup>113</sup> The adaptations themselves must be unique and innovative and forging effective institutions in

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<sup>109</sup> A. Llosa, “The Case of Latin America” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 189-222.

<sup>110</sup> *Id.* at 202.

<sup>111</sup> D. North, *The New Institutional Economics and Development* (St. Louis: Washington University, 1992).

<sup>112</sup> One extensive menu of institutions included “political democracy; an independent judiciary; a professional bureaucracy, ideally with open and flexible recruitments; a small public-enterprise sector, supervised by a politically independent regulator; a developed stock market with rules that facilitate hostile mergers and acquisitions; a regime of financial regulation that encourages prudence and stability, through things like the politically-independent central bank and the Bank for International Settlements capital adequacy ratio; a shareholder-oriented corporate governance system; labor market institutions that guarantee flexibility”. M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 21 (citing H-J. Chang, *Understanding the Relationship between Institutions and Economic Development: Some Key Theoretical Issues*, Paper presented at the UNU/WIDER Jubilee Conference, Helsinki, 17–18 June 2005, 6).

<sup>113</sup> M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 22.

developing countries must take into account “local context, traditions, habits, and political culture”.<sup>114</sup> This means that policy makers with local knowledge must be involved since they are best positioned to know how current institutions are working and what changes can reasonably be made to reform them.

Ayittey argued that from colonial times onward much of Africa has focused its economic activities on resource extraction rather than development and that in many cases the reaction to independence was a shift away from anything that reminded the locals of their colonial oppressors, including capitalism.<sup>115</sup> The results has been a number of African states operating on a foundation of socialism; however, when African leaders were unable to successfully deploy socialist policies they transformed their economies into what Avitney referred to as “vampire states” which existed only to enrich the rulers and those close to them. As conditions for most of the people worsened these states declined into civil war and the result has often been decades of bloodshed and extreme poverty for most of the population in many African countries. Ayittey’s recipe for development in Africa calls for an end to “top-down” aid to the leaders of the vampire states and a shift toward providing support for indigenous institutions and the efforts of potential entrepreneurs in the traditional and informal sectors where most of the citizens of Africa have been working. Like others, Ayittey calls for changes that strength property rights, incentives and the “rule of law”.

Not only are “localization” and “customization” important to effective institutional reform in developing countries, timing, policies and planning are also key determinants of success. While the usual prescription is to undertake a large number of institutional reforms simultaneously, Rodrik advised that “[t]he onset of economic growth does not require deep and extensive institutional reform”<sup>116</sup> and Milo pointed out that large developing economies such as China and India achieved success through “modest changes in institutional arrangements and in official attitudes towards the economy . . . [and] . . . focusing reform efforts on the most binding domestic constraint on growth”.<sup>117</sup> Institutional reforms must also be supported and explained by governmental policies that describe the intended “rules of the game” for the country and its economic actors.<sup>118</sup> Finally, the need for planning has been emphasized by the following approach suggested by Rodrik: “first, a diagnostic analysis must be undertaken to identify the most significant constraints on economic growth in a given setting; second, a creative and imaginative policy design needs to be formulated to suitably target the identified constraints; and

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<sup>114</sup> Id. See also D. Rodrik, *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton, NJ: Princeton University Press, 2003), 12 (“[g]ood institutions can be acquired, but doing so often requires experimentation, willingness to depart from orthodoxy, and attention to local conditions”).

<sup>115</sup> G. Ayittey, “The African Development Conundrum” in B. Powell (Ed.), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development* (Stanford, CA: Stanford Economics and Finance, 2008), 137-188.

<sup>116</sup> D. Rodrik, *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton, NJ: Princeton University Press, 2003), 15.

<sup>117</sup> M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 22.

<sup>118</sup> Id. at 23. See also R. Hasan, D. Mitra and M. Ulubasoglu, *Institutions and Policies for Growth and Poverty Reduction: The Role of Private Sector Development* (Manila: ERD Working Paper Series No. 82, Asian Development Bank, 2006).

third, the process of diagnosis and policy response must be institutionalized to make sure the economy remains dynamic and growth is sustained”.<sup>119</sup>

### **§1:9 --Questions for further research**

Acemoglu has argued that while progress has been made in understanding the relationship between institutions and economic development there are still several key research questions that warrant the attention of scholars, such as the following<sup>120</sup>:

- Why do institutions persist? There is evidence that the institutional features of national economies will be strongly influenced by historical factors, such as the events that occurred during the colonial periods of developing countries, as well as by political and social beliefs. However, Acemoglu believes that more research is needed to understand which factors within a society contribute to resistance to institutional change.
- What enables institutional reform and why do many attempts at reform fail and even backfire? This question is, of course, recognizes that while institutions often persist and are resistant to change there are numerous examples of successful reforms that have altered the trajectory of growth and development for countries such as Botswana, China and Korea. In order to create effective policies for institutional change it is important to know why some countries have been successful and why others have failed.
- What specific combinations of economic and political institutions are most conducive to economic growth? Acemoglu notes that while the items on the menu for policymakers have become relatively well-known there is still much to learn about “which combinations of property rights, financial institutions, judicial institutions, education and various dimensions of social institutions are most conducive to economic development”.
- How can policymakers determine the appropriate balance between state action and the private sector? It is understood that the state can play an important role in creating and protecting property rights and establishing political stability; however, there is still no clear answer on how strong a role the state should play in the economy. Many East Asian economies have prospered under a firm government-driven industrial policy but there is a danger that too much state control can lead an environment, such as has often been found in Africa, in which political elites appropriate all the benefits from exploitation of the country’s resources.
- What is the role of democracy and checks on political power in fostering an environment conducive to innovation and economic growth? Acemoglu noted that while many of the more successful developing countries in recent years have been relatively democratic, “in the postwar era democratic countries do not have appreciably higher growth rates than nondemocratic ones” and pointed out China, led

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<sup>119</sup> Id. (citing D. Rodrik, “Goodbye Washington Consensus, Hello Washington Confusion?” Draft, Harvard University, 2006).

<sup>120</sup> The following discussion is adapted from, and quotes are as appearing in, D. Acemoglu, Challenges for social sciences: institutions and economic development, [http://www.aeaweb.org/econwhitepapers/white\\_papers/Daron\\_Acemoglu.pdf](http://www.aeaweb.org/econwhitepapers/white_papers/Daron_Acemoglu.pdf)

by a highly authoritarian regime, has been an obvious example of the possibility that economic growth can be achieved in a political environment that is far from open. He suggested that further research is needed on interactions between political regimes and economic growth.

