Firms in developing countries

Lecture 7: Characteristics of firms in developing countries

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Firms in developing countries

- Who are entrepreneurs?
- Entrepreneur's characteristics in developing countries
- Bottlenecks for entrepreneurship in developing countries
- What's about Thai entrepreneur?

Who Are (China's) Entrepreneurs?

- Djankov, Qian, Roland, and Zhuravskaya. AER (2006)
- Data:
  - Bejing and 6 other cities surveyed in 2004-05 for both entrepreneurs and nonentrepreneurs
- Method:
  - Compare entreprenuers with nonentrepreneurs using conditional means controlling for age, gender, education, and city dummies

Comparing entrepreneurs with nonentrepreneurs

- No important differences in cognitive scores, or excellence in education
- Entrepreneurs are more mobile, wealthier, and more willing to accept a risk-neutral gamble
- Parents of entrepreneur do not have a higher education than nonentrepreneurs, they are wealthier
- Entrepreneurs tend to have family members/relatives involving in entrepreneurship activities
- They tend to be motivated and want to earn more.
- Nonentrepreneurs view institutional environment (complicated tax rules, inflation, macroeconomic instability) as problems more than entrepreneurs

Different types of entrepreneurs and nonentrepreneurs

- Table 1 in the paper
- Probits (model for binary dependent variable) of 3 different comparisons
- Multinomial logit model (multiple choices model) for entrepreneurs, nonentrepreneurs with once failed entrepreneurs, and nonenterpreneurs who were never entrepreneurs
- Multinomial logit model for entrepreneurs by opportunity, entrepreneurs by necessity, and nonentrepreneurs who were never entrepreneurs

Different types of entrepreneurs and nonentrepreneurs

- Social environment (family and friends) has an effect on thinking about becoming an entrepreneur, but risk taking and greed are necessary to be an entrepreneur
- Fail entrepreneurs have worst scores on aptitude tests, but have the best self-reported performance in school and perceive the government as least favorable to business

Entreperneurs in the occupational transitions

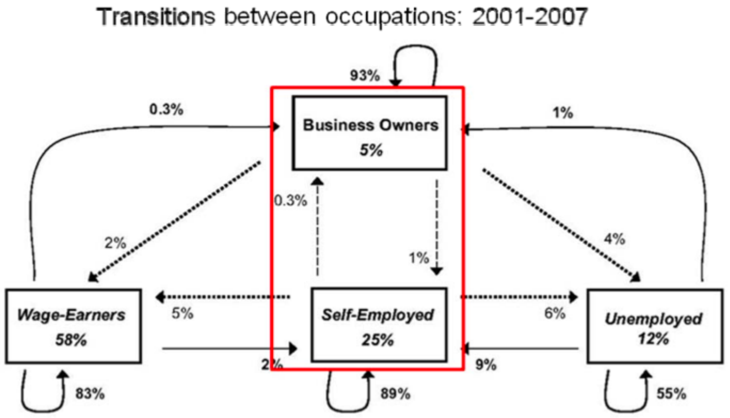

Figure 1: From Mondragon-Velez and Pena-Parga (2008)

Subsistence vs. transformational entrepreneurs

- Subsistence entrepreneurs:
  - Becoming entrepreneurs as a means of earning subsistence incomes, alternative sources of income
  - Most are small businesses, self-employed with family members, no labor from outside family
  - Do not aim to grow into larger firms
- Transformational entrepreneurs:
  - Aiming to create large, potentially growing business that can provide jobs for others
  - Seen as true engines for economic growth

Subsistence vs. transformational entrepreneurs

- Many policies assume that subsistence entrepreneurship is the first step towards transformational entrepreneurship. This is not supported by the recent literature.
- "Missing middle": a large fraction of micro-firms and some large firms, but mid size firms are less prevalent in developing countries.
- Only small number of individuals who transition from subsistence to transformational entrepreneurs.
- These two groups respond to growth opportunities differently. Their characteristics are also different.
- Capital market, regulatory imperfections, and labor market constraints are main hindrances that affect the transformation.

Different characteristics

- Subsistence entrepreneurs:
  - Low human capital and strong motivation to support families (just want to survive)
  - Voluntary exit to better jobs, no intention of growing their business
- Transformational entrepreneurs:
  - Higher human capital (higher scores on measures of IQ and the level of managerial and financial literacy)
  - Higer willingness to take risks, less fear of failure and more confidence in their skills
  - Study in India (Iyer and Schoar, 2008) shows that expansion strategies are also different: those who aim to build a long-term business are willing to give up short-terms profit to build reputation.

Bottlenecks for transformational entrepreneurs

- Access to capital:
  - Capital constraints for start-up firms: when there is a shock to supply of credit, if firms are credit constraints, we will see a larger impact on firm growth (e.g. increase in a demand for credits and increase significant profits)
  - Banerjee et al. (2009)'s randomized experiment on the impact of microcredit shows that the improved access to credit seems to have reduced borrowing costs and increased the profits, but it did not lead to explosive growth of businesses.

Bottlenecks for transformational entrepreneurs

- Regulation:
  - Reduction in getting business licencing time and costs to register a business increase the number of newly-licensed firms (in Peru)
  - Administrative barriers to starting a business and the cost of registering a business are negatively correlated with business density and the entry rate
  - People might prefer to stay informal, smaller firm size rather than growing into a larger firm if more regulatory are required from the government (This might lead to more rent extraction by government officials.)
  - Tight labor market regulations also increase the importance of social networks and risk attitudes, affecting the decision to start a business

What's about Thai Entrepreneur?

Townsend (2011, Chapter 5)

- Most firms are small in terms of number of employees
- SMEs account for over 95% (or more) of all firms
- In rural, there is a movement of households out of agriculture and into non-farm self-employment or employers. Those who move into non-farm have higher incomes, but there is within-group (nonfarm) inequality.
- Initial household wealth seems to facilitate household transition into business, and the assets of a new business are lower if the household is not borrowing. Here, there is wealth constraint.