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Business groups and entrepreneurship in developing countries after reforms

Murali D.R. Chari [a,*], Jaya Dixit [b]

[a] Lally School of Management, Rensselaer Polytechnic Institute, 110 8th Street, Troy, NY 12180, United States
[b] Indian School of Business, Hyderabad, India

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ABSTRACT

Drawing from the literature on markets and market development we develop hypotheses on the startup and growth of formal business by business groups relative to independent entrepreneurs after reforms. We then test the hypotheses in a large sample of firms that were started up after reforms in one large developing country—India. Findings show that (a) the likelihood of formal business startup by business groups, relative to independent entrepreneurs, declines with market development following reforms, (b) the likelihood of formal business startup by business groups, relative to independent entrepreneurs, is greater in industries privatized by reforms and in industries with greater foreign firm presence, and (c) formal businesses started by business groups experience greater growth than formal businesses started by independent entrepreneurs.

1. Introduction

Starting and growing formal businesses, defined as privately owned or publicly owned firms that draw or seek to draw significantly on external resources, were very difficult in developing countries because of their underdeveloped markets before these countries enacted economic reforms (Leff, 1978, 1979). Business groups (BGs), which are collections of firms with common ownership and control by a family, were particularly successful in starting and growing formal businesses in many of these countries because they leveraged internal markets to supplement and overcome the constraints of underdeveloped markets (Amsden & Hikino, 1994; Leff, 1976). BGs, as a result, dominated formal business and economic activities in a number of developing countries including Argentina, Brazil, Chile, India, Malaysia, Mexico, Nicaragua, Pakistan, South Korea, South Africa, Taiwan, and Turkey (Amsden & Hikino, 1994; Guillen, 2000; Khanna & Palepu, 2000b; Leff, 1976, 1978, 1979).

In recent years, a number of developing countries have enacted pro-market economic reforms (hereafter called 'reforms') aimed at developing their markets to promote entrepreneurship and private enterprise (Hoskisson, Eden, Lau, & Wright, 2000). As a result of these reforms, these countries are becoming major economic forces in the world, and entrepreneurship (including the startup and growth of formal businesses) has been credited with playing 'a key role in this development' (Bruton, Ahlstrom, & Obloj, 2008: 1). Noting the growing importance of entrepreneurship in developing countries, and citing a paucity of research on the topic, scholars have called for more research into entrepreneurship in developing countries (Bruton et al., 2008). Despite their widely acknowledged dominance in the startup and growth of formal businesses before reforms, there is virtually no research to our knowledge on the startup and growth of formal businesses by BGs in developing countries after reforms.

Who starts businesses and who succeeds in growing their businesses are important questions for scholars, entrepreneurs, and policy makers (Shane, 2003). Relative to independent entrepreneurs, how likely are BGs to start and grow formal businesses after reforms? We examine the startup and growth of formal businesses by BGs relative to independent entrepreneurs in developing countries after reforms. We draw from the literature on markets and market development to advance hypotheses on the likelihood of formal business startup by BGs relative to independent entrepreneurs following reforms, and the relative success of such startups. We then test the hypotheses on a large sample of formal businesses started up in one large developing country that has enacted reforms, India.

Our study makes important contributions as detailed in the Discussion section. Briefly, the study provides, to our knowledge, the first set of empirical findings on startup and growth of formal businesses by BGs in a developing country after reforms. The study also contributes to the literature on BGs by identifying some sources of BG advantage that persists after the reforms.

* Corresponding author. Tel.: +1 518 669 9164.
E-mail addresses: Charim2@rpi.edu (M.D.R. Chari), Jaya_Dixit@isb.edu (J. Dixit).

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2. Background: entrepreneurial constraints and BGs in developing countries

The institutional context, made up of a matrix of formal rules such as laws and regulations, informal norms, and the enforcement of rules, significantly impacts economic activity in a country (North, 1990). Restrictive laws and regulations in developing countries were not supportive of markets, and the resulting deficiencies in "factor and product markets" made startup and growth of formal businesses very difficult (Leff, 1978, 1979: 46). Underdeveloped factor markets made the mobilization of capital, labor, and other production factors required to start formal businesses difficult (Leibenstein, 1968). Venture capitalists who mobilize capital to fund formal business startups were non-existent. Paucity of educational institutions left a void in the labor market for trained managers and professionals (Khanna & Palepu, 2010). Absence of product market intermediaries made it difficult to obtain information to make entrepreneurial decisions (Khanna & Palepu, 2010). Restrictive regulations, in addition, introduced bureaucratic barriers to start formal businesses. These conditions led to pessimism about the prospects for startup and growth of formal businesses in developing countries (Leff, 1979).