### **§1:10 Policies for entrepreneurship in developing countries**

Setting the appropriate policies for promoting entrepreneurship in developing countries is not an easy task and policymakers have often failed mightily in their efforts and seen huge amounts of resources effectively wasted. Accepting the importance of institutions, notice should be taken of the advice of Milo, who suggested that to achieve the institutional efficiency necessary for achieving development countries must have institutions “that promote exchange by lowering transaction costs and promoting trust . . . and [institutions] that induce the state to protect rather than expropriate private property”.<sup>121</sup> Institutions that are likely to have the desired effect of improving the efficiency and integrity of economic transactions include “contracts and contract enforcement mechanisms, commercial norms and rules, and habits and beliefs favoring shared values and the accumulation of human capital” and institutions that can be expected to contribute to the creation and protection of private property rights include “[c]onstitutions, electoral rules, laws governing speech and education, and legal and civic norms”.<sup>122</sup>

Acs and Virgill adopted the approach of attempting to identify and analyze the “relevant externalities” for entrepreneurship in developing countries as a means for making policy recommendations as to how governments might intervene in their local economies to provide encourage to entrepreneurs.<sup>123</sup> Based on their review of the relevant literature, they settled on three sets of externalities that they labeled “network”, “knowledge” and “failure and demonstration”.<sup>124</sup> In the sections that follow we use those categories as a basis for discussing the policies relating to entrepreneurship that might be undertaken in developing countries; however, as noted above, there is still much to be learned about the most effective way to design and implement specific initiatives. Moreover, timing and sequencing play an important role in effective policymaking. No country can, or should, implement all of the recommended policies at once and it will likely take years, if not decades, for institutional changes to take root and for necessary adjustments in cultural attitudes to gain widespread acceptance. Selecting the most effective portfolio of policy

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<sup>121</sup> M. Milo, *Integrated Financial Supervision: An Institutional Perspective for the Philippines* (Tokyo: Asian Development Bank Institute, ADBI Discussion Paper 81, 2007), 19.

<sup>122</sup> *Id.* at 20 (citing M. Shirley, “Institutions and Development” in C. Menard and M. Shirley, *Handbook of New Institutional Economics* (Dordrecht, Netherlands: Kluwer Academic Publishers, 2005)).

<sup>123</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, *Jena Economic Research Papers*, No. 2009-023, March 2009.

<sup>124</sup> *Id.* at 33-34. In identifying these three sets of externalities, Acs and Virgill gave credit to Audretsch, Keilback and Liemann and their work on the study of entrepreneurship in developed countries, which Acs and Virgill felt would also be applicable in developing countries. See D. Audretsch, M. Keilbach and E. Lehmann, “The Knowledge Spillover Theory of Entrepreneurship and Technological Diffusion” in G. Libecap (Ed.) *University Entrepreneurship and Technology Transfer (Advances in the Study of Entrepreneurship, Innovation & Economic Growth, Volume 16)* (Bingley, UK: Emerald Group Publishing Limited, 2005), 69-91.

measures requires careful and continuous analysis of how markets are functioning in a particular country; the gaps, obstructions and impediments in the market network of the economy and the motivational states of potential entrepreneurs.<sup>125</sup>

### §1:11 --Demonstration externalities

Demonstration externalities, sometimes referred to as “failure and demonstration externalities”, include the benefits that entrepreneurs realize from their own experiences, and those of other entrepreneurs (i.e., “learning by watching”)<sup>126</sup>, with new firm creation, managing firms through their life cycles and even closing down failed firms.<sup>127</sup> In order for these benefits to be accessible, scholars such as Kirzner argue that countries must focus on “market entry”, a goal that he emphasized when he wrote that “[t]o induce dynamic entrepreneurial competition we require the fulfillment of only one condition: guaranteeing free entrepreneurial entry into any market where profit opportunities may be perceived to exist”.<sup>128</sup> Acs and Virgill pointed out that “[t]he relatively small numbers of successful entrepreneurship renders demonstration and failure externalities extremely important in developing countries”.<sup>129</sup> They further explained that “[p]otential entrepreneurs observe the strategies and business operations of existing entrepreneurs and gather information about potential markets, input suppliers and production techniques”.<sup>130</sup>

Acs and Virgill explained that demonstration externalities are affected by the societal culture and associated values and norms that prevail in the particular country and cited Lavoie and Chamlee-Wright for the proposition that “one cannot study economic development without exploring culture”.<sup>131</sup> One area of inquiry is whether potential entrepreneurs in the country possess the so-called “universal” traits thought to exist among all entrepreneurs across all cultures. Perhaps more important, however, is whether changes in local cultural traits will be needed in order for entrepreneurship to grow and flourish. For example, Acs and Virgill described the findings of Dana that the “combination of social structure and cultural values has constrained entrepreneurship in India”<sup>132</sup> and noted that Zapalalska and Edwards had found evidence that while some

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<sup>125</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, Jena Economic Research Papers, No. 2009-023, March 2009, 36 (also citing H. Leibenstein, “Entrepreneurship and Development”, *The American Economic Review*, 58(2) (1968), 72-83, 83).

<sup>126</sup> *Id.* at 37 (citing M. King and M. Robson, “A Dynamic Model of Investment and Endogenous Growth”, *The Scandinavian Journal of Economics*, 95(4) (1993), 445-466, 449).

<sup>127</sup> *Id.* at 34 (citing D. Audretsch, M. Keilbach and E. Leimann, *Entrepreneurship and Economic Growth* (Oxford: Oxford University Press, 2006)).

<sup>128</sup> *Id.* (citing I. Kirzner, “Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach”, *Journal of Economic Literature*, 35(1) (1997), 60-85, 74).

<sup>129</sup> *Id.* at 37.

<sup>130</sup> *Id.* at 38.

<sup>131</sup> *Id.* at 39 (citing D. Lavoie and E. Chamlee-Wright, *Culture and Enterprise: The Development, Representation and Morality of Business* (New York: Routledge, 2002), 17). For further discussion of the influence of societal culture on entrepreneurship see the chapter on “Societal Culture and Entrepreneurship” in this Survey.

<sup>132</sup> *Id.* at 41 (citing L. Dana, “Creating Entrepreneurs in India”, *Journal of Small Business Management*, 38(1) (2000), 86-92, 86).

cultural traits in China were conducive to entrepreneurship other traits were changing and evolving to accommodate market reforms<sup>133</sup>. In addition, Acs and Virgill cautioned that “sociocultural rigidities persist” in many countries and cited various potential barriers to entrepreneurship such as “custom and tradition, low status given to businessmen [and] the high risks involved in enterprise”.<sup>134</sup>

Another factor that influences market entry is “a country’s acceptance and tolerance of ‘outsiders’ and its levels of inclusiveness”.<sup>135</sup> These factors are related to the concept of “social capital” and impact the degree to which entrepreneurial firms can rely on the advantages of trust, cooperation and coordination, all of which reduce transactions costs and ease the burdens of the path that new firms must follow in order to become established and stable.<sup>136</sup> Acs and Virgill referred to the findings of Elkan that there was a “distrust of outsiders” in Africa and that this has often limited the growth of African firms.<sup>137</sup> For example, the traditional boundaries of trust in Africa and other developing countries extend only to “kinship relations” and Acs and Virgill pointed out that “this close control of business operations can negatively impact business success, as outside managerial and technical talent is often excluded”.<sup>138</sup> In developing countries where ethnic minorities are excluded from participation in mainstream economic activities entrepreneurship may be one of the few ways for persons from these groups to survive and, in fact, Acs and Virgill speculate that “[e]thnic minorities which are relatively isolated from the indigenous population would be more likely to engage in high rates of entrepreneurial activity”.<sup>139</sup> Of course, they activities may be fortuitous for the society as a whole; however, opportunities for developing countries to benefit from the demonstration externalities associated with these businesses may be undercut if “restrictions . . . [are] . . . placed on ethnic minority and non-indigenous local entrepreneurs in many developing countries when they are perceived as being too entrepreneurial”.<sup>140</sup>

Economic freedom, a concept referred to elsewhere in this chapter, also has a strong influence on demonstration externalities both in terms of ease of “market entry” and the scope of activities that are available in the economy for private entrepreneurs.<sup>141</sup> Acs and Virgill emphasize that governments in developing countries must be willing to accede

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<sup>133</sup> Id. at 40 (citing A. Zapalska and W. Edwards, “Chinese Entrepreneurship in a Cultural and Economic Perspective”, *Journal of Small Business Management*, 39(3) (2001), 286-292, 286 and 290).

<sup>134</sup> Id. at 41 (citing M. Manimala et al. *India GEM 2001 National Report*. Global Entrepreneurship Monitor 2002, [http://www.altassets.com/pdfs/GEM\\_india.pdf](http://www.altassets.com/pdfs/GEM_india.pdf)).

<sup>135</sup> Id. at 43.

<sup>136</sup> Id. at 43 (citing F. Fukuyama, “Social Capital” in L. Harrison and S. Huntington (Eds.), *Culture Matters* (New York: Basic Books, 2000), 98-111, 99).

<sup>137</sup> Id. at 43 (citing W. Elkan, *Entrepreneurs and Entrepreneurship in Africa* (Washington DC: World Bank Working Papers No. 14136, 1988), 177).

<sup>138</sup> Id. at 43 (citing W. Elkan, *Entrepreneurs and Entrepreneurship in Africa* (Washington DC: World Bank Working Papers No. 14136, 1988), 172).

<sup>139</sup> Id. at 44 (citing H. Leibenstein, “Entrepreneurship and Development”, *The American Economic Review*, 58(2) (1968), 72-83, 81)..

<sup>140</sup> Id. at 44 (citing N. Leff, “Entrepreneurship and Economic Development: The Problem Revisited”, *Journal of Economic Literature*, 17(1) (1979), 46-64, 51).

<sup>141</sup> Id. at 45.

greater autonomy to the private sector to engage in activities that would promote development and this requires both removing restrictions on the private sector and “divestiture of activities from the public sector—privatization”. In other words, entrepreneurs must be free to lawfully pursue the opportunities that they identify.<sup>142</sup> Acs and Virgill make several diverse and interesting points with regard to the potential damage caused by excessive government involvement in the marketplace. First, they note that “[w]here government activity is pervasive, a managerial type of business culture is likely to prevail rather than one which supports innovative entrepreneurship”.<sup>143</sup> Second, they argue that the mobility of entrepreneurs is obstructed and attempts to gather knowledge from interaction with foreign consultants are delayed, and often blocked, by the need to obtain the approval of senior officials for inbound investments.<sup>144</sup> Acs and Virgill observed that strong government involvement in economic activities eventually leads to the emergence of an informal sector, as has been the case in Africa and in many of the former Soviet countries, that serves as the foundation for an expansion of the private sector as time goes by and pointed to studies that provide support for the prediction that privatization, and the accompanying creation of new markets, will expand entrepreneurship by “generating new demonstration and failure externalities”.<sup>145</sup>

While there is an indication that large-scale privatization, such as what occurred in many of the socialist countries after the disintegration of the Soviet Union, was followed by high rates of new business formation<sup>146</sup> the ultimate success of those firms was undermined by the lack of formal institutions.<sup>147</sup> A menu of institutions though to be essential for development has already been presented and explored elsewhere in this chapter; however, Acs and Virgill specifically emphasized contracting laws that allow entrepreneurs to “take on anonymous dealings”, financial regulations that facilitate bank lending and raising capital from outside investors, property rights, supervision of market activities (i.e., competition laws), dispute resolution mechanisms and financial and accounting systems.<sup>148</sup> They also noted that “[t]he inadequacy, in terms of both quantity and quality, of infrastructure in developing countries is another important factor which limits successful business entry and growth and thus demonstration externalities”.<sup>149</sup> Areas of concern would include the availability of electricity and other utilities, the lack

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<sup>142</sup> Id. at 45 (citing W. Elkan, “Entrepreneurs and Entrepreneurship in Africa”, *The World Bank Research Observer*, 3(2) (1988), 179).

<sup>143</sup> Id. at 46 (citing B. Hoselitz, “Entrepreneurship and Economic Growth”, *American Journal of Economics and Sociology*, 12(1) (1952), 97-110, 100).

<sup>144</sup> Id. at 46 (citing A. Zapalska and W. Edwards, “Chinese Entrepreneurship in a Cultural and Economic Perspective”, *Journal of Small Business Management*, 39(3) (2001), 286-292, 291).

<sup>145</sup> Id. at 47.

<sup>146</sup> Id. at 48 (citing J. McMillan and C. Woodruff, “The Central Role of Entrepreneurs in Transition Economies”, *The Journal of Economic Perspectives*, 16(3) (2002), 153-170, 154).

<sup>147</sup> Id. at 48 (citing R. Aidis, *Entrepreneurship in Transition Countries: A Review* (University College London: SSEES, 2005), 2).

<sup>148</sup> Id. at 48 (citing J. McMillan and C. Woodruff, “The Central Role of Entrepreneurs in Transition Economies”, *The Journal of Economic Perspectives*, 16(3) (2002), 153-170, 165 and P. Reynolds, “The role of entrepreneurship in economic systems: developed market and post-socialist economies” in H. Brezinski and M. Fritsch (Eds.), *The Economic impact of new firms in post-socialist countries: Bottom-up transformation in Eastern Europe* (Cheltenham, UK: E. Elgar, 1996), 7-34, 29-30).

<sup>149</sup> Id. at 50.

of land improvement systems (i.e., irrigation) and poor transportation and communications systems. Finally, they pointed out that the ability of the government to improve overall macroeconomic performance influences the types of entrepreneurial activities and the motivations of entrepreneurs since entrepreneurs operating in countries where economic times are hard are more likely to be engaged in “necessity entrepreneurship” as opposed to innovation-based “opportunity entrepreneurship”.<sup>150</sup>

Acs and Virgill closed their discussion of demonstration externalities with several overriding policy recommendations.<sup>151</sup> First, they called for assessing which cultural traits within a country are barriers to entrepreneurship or to groups of potential entrepreneurs. They noted, for example, that countries often have culturally-based biases against certain members of society engaging specified activities, such as women wishing to work outside of the home and establish their own businesses, and pointed out that cultural change is possible, albeit slow, as incentives and conditions in the country change.<sup>152</sup> They also pointed out that scholars such as Hoselitz had advocated “that countries need to create a climate which allows entrepreneurs to pursue opportunities, while also encouraging the personality traits which leads to entrepreneurial activities”.<sup>153</sup> Second, a determination must be made as to whether the country has the institutions in place that will be able to support arm’s length transactions and reduce information and transaction costs. Third, inquiry must be made as to whether the country’s business and regulatory environment acts as a barrier to entrepreneurial activities. In other words, are entrepreneurs “free to act”? Finally, policymakers need to focus on whether the country’s macro-economy, infrastructure and financial markets support entrepreneurship. Acs and Virgill felt strongly that the evidence is clear that “entrepreneurs need good infrastructure and functioning financial markets” and that policies regarding promotion of entrepreneurship must be coordinated with broader efforts to reduce poverty and promote growth.<sup>154</sup>

### **§1:12 --Knowledge and information externalities**

It is no surprise that knowledge is considered to be an important element of improving and expanding entrepreneurial activity in developing countries. Acs and Virgill explained that “[k]nowledge expansion results in productivity improvements within the firm which created it and other proximate firms and thus promotes economic growth” and noted that “for developing economies, knowledge is important in the product and

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<sup>150</sup> Id. at 50 (citing A. Yusuf and M. Schindehutte, “Exploring Entrepreneurship in a Declining Economy”, *Journal of Development Entrepreneurship*, 5(1) (2000), 41-56).

<sup>151</sup> Id. at 63.