BGs were particularly successful under these conditions because they were able to supplement and overcome the deficient product and factor markets. Specifically, founders of BGs mobilized capital initially from their extended families and ethnic communities to start and operate multiple formal businesses (Leff, 1976). They subsequently leveraged internal markets, created by pooling the resources of their various businesses, to start and grow additional formal businesses (Amsden & Hikino, 1994; Leff, 1978, 1979). To overcome talent market voids BGs often ran their own management development programs (Khanna & Palepu, 2010). When faced with a lack of intermediary products, BGs started new businesses to produce these products. Operating businesses in multiple industries generated internal information flows which helped reduce uncertainties regarding production and investment decisions (Leff, 1979: 53). BGs adapted technologies imported from developed countries to overcome deficiencies in domestic technology sources (Amsden & Hikino, 1994). BGs were also better at dealing with bureaucratic hurdles as their multiple businesses provided economies of scope in lobbying (Ghemawat & Khanna, 1998; Leff, 1978: 668). Finally, repeated entry into new businesses provided BGs extensive experience in the entrepreneurial process (Amsden & Hikino, 1994; Guillen, 2000).

BGs, thus, were credited with overcoming the entrepreneurial constraints of the pre-reform era. The success of BGs has spawned a large body of literature examining their effects on firm performance, risk sharing, innovation, and socio-economic welfare (Colpan, Hikino, & Lincoln, 2010; Khanna & Palepu, 2000b; Singla & George, 2013).

Recognizing the importance of well-developed markets for economic growth, a number of developing countries have enacted reforms to transform their institutional contexts in support of market development and private enterprise (Hoskisson et al., 2000). What effect does this have on the startup and growth of formal businesses by BGs?

3. Hypotheses

We draw from the literature on markets and market development for our hypotheses. Our main arguments are as follows. Markets evolve gradually following reforms and hence the startup and growth of formal businesses by BGs after reforms are best observed as markets develop over time (North, 1990). The development of markets eases pre-reform era constraints by increasing the availability of resources through markets, and this would lower the advantages of BGs in starting formal businesses relative to independent entrepreneurs.

Accessing resources from markets however is not universally advantageous because markets are not always efficient. Specifically, when measurement problems are high, arriving at price and terms of contract are difficult for market participants, and therefore markets will be inefficient (Akerlof, 1970; Alchian & Demsetz, 1972; Coase, 1937; Williamson, 1979). Markets are also inefficient when the reliability of supply is important (Bernanke & Gertler, 1987), and when the need for secrecy prevents sufficient disclosure to aid measurement and thereby the determination of price and terms of contract (Coffee, 1984). Because of market inefficiency, access to internal markets would provide BGs an advantage in starting formal businesses in certain areas of the economy, and in growing formal business startups. We develop these arguments below.

3.1. Market development following reforms and the startup of formal businesses by BGs

Reforms are efforts to change the institutional context in support of market development and private enterprise (Hoskisson et al., 2000; North, 1990). Reforms typically include measures that strengthen shareholder protection, deregulate labor restrictions, and liberalize entry for product and factor market intermediaries (Chari & David, 2012; Cuervo-Cazurra & Dau, 2009; Khanna & Palepu, 2000a). Greater protection for shareholders contributes to equity market development by increasing investor confidence, which in turn increases access to and lowers the cost of capital (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1997). Development of equity markets also enables entrepreneurs to defray startup risks. Entry liberalization for venture capitalists enables these intermediaries to raise capital and fund startups. Entry liberalization for educational institutions increases the availability of trained managers and professionals. Entry and growth in the number of product and factor market intermediaries such as market research firms, consultants, and rating agencies increase the amount of information and intermediary services available through the market for entrepreneurial decision making. The development of markets following reforms thus increases the availability of resources required to start formal businesses.

Market development, however, occurs gradually over time, rather than immediately, after reforms (Ghemawat & Khanna, 1998). This is because institutional change, including those intended to support market development, is overwhelmingly incremental (North, 1990). While changes in formal rules can, at least in theory, be enacted quickly, changes in the other two components of the institutional matrix are necessarily incremental (North, 1990). Informal norms that extend and complement the new formal rules only evolve gradually over time through repeated exchange by organizations within the new policy framework (North, 1990). Supervisory institutions such as regulatory agencies that enforce the new rules also evolve only over time through a process of learning by doing (Panagariya, 2008). Even the new formal rules often evolve as regulatory agencies discover changes necessary to make the rules enforceable.

The availability of resources required to start businesses therefore can be expected to increase as markets develop over time following reforms rather than immediately after reform initiation. An increase in resources available through markets will favor formal business startup by independent entrepreneurs who can now more easily marshal the necessary resources through the markets. In addition, as the availability of resources through markets increases, BGs' advantages in starting formal businesses that stem from their ability to use internal markets to overcome or supplement the underdeveloped markets would decline. The above arguments suggest a decline in the relative likelihood of formal business startup by BGs as markets develop following reforms.

Hypothesis 1. The likelihood of formal business startup by BGs, relative to independent entrepreneurs, declines with market development following reforms.

3.2. Market inefficiency and the startup of formal businesses by BGs

As noted by Coase (1937), Alchian and Demsetz (1972), and Williamson (1979), even within well-developed market economies