<sup>152</sup> Id. at 61 (citing M. Tesfayohannes, *Elements of SMEs Policy Implementation in Sub-Saharan Africa: The Case of Botswana* (Waterloo, 2005), 6 and C. Schramm, “Building Entrepreneurial Economies”, *Foreign Affairs*, 83(4) (2004), 104).

<sup>153</sup> Id. at 42 (citing B. Hoselitz, “Entrepreneurship and Economic Growth”, *American Journal of Economics and Sociology*, 12(1) (1952), 97-110, 108).

<sup>154</sup> Id. at 64.

production discovery process”.<sup>155</sup> They argued that developing countries must be particularly attentive to avoiding the “under-production” of knowledge and education since this would lead to “a low level of human capital accumulation [that] will slow down technological change”.<sup>156</sup>

According to Acs and Virgill, “[k]nowledge and information externalities affect entrepreneurship in developing countries in two important ways: these externalities affect the ability of entrepreneurs to discover what to produce and they impact the technology and processes used in production”.<sup>157</sup> Specifically, difficulties in obtaining and analyzing information often lead potential entrepreneurs in developing countries to select the “wrong” markets for their activities, which typically are “well established sectors rather than . . . new production and new market niches”.<sup>158</sup> Faulty market choices are usually accompanied by mistake in choosing just “what to produce”<sup>159</sup> and, overall, entrepreneurs in developing countries are not able to fully appropriate their discovery costs into their activities and there is a real danger that information and search costs will eventually lead to lower levels of entrepreneurship in those countries.<sup>160</sup> As to the second area mentioned above, the technology and processes that entrepreneurial firms are able to acquire, assimilate and use effectively is often constrained by what Acs and Virgill described as “the paucity of available educational resources” in developing countries.<sup>161</sup>

Acs and Virgill observed that “[i]t is widely recognized that education policy has a strong influence on the effectiveness with which technologies are assimilated and improved”.<sup>162</sup> They also provided evidence from other researchers to support the proposition that education has a strong and positive impact on entrepreneurship, both in terms of likelihood that someone may choose the entrepreneurial path and the performance and international competitiveness of entrepreneurs.<sup>163</sup> Education has also been found to be a factor in the ability of an entrepreneur to enter into more formal and complex activities, such as projects in the formal industrial sector.<sup>164</sup> However, Acs and Virgill also provided a reminder that education policy is even more complicated than it first appears since curriculum priorities must be consistent with national goals and objectives

<sup>155</sup> Id. at 33-34 (citing Z. Acs, *Innovation and the growth of cities* (Cheltenham, UK: E. Elgar, 2002), 10 and R. Hausmann and D. Rodrik, “Economic development as self-discovery”, *Journal of Development Economics 14th Inter-American Seminar on Economics*, 72(2) (2003), 603-633).

<sup>156</sup> Id. at 33 (citing P. Nijkamp and J. Poot, “Spatial perspectives on new theories of economic growth”, *The Annals of Regional Science*, 32 (1998), 7-37).

<sup>157</sup> Id. at 51.

<sup>158</sup> Id. (citing C. Mambula, “Perceptions of SME Growth Constraints in Nigeria”, *Journal of Small Business Management*, 40(1) (2002), 58-65, 63).

<sup>159</sup> Id. (citing R. Hausmann and D. Rodrik, “Economic development as self-discovery”, *Journal of Development Economics 14th Inter-American Seminar on Economics*, 72(2) (2003), 603-633).

<sup>160</sup> Id. at 52 (citing R. Hausmann and D. Rodrik, “Economic development as self-discovery”, *Journal of Development Economics 14th Inter-American Seminar on Economics*, 72(2) (2003), 603-633).

<sup>161</sup> Id.

<sup>162</sup> Id. at 53.

<sup>163</sup> Id. at 52 (citing W. Elkan, *Entrepreneurs and Entrepreneurship in Africa* (Washington DC: World Bank Working Papers No. 14136, 1988), 175 and D. Berkowitz and D. DeJong, “Entrepreneurship and Post-socialist Growth”, *Oxford Bulletin of Economics and Statistics*, 67(1) (2005), 25-46, 27).

<sup>164</sup> Id. (citing W. Elkan, *Entrepreneurs and Entrepreneurship in Africa* (Washington DC: World Bank Working Papers No. 14136, 1988), 175).

regarding the types of technologies that will be pursued and exploited. For example, “[l]iteracy is advantageous in supplier-dominated technologies, and higher technical and graduate engineering skills are necessary in scale-intensive and specialized-supplier technologies”.<sup>165</sup>

Even if the requisite knowledge can be discovered or otherwise obtained, another crucial issue for developing countries has been their ability to effectively transfer the knowledge in a manner that promotes and allows them to develop marketable products. For example, two researchers analyzing knowledge transfers within the Nigerian biopharmaceutical industry uncovered several impediments to effective transfers.<sup>166</sup> For example, they bemoaned the lack of a coherent “knowledge and innovation policy” and reported that the national technological infrastructure in Nigeria “tend[ed] to give little support to domestic firms that would benefit from the evolutionary process of technological deepening through learning that is the hallmark of dynamic latecomers”.<sup>167</sup> Other problems, which almost certainly would be found in other developing countries as well, included a lack of funding for research organizations in Nigeria and a failure of those organizations to communicate and collaborate among themselves.<sup>168</sup>

A final important factor relating to knowledge and information externalities is foreign direct investment (“FDI”) policies and their impact on inbound technology transfers. Acs and Virgill cited the observations of others that “FDI may assist developing countries through: the provision of capital, the inflow of technology, the inflow of managerial know-how, and their impact on the creation of efficient markets”.<sup>169</sup> Acs and Virgill cautioned, however, that in order for FDI to provide effective support for innovation it must be strategically pursued and coordinated with other policies that are part of the country’s overall goals and objectives for technology-based growth and development. For example, they pointed to Ireland’s decision to seek to attract FDI in strategic sectors such as electronics, chemicals and pharmaceuticals by establishing “clusters of high skill activities” in these sectors that included skilled local labor and incentives in the form of export processing zones.<sup>170</sup> The desire of the Irish to provide foreign investors with skilled local labor was supported by the country’s education and training policies. Acs and Virgill also pointed out that Ireland was “successful in forming those important backward linkages which transmit knowledge spillovers from FDI”<sup>171</sup> by taking steps to

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<sup>165</sup> Id. at 53 (citing M. Bell and K. Pavitt, *Accumulating Technological Capability in Developing Countries* (Washington DC: Proceedings of the World Bank Annual Conference on Development Economics, 1992), 257-281).

<sup>166</sup> B. Oyelaran-Oyeyinka and P. Sampath, *Rough Road to Market: Institutional Barriers to Innovations in Africa* (Maastricht: UNU-MERIT, 2006).

<sup>167</sup> Id. at 7.

<sup>168</sup> Id. at 19 and 23.

<sup>169</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, *Jena Economic Research Papers*, No. 2009-023, March 2009, 54 (citing P. Buckley and F. Ruane, “Foreign Direct Investment in Ireland: Policy Implications for Emerging Economies”, *The World Economy*, 29(11) (2006), 1611-1628, 1612).

<sup>170</sup> Id. at 54 (citing P. Buckley and F. Ruane, “Foreign Direct Investment in Ireland: Policy Implications for Emerging Economies”, *The World Economy*, 29(11) (2006), 1611-1628, 1620-1621).

<sup>171</sup> Id. (citing P. Buckley and F. Ruane, “Foreign Direct Investment in Ireland: Policy Implications for Emerging Economies”, *The World Economy*, 29(11) (2006), 1611-1628, 1623).

ensure that investors felt comfortable building linkages with local suppliers that created paths for transfers of knowledge to those suppliers.

From an overall policy perspective, Acs and Virgill argued to the creation and implementation of a high-quality system of knowledge infrastructure in developing countries, one that funneled resources to basic education, sophisticated training of scientists and engineers and public scientific research and development.<sup>172</sup> The knowledge infrastructure must be aligned with national industrial policies and elements of those policies that deal with specific issues such as FDI. Knowledge and information, and experience in using knowledge and information, is essential for policymakers and entrepreneurs in developing countries to learn how to make “good technological choices”, a skill said to be lacking in developing areas such as Africa.<sup>173</sup> In summary, Acs and Virgill advised developing countries to “address educational deficiencies at the basic and tertiary levels; assess whether current knowledge and innovation activities provide spillover opportunities; assess whether there are high costs to discovering what to produce; and assess whether the country’s FDI strategy promotes entrepreneurship”.<sup>174</sup>

### **§1:13 --Network externalities**

Acs and Virgill observed that there are a number of dimensions of network externalities. In general, networking refers to intelligent groupings of, and communications between, persons engaged in entrepreneurial activities and is deemed important given the evidence that dense and cooperative networks of entrepreneurial actors are beneficial to entrepreneurial activity.<sup>175</sup> For example, there is growing interest in, and support for, efforts to develop industrial clusters between entrepreneurial firms in developing countries that would facilitate linkage of those firms to one another and linkage of the entire cluster to international clusters. Another type of “network” consists of linkages between entrepreneurs within the country (or within a region of the country), perhaps in the form of domestic associations (i.e., chambers of commerce), to share information on suppliers, markets and production techniques and, quite importantly in the case of developing countries, advocate for their mutual interests before government officials.<sup>176</sup> Among other things, it is believed that “regional clusters and networks ‘foster fast learning’ and perpetuate spillovers”<sup>177</sup> and such clusters and networks can also overcome information failures commonly found in developing country markets and the

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<sup>172</sup> Id. at 65 (citing B. Oyelaran-Oyeyinka and P. Sampath, *Rough Road to Market: Institutional Barriers to Innovations in Africa* (Maastricht: UNU-MERIT, 2006), 22).

<sup>173</sup> Id. (citing W. Elkan, *Entrepreneurs and Entrepreneurship in Africa* (Washington DC: World Bank Working Papers No. 14136, 1988), 176).

<sup>174</sup> Id. at 66.

<sup>175</sup> Id. at 33 (citing D. Audretsch, M. Keilbach and E. Leimann, *Entrepreneurship and Economic Growth* (Oxford: Oxford University Press, 2006)).

<sup>176</sup> With regard to networks of entrepreneurs in Africa, see B. McDade and A. Spring, “The ‘New Generation of African Entrepreneurs’: Networking to Change the Climate for Business and Private Sector-Led Development”, *Entrepreneurship and Regional Development*, 17 (January 2005), 17–42.

<sup>177</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, *Jena Economic Research Papers*, No. 2009-023, March 2009, 33 (citing Z. Acs, *Innovation and the growth of cities* (Cheltenham, UK: E. Elgar, 2002), 171).

disadvantages that entrepreneurs in those countries often confront due to their smallness and resultant inability to achieve economies of scale.<sup>178</sup>

An interesting role for networks of entrepreneurs in developing countries is their ability to influence governmental policies that can create an environment that is more conducive to entrepreneurship. One group of researchers has discussed “growth coalitions” between the state and business networks consisting of firms involved in a wide range of industries to promote economic growth and development.<sup>179</sup> Whenever possible, business networks should be constructed in ways that include and accommodate numerous ethnic groups and both small and large organizations.<sup>180</sup> Acs and Virgill quoted Heilman and Lucas, who concluded that: “In countries where the power of capital is not yet institutionalized, the fate of capitalism may well depend on the ability of capitalist social movements to promote the policies, institutions and reforms necessary to long-term growth.”<sup>181</sup> In the same vein, the pioneers of the software industry in India, who had to overcome an extremely hostile institutional environment, have been praised as “institutional entrepreneurs” who not only build and expand their business but also help destroy the prevailing non-market institutions in order for their businesses to be successful.<sup>182</sup>

Industrial clusters have been studied extensively with respect to both developed and developing countries and Humphrey found that “competitive and successful clusters [in developing countries] focus on continuous ‘innovation and upgrading’”.<sup>183</sup> Unfortunately, however, Humphrey observed that in many instances clusters in developing countries suffer from poor design; limit their potential benefits by focusing too much, often exclusively, on production for the local economy; and integrate themselves into the global value chain in “disadvantageous ways”.<sup>184</sup> Altenburg and Meyer-Stamer, who studied clustering in Latin America, concluded that there were

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<sup>178</sup> Id. at 55 (citing M. Fafchamps, “Networks, Communities and Markets in Sub-Saharan Africa: Implications for Firm Growth and Investment”, *Journal of African Economies*, 10(2) (2001), 109-142, 114-118 and C. Mambula, *Perceptions of SME Growth Constraints in Nigeria*, *Journal of Small Business Management*, 40(1) (2002), 58-65, 61).

<sup>179</sup> Id. (citing D. Bräutigam, L. Rakner and S. Taylor, “Business associations and growth coalitions in Sub-Saharan Africa”, *The Journal of Modern African Studies*, 40(04) (2002), 519-547, 520).

<sup>180</sup> Id. at 56 (citing B. Heilman and J. Lucas, “A Social Movement for African Capitalism? A Comparison of Business Associations in Two African Cities”, *African Studies Review*, 40(2) (1997), 141-171, 155 and 163).

<sup>181</sup> Id. (citing B. Heilman and J. Lucas, “A Social Movement for African Capitalism? A Comparison of Business Associations in Two African Cities”, *African Studies Review*, 40(2) (1997), 141-171, 165).

<sup>182</sup> A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 25 (citing S. Athreye, “Overcoming Adversity in Entrepreneurship-led Growth” in A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 265-285; and D. Li, J. Feng and H. Jiang, “Institutional Entrepreneurs”, *American Economic Review*, 96(2) (2006), 358-362, 358).

<sup>183</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, *Jena Economic Research Papers*, No. 2009-023, March 2009, 58 (citing J. Humphrey, *Opportunities for SMEs in Developing Countries to Upgrade in a Global Economy* (Geneva: International Labour Organisation SEED Working Paper, 2003), 5).

<sup>184</sup> Id. (citing J. Humphrey, *Opportunities for SMEs in Developing Countries to Upgrade in a Global Economy* (Geneva: International Labour Organisation SEED Working Paper, 2003), 7, 9-10).

several significant barriers to cluster formation in that region including “scarcity of entrepreneurial spirit, barriers to information-sharing, lack of trust, and similar ‘soft’ constraints”.<sup>185</sup> Altenburg and Meyer-Stamer also identified three types of clusters in Latin America, each of which achieved mixed results in their activities: “necessity clusters”, which were common in the informal sectors of Latin American economies; “domestic enterprise clusters”, which typically included firms of various sizes; and clusters of multinational firms that were engaged in complex activities.<sup>186</sup>

Ackomak studied a specific clustering strategy—“incubators”—in Brazil, China, India and Turkey.<sup>187</sup> He noted that, in general, incubators established since 2000 have tended to be both “for profit” and highly specific, a contrast with the emphasis on general, not-for-profit facilities that were typically relied upon prior to 2000. He concluded that “the challenges faced by incubators [in developing countries] should not be underestimated and then went on to outline a set of factors that he believed needed to be considered by countries hoping to create and implement a good incubator policy: the purpose and mission of the incubator should be clear; incubators should set clear selection, entry and exit criteria; incubator-managers should be qualified, preferably with business experience; monitoring firms is essential for success; services that are provided by the incubator should be strategically selected; intangible services are more important than tangible services; networking adds value only if it is a deliberate strategy; and the incubator should be able to self-sustain its operations.”<sup>188</sup> Interestingly, Ackomak commented that “sheltering entrepreneurs under one roof does not guarantee beneficial effects from network externalities”, hence the recommendation that networking should be a “deliberate strategy” of the incubator. However, he noted that networking can only incur in an environment of trust lest tenant firms become too reluctant to share information out of fear of misappropriation of ideas and critical personnel.

One interesting and distinctive feature of domestic and external networks in developing countries is that many of them are ethnic-based business networks, which have been defined as “the professional and social relationships among entrepreneurs sharing a particular ethnic or cultural background.”<sup>189</sup> Inside their countries these networks serve an important role in what are otherwise underdeveloped market systems by facilitating sharing of technical knowledge, marketing information and are often sources of

<sup>185</sup> Id. (citing T. Altenburg and J. Meyer-Stamer, “How to Promote Clusters: Policy Experiences from Latin America”, *World Development*, 27(9) (1999), 1693-1713, 1694).

<sup>186</sup> Id. (citing T. Altenburg and J. Meyer-Stamer, “How to Promote Clusters: Policy Experiences from Latin America”, *World Development*, 27(9) (1999), 1693-1713, 1695).

<sup>187</sup> J. Akcomak, “Incubators as Tools for Entrepreneurship Promotion in Developing Countries” in A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 228-264. The article also included a comprehensive summary of the findings of the literature assessing incubators broken out by country, including studies conducted in the US and in several developing countries.

<sup>188</sup> Id. at 247-249. With regard to incubators in India, see S. Mani, “Promoting Knowledge-intensive Entrepreneurship in India” in A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 194-227.

<sup>189</sup> Z. Acs and N. Virgill, “Entrepreneurship in Developing Countries”, *Jena Economic Research Papers*, No. 2009-023, March 2009, 56 (citing D. Bräutigam, “Close encounters: Chinese business networks as industrial catalysts in Sub-Saharan Africa”, *African Affairs*, (102) (2003), 447-467, 449).

financing. When done well, networking can provide participants with “an established reputation, greatest access to capital and lines of credit”.<sup>190</sup> As to external networks there are numerous stories of how Chinese entrepreneurs in one country, even the small African nation of Mauritius, have been able to rely on kinship and other personal ties to build strong and trusting relationships with manufacturers in China, Hong Kong and Taiwan.<sup>191</sup> These relationships not only provided Chinese entrepreneurs in countries such as Mauritius with a market for their goods it also opened doors for entrepreneurs in China, Hong Kong and Taiwan interested in investing in Mauritius and other parts of Africa. Interestingly, the same study that focused on Mauritius assessed relationships between indigenous Nigerian entrepreneurs and overseas Chinese manufacturers and found that while they were useful with respect to access to inputs and technologies they did not lead to bond as strong as those found in ethnic-based networks such as extension of credit.<sup>192</sup>

Acs and Virgill made several policy recommendations with respect to networking externalities.<sup>193</sup> First of all, they called for encouragement of the involvement of multi-industry, multi-ethnic business associations in public policy making aimed at economic liberalization. Second, cluster formation should be encouraged, particularly where international production opportunities are involved; however, industry clusters should be assessed for completeness and to determine whether clustering strategies are appropriate for taking advantage of the most attractive export markets for the country’s products. In addition, the role of business networks in facilitating the creation and transfer of knowledge, improving managerial and technical skills and encouraging demonstration externalities should also be recognized.

### **§1:14 Knowledge-based entrepreneurship in developing countries**

The dramatic successes in China and India, which have followed the rise to global prominence of technology firms based in countries such as Korea and Taiwan as part of their impressive development, has triggered an interest in research and policy relating to dynamic, or “knowledge-based”, entrepreneurship in developing countries. According to Aidis, “[k]nowledge based entrepreneurship focuses on the development of innovation in sectors that necessitate high levels of human capital, technology and research”.<sup>194</sup> Until recently, developments in this area had been ignored or under-researcher; however, the trend is changing. For example, the China Association for Management of Technology has provided support for the publication of the “Journal of Knowledge-based Innovation in China”, which is focusing on knowledge, innovation and development; the development of global, national, regional and sectoral innovation systems for knowledge

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<sup>190</sup> Id. at 57 (citing A. Yusuf, “Critical Success Factors for Small Business: Perceptions of South Pacific Entrepreneurs”, *Journal of Small Business Management*, 33(2) (1995)).

<sup>191</sup> Id. (citing D. Bräutigam, “Close encounters: Chinese business networks as industrial catalysts in Sub-Saharan Africa”, *African Affairs*, (102) (2003), 447-467, 456-457).

<sup>192</sup> Id. (citing D. Bräutigam, “Close encounters: Chinese business networks as industrial catalysts in Sub-Saharan Africa”, *African Affairs*, (102) (2003), 447-467, 464).

<sup>193</sup> Id. at 67.

<sup>194</sup> R. Aidis, *Entrepreneurship in Transition Countries: A Review* (London: SSEES, University College London, 2005), 26-27.

creation and sharing; the role of governments, universities and public institutions in the “knowledge economy”; venture capital in knowledge-based innovation and entrepreneurship; regional economic and social development strategy; knowledge management and learning networks; managing intellectual property rights and international technology transfer; and culture and innovation. Researchers have also identified some of the specific challenges to knowledge-based entrepreneurship in developing countries, such as understanding and overcoming contextual factors (e.g., reliance on agrarian activities, low literacy rates, low exposure and mobility and cultural/religious beliefs that are not conducive to entrepreneurial activities), lack of technical knowledge and practice experience, lack of industrial and social infrastructure and access to financing. Even in those developing countries where a private sector has emerged firms still have difficulties with knowledge-based activities because of their lack of familiarity with knowledge management systems, a reluctance of employees to share information and ideas and a lack of experience in managing the development and commercialization of knowledge-based products and services.<sup>195</sup>

Mani has emphasized the importance of technology-based entrepreneurial firms for economic growth in India and observed that, in recent years, Indian enterprises have achieved leading global roles in areas such as software, biotechnology, aerospace and telecommunications.<sup>196</sup> Mani identified the following factors as contributors to “knowledge-intensive entrepreneurship” in India: liberalization of the Indian economy in general, which provided many new market opportunities for exploitation by entrepreneurs; a general increase in the availability of financial resources for use in innovative and entrepreneurial activities, particularly the creation and growth of a domestic venture capital sector; a rise in government support programs and public-private partnerships; the emergence of private institutions and initiatives to support the government’s efforts to ignite innovation; and, finally, the continuous increase in the availability of skilled labor, which Mani noted as being crucial for development and commercialization of high-technology products and services.<sup>197</sup> Mani cautioned, however, that more still needs to be done with respect to creating the right institutional environment for launching new businesses, skill formation, access to risk capital and facilitating networking and organizational learning.<sup>198</sup>

Kantis developed an extensive profile of new dynamic enterprises in Latin America based on information collected from approximately 1,000 entrepreneurs in Argentina, Brazil,

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<sup>195</sup> T-W Liang (Ed.), *Entrepreneurship and Innovation in the Knowledge-based Economy: Challenges and Strategies* (Tokyo: Asian Productivity Organization, 2003).

<sup>196</sup> S. Mani, “Promoting Knowledge-intensive Entrepreneurship in India” in A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 194-227.

<sup>197</sup> A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 23-24 (describing the factors covered in more detail in S. Mani, “Promoting Knowledge-intensive Entrepreneurship in India” in A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 194-227, 211-220).

<sup>198</sup> S. Mani, “Promoting Knowledge-intensive Entrepreneurship in India” in A. Szirmai, W. Naude and M. Goedhuys (Eds.), *Entrepreneurship, Innovation and Economic Development* (Oxford: Oxford University Press, 2011), 194-227, 221.

Chile, Costa Rica, El Salvador, Mexico and Peru.<sup>199</sup> These enterprises employed an average of 26 workers in their third year of business and their average annual sales and sales/employee at that point in their evolution was around \$800,000 and a little more than \$30,000, respectively. By their sixth year of business they had continued to expand to more than 40 employees on average, not counting the entrepreneurs, and sales growth remained just as strong as it had been several years earlier. There was substantial variety among the enterprises and the countries in which they operated; however, the following general statements are informative<sup>200</sup>:

- Initial investments tended to be small, in most cases requiring less than \$100,000 during the first year (only one in five of the firms required more than that amount for launch). Variations between countries could be identified: only one in ten Mexican enterprises required more than \$100,000 while one in three firms in Argentina needed that amount.
- Most of the enterprises, about three in four, were located in metropolitan areas; however, in Mexico half the enterprises operated in what Kantis described as “the interior of the country in areas characterized by entrepreneurial vigor”.<sup>201</sup>
- The enterprises were generally focused on production and sale of traditional manufactured goods (i.e., food, furniture, clothing, metallurgy and metal working); however, one-third of the firms were involved in knowledge-based sectors such as software, Internet and telecommunications-related products and services.<sup>202</sup>
- While domestic markets were the main source of businesses for enterprises included in the survey exporting was important for firms in countries with smaller home markets such as Costa Rica, El Salvador and Peru. Exporters from these countries typically attempted to take advantage of their ties with nationals of their countries who had previously moved to foreign markets.
- In most instances the enterprises elected to compete on the basis of offering differentiated products or services as opposed to relying on price competition or introducing innovations. Internationally innovative products were less than 10% of the total and Kantis commented that “[t]he low presence of innovative enterprises may be associated with the degree of sophistication of demand of the companies, the families related to the sector, the technology profile of productive structures and the level and distribution of income . . . [i]t may also reflect the ineffectiveness of innovation systems”.<sup>203</sup>

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<sup>199</sup> H. Kantis, “Dynamic Enterprises in Latin America” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 29-45.

<sup>200</sup> *Id.* at 30-32.

<sup>201</sup> *Id.* at 30-32. For further discussion and comparison of dynamic local and metropolitan enterprises in Latin America, see V. Koenig and H. Kantis, “Dynamic Local and Metropolitan Enterprises” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 61-74.

<sup>202</sup> For further discussion and comparison of the creation of traditional and knowledge-intensive enterprises in Latin America, see P. Angelelli and H. Kantis, “Creating Enterprises in Traditional and Knowledge-Intensive Sectors” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 75-88.

<sup>203</sup> H. Kantis, “Dynamic Enterprises in Latin America” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005),

- The main customers of the enterprises were other businesses and outsourcing (i.e., producing goods and services on behalf of enterprises that used to produce those goods and services) was not a widespread source of revenues. Sales were made to both large firms and small- and medium-sized enterprises; however, the relative importance of the customer categories varied from country-to-country. The largest customer sector was the manufacturing industry followed by services, wholesale trade and retail trade.

Kantis summarized the main characteristics of dynamic enterprises as follows<sup>204</sup>:

- Most of the dynamic enterprises were set up by entrepreneurial teams with complementary specialized functions, a finding that debunked the myth of the “heroic individual” who conceives, launches and builds the firm with little or no help.
- The main “incubators” for entrepreneurs are the companies where they previously worked.
- Successful dynamic entrepreneurs established networks to assist in identifying the business opportunity and accessing technology or financing.
- The dynamic enterprises start larger and are more export-oriented.
- Most of the dynamic entrepreneurs contributed most of the financing for the creation of their new enterprises from the personal and family savings.
- Local enterprises are less dynamic than those in metropolitan areas.
- The more dynamic enterprises are engaged in knowledge-intensive activities rather than producing traditional manufactured goods.

In his survey Kantis found that the “typical” dynamic entrepreneur was a young, highly educated middle-class male. The career projection of the entrepreneurs appeared to be influenced by familial background—half of the entrepreneurs came from homes where the father worked independently as a businessman or professional—and their prior work experience (e.g., many of the entrepreneurs had worked for other companies in the same sector as their “start-up” or were otherwise involved in a related line of business). Entrepreneurs tended to begin their entrepreneurial activities at a fairly young age—two-thirds started their first businesses when they were between the ages of 20 and 35—and about half of the respondents launched more than one business over their careers.

Kantis observed that the three main reasons for launching a new business were all “positive” and included “the desire for personal fulfillment, to apply one’s knowledge, and to improve personal income”.<sup>205</sup> These dynamic entrepreneurs rarely chose their path

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29-45, 30. Among the countries surveyed Argentina had the highest percentage of innovative business proposals and Kantis attributed this to the fact that Argentina had “higher gross rates of university enrollment and a higher density of research and development personnel per inhabitant than the other countries”. *Id.* at 30-31.

<sup>204</sup> H. Kantis, P. Angelelli and J. Llisteri, “Conclusions and Policy Implications” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 101-107, 101-102.

<sup>205</sup> H. Kantis, “Dynamic Enterprises in Latin America” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 29-45, 33.

for negative reasons such as being unemployed or not having sufficient education or training to find a job with an established firm. In spite of the generalizations regarding the characteristics of dynamic entrepreneurs in Latin America, differences in the cultural environment in each of the countries were apparent and Kandis explained that “[t]o be independent, to gain social esteem, or to follow in the footsteps of other entrepreneurs who served as an example to them (role models) were not very important in Argentina, Brazil and Chile . . . [b]y contrast, Mexicans and Salvadorians were attracted by the idea of being their own boss and, along with the Peruvians, by the presence of role models and the desire to gain social esteem”.<sup>206</sup>

Kandis attempted to explain some of the main differences between dynamic and less dynamic enterprises in Latin America and the entrepreneurs who led them.<sup>207</sup> For example, family influence appeared to play an important role with dynamic entrepreneurs more likely to come from families where a parent had already been involved in entrepreneurial activities. Dynamic entrepreneurs tended to benefit from familial values that emphasized hard work and problem solving and their families were more likely to provide financial support, ideas for a new business and non-monetary resources such as raw materials and facilities. Interestingly, Kandis found that “[i]n almost all of the countries, the entrepreneurs have high education levels, but there tend to be no significant differences between those of different degrees of dynamism, except in Mexico and Chile”.<sup>208</sup> Instead, it appeared that previous work experience was far more important as a source of the learning necessary for dynamic entrepreneurship and that dynamic entrepreneurs were able to access and exploit social, production and institutional networks to complement the support they enjoyed from their families. Among other things, networking was cited as being “crucial for identifying business opportunities, obtaining access to in-kind resources, and dealing with the problems of managing a new company”.<sup>209</sup> Kandis found that “[d]ynamic entrepreneurs showed a greater disposition to export” but that there was no significant difference between dynamic enterprises and the rest with respect to the level of formal planning and preparation.<sup>210</sup>

Kandis also explored some of the apparent differences between dynamic entrepreneurship in Latin America and in other parts of the world such as East Asia, Italy and Spain.<sup>211</sup> He noted that “the emergence of entrepreneurs from lower socioeconomic strata [was] more limited in Latin America than in East Asia” and attributed that to greater social mobility in East Asia than in most of Latin America.<sup>212</sup> In addition, Kandis observed differences between the social-cultural context in Latin America and in the other regions that influenced the factors that motivated persons toward entrepreneurship. For example, entrepreneurial models and business opportunities were much more publicized in East Asia than in Latin America and the desire to create and perpetuate family businesses was much more powerful in Italy than in Latin America. Another important finding was that

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<sup>206</sup> Id. at 34.

<sup>207</sup> Id. at 34-45.

<sup>208</sup> Id. at 36.

<sup>209</sup> Id. at 45.

<sup>210</sup> Id. at 40-41.

<sup>211</sup> Id. at 59-60.

<sup>212</sup> Id. at 59.

dynamic entrepreneurs in East Asia, Italy and Spain benefitted from greater access to local knowledge-intensive firms as sources for learning, not surprising given that entrepreneurs in Latin America operated in an environment where such firms were relatively scarce and thus relied more on university courses for acquiring technical knowledge. Knowledge-based, subcontracting and exports businesses were less common among Latin American dynamic enterprises than in the other regions and firms in the other regions were also more likely to be competing on the basis of differentiation than firms in Latin America. Finally, Kandis concluded that dynamic entrepreneurs in Latin America must overcome much more difficult institutional hurdles, particularly with respect to financing, than their counterparts in the other regions.

With regard to potentially productive policy areas for promotion and expansion of entrepreneurship in Latin America, Kandis et al. presented the following ideas<sup>213</sup>:

- Broadening the social and gender bases from which dynamic enterprises emerge;
- Expanding the number and quality of business opportunities;
- Facilitating the access of potential entrepreneurs to work experience;
- Fostering the development of entrepreneurial teams and networks;
- Improving access to financing;
- Enhancing the entrepreneurial process in local areas;
- Taking advantage of the transformational power of knowledge-based businesses;
- Generating environmental (institutional) conditions more favorable to the growth of new enterprises;
- Adopting a systematic approach based on complementary efforts between different areas and levels of government, with strong leadership from the private sector<sup>214</sup>; and
- Making development of entrepreneurs a social investment with a long-term vision.

With regard to specific “entrepreneurial development policies”, Kantis drew on the experiences of countries from both the developed and developing world to generate the following list: adroit use of the media for promotion of an entrepreneurial culture; entrepreneurial education, which should not just be limited to business schools; development of networks, including the creation of clubs, associations and forums that would connect entrepreneurs with other relevant actors; creation of a “support infrastructure” for young and small enterprises (e.g., “one-stop windows”, online porters, mentoring programs and incubators); simplification of the regulatory framework for new enterprises, a topic already discussed at length elsewhere in this chapter; creation of

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<sup>213</sup> H. Kantis, “Initiatives for Fostering Entrepreneurial Growth” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 111-118.

<sup>214</sup> For discussion and analysis of various efforts to develop entrepreneurship in Latin America, see M. Bacic, L. Vaconcelos, G. Baruj and J. Martinez, “Experiences in Latin America” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 171-197. They noted, for example, that the Brazilian Software Export Program (“SOFTEX”) supported the production and marketing of Brazilian software through: “the dissemination of Brazilian software abroad; software production support; improving software quality; support for the emergence of entrepreneurial attitudes on the part of students in computer courses; and the development of financing sources for software enterprises and business incubation”. *Id.* at 171.

policies and programs aimed at specific groups of potential entrepreneurs, such as younger persons, women and ethnic minorities; and increasing access to seed capital and financing from both public and private sources.<sup>215</sup>

Attendees at a Taiwan conference on entrepreneurship and innovation in the knowledge-based economy also had a menu of recommendations for governments and firms in the developing world. As for governments, they were called upon to improve literacy rates and create opportunities for social mobility so that citizens can move with their education to areas where their skills can be used. In addition, governments must take steps to create educational and training programs that will lead to the creation of a pool of local human capital versed in relevant technologies and then establish an environment that will motivate local scientists and engineers to remain in the country. This means investing in the development of a strong industrial and social infrastructure; establishing competitive markets where information can flow freely and technology-based entrepreneurs can find and exploit appropriate opportunities<sup>216</sup>; and providing support for knowledge-based entrepreneurs (i.e., financing, incubators and publicly-funded research and development with subsequent transfer to the private sector). At the enterprise level, management is advised to form cross-functional venture teams to encourage entrepreneurship; develop the appropriate support systems to facilitate the exchange of knowledge and sharing of knowledge; promote internal innovation and entrepreneurship and provide managers and employees with the required resources such as training in business plan preparation and financing; and implement policies to encourage calculated risk-taking, such as incentives for work that results in patent registrations and profitable commercial alliances. With respect to the intersection of the public and private sectors, government bureaucrats should be trained to understand the needs of technology-based entrepreneurs.<sup>217</sup>

Finally, Naude et al. provided an overview of the “entrepreneurship-innovation nexus in the context of development” and offered their views on policies that should be implemented in order to promote innovation by entrepreneurs at even the earliest stages of economic development.<sup>218</sup> Their recommendations were similar to those detailed above and included market development, including removal of market restrictions created by “inappropriate regulations” and “predatory governments or monopolies”; recognition and enforcement of property and contract rights; capacity building, particularly educational policies and programs that lead to “not only highly-knowledgeable, experienced and skilled entrepreneurs, but also highly-skilled labor”; development of the

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<sup>215</sup> H. Kantis, P. Angelelli and J. Llisterri, “Conclusions and Policy Implications” in H. Kantis (Ed.), *Developing Entrepreneurship: Experience in Latin America and Worldwide* (Washington, DC: Inter-American Development Bank, 2005), 101-107, 105.

<sup>216</sup> Aidis, when discussing the challenges of knowledge-based entrepreneurship in transition economies, noted that efforts must be made to match technical skills with market opportunities lest the high levels of human capital and technological expertise available in those economies are wasted on less productive activities. R. Aidis, *Entrepreneurship in Transition Countries: A Review* (London: SSEES, University College London, 2005), 26-27.

<sup>217</sup> T-W Liang (Ed.), *Entrepreneurship and Innovation in the Knowledge-based Economy: Challenges and Strategies* (Tokyo: Asian Productivity Organization, 2003), 12.

<sup>218</sup> W. Naude, A. Szirmai and M. Goedhuys, *Policy Brief: Innovation and Entrepreneurship in Developing Countries* (Helsinki, Finland: United Nations University-World Institute for Development Economics Research, November 1, 2011).

absorptive capacity necessary for knowledge to be integrated into, and efficiently transferred within, the local economy; and promotion of competition. They also reiterated some of the recommendations described earlier by commentators such as Mani and Akcomak with respect to government support for innovation by improving infrastructure, developing incubators, establishing public-private partnerships, improving access to financing and providing technical and managerial education.