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Foreign direct investment, institutional quality, economic freedom and entrepreneurship in emerging markets

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ABSTRACT

This study investigates the relationship between foreign direct investment, institutional quality, economic freedom, and entrepreneurship in emerging markets. The research compares the capacity and appetite for business creation among high-income, low-income and emerging countries. The results are based on a panel study of data, from 2004 to 2009 for 87 countries, using as its source "The World Bank Entrepreneurship Snapshots" to look at the connection between business creation, institutional quality, market freedom and foreign direct investment (FDI). The findings reveal a strong positive relationship between institutional quality and business generation in all three of the above categories. The freedom to create businesses and invest has an impact on business generation in emerging countries, while the influence of international trade appears more important as a spur to the genesis of business in low-income countries. Finally, there is a direct and significant relationship between FDI and business development in emerging countries. This result is consistent with "the spillover theory of entrepreneurship" (Acs et al., 2009; Ayyagari and Kosová, 2010; Görg and Strobl, 2002).

1. Introduction

Few studies are available on the relationship between entrepreneurship and factors ancillary to a free market (including freedom to trade and invest). In the available research, the results are inconclusive and do not allow for a consensus on whether these factors, in fact, stimulate business development.

The majority of studies look at the relationship between institutions and entrepreneurship and whether institutional quality spurs would-be entrepreneurs to create businesses (Aidis, Estrin, & Mickiewicz, 2008; Desai, Gompers, & Lerner, 2003; Spencer & Gómez, 2004) and, therefore, whether or not a direct relationship occurs between entrepreneurship and institutions. However, findings are not yet exhaustive or conclusive in this area, making the correlation between institutions and entrepreneurship difficult to assess, particularly in relation to emerging countries.

This study employs a panel study from 2004 to 2009 for 87 countries. Utilizing the registry of new companies on "The World Bank Entrepreneurship Snapshots", the study tracks the relationships among company creation, institutional quality, a free market and FDI. To allow for comparative analysis, the 87 countries are split into three groups. The first group comprises countries of high and middle income; the second group comprises countries of low income (both groups selected according to the proposed classifications by the Atlas method of The World Bank); and, the third group comprises emerging or frontier emerging countries (these countries do not figure in previous groups and are grouped according to classifications from *The Financial Times* and The London Stock Exchange (FTSE) Index).

This study makes four contributions to the canon of work on the subject. First, the study here analyzes the relationship between institutional strength and business creation in emerging countries, shedding light on the impact of institutional quality on business creation and how outside influences affect institutional quality. Second, it evaluates the relationship between entrepreneurship and aspects of the free market (in particular relative aspects such as financing, foreign trade, flow of capital and conditions for starting up, and operating and winding down a business over the lifespan of an enterprise), while considering which factor has the greatest influence and how gradations in the factors impact business creation.

Third, the study examines the impact of FDI in assisting business development in emerging countries. This work considers whether FDI facilitates business creation in the host country or, actually, deters domestic company development. Fourth, the study looks at the interplay between FDI, institutional quality and the free market and how they combine to lay the groundwork for business development in emerging countries.

This article continues as follows. The second section reviews recent literature and considers the rationale for the study; the third part presents the chosen econometric model; the fourth section details the

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data and sources while the fifth section offers the results and how they stand up to testing. The final section has conclusions, considers limitations of the research, and suggests opportunities for further research.

2. Literature review

2.1. Business creation and institutional quality

To measure how the quality of institutions impacts startups, researchers aim to show the impact on entrepreneurs, property rights protection, the quality of legal services, law enforcement and corruption control. Studies charting the relationship between property rights and business creation have already established the significance of property rights in promoting economic development (Mauro, 1995; Svensson, 1998) and innovation (Broberg, McKelvie, Short, Ketchen, & Wan, 2013). Strong property rights protection prompts economic growth as businesses consider and take advantage of the significant benefits. Conversely, it has been shown that weak property rights protection increases the perception of risk for would be entrepreneurs, deters individuals from starting up a business and reduces their involvement in future development projects (Claessens & Laeven, 2003; Demirgüç-Kunt and Maksimovic, 1998; La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1997; Parker, 2007).

Protection of property rights is fundamental to the entrepreneurial process because it allows entrepreneurs to enjoy the fruits of their labor and, at the same time, losing out to public or private theft of property (Hodler, 2009). The guarantee of secure property protection rights is even more critical to the relationship between investor and entrepreneur as the risks they shoulder and fears of losing out are reciprocal. On one hand, investors may have a legitimate fear they may not recover anything if an entrepreneur acts opportunistically. On the other hand, the entrepreneur may fear that their idea could be stolen by an investor, who may have the financial means and motivation to develop the concept without their participation.

Researchers show how entrepreneurship fails to flourish where inadequate legal quality, poor law enforcement and high levels of corruption proliferate. This phenomenon disadvantages entrepreneurial activity in several ways. First, where there is low legal quality and high corruption, entrepreneurs find political support is crucial to their survival and entrepreneurial development. Consequently, there is no incentive to an honest entrepreneur—one who is not open to corruption (Aidis & Adachi, 2007; Aidis et al., 2008; Aidt, 2009). Second, an environment that fosters those kind of designs does not promote loyalty and encourages dishonest practices—deterrents to new entrants to the business arena (Aidis & Mickiewicz, 2006; Barkhatova, 2000). Third, where law enforcement falters and there is a lot of corruption, this can taint the entrepreneurial experience (Glaeser, Scheinkman, & Shleifer, 2003; Hodler, 2009) and, in turn, create prejudicial views of entrepreneurial activity (Aidis, Estrin, & Mickiewicz, 2010).

To conclude, the scope of entrepreneurial activity is influenced by how much confidence stakeholders have in institutions and how willing they are to abide by the law. What also matters are the police, courts and government are and how they promote laws to help the private sector develop and create conditions in which contracts are honored and corruption is not tolerated.

2.2. Business creation and free market economies

Kirzner (1992) considers a free market as the legal, political, constitutional, and economic principle most likely to encourage entrepreneurship. Studies for emerging countries like Okoroafo (1993) confirm that liberalized environments in improving business climates. In a free market economy, supply and demand determine which goods and services must be produced and the price for which they are sold. Although an entirely free market does not exist, the degree of freedom is measured through reference to existing intervention mechanisms. The most common among these are: price controls; taxes; import and export tariffs; monetary control; subsidies and state monopolies. Some of these are considered in this study as instrumental to entrepreneurial activity:

2.2.1. Freedom to start and close business

Researchers advocate one of two views on how the relationship between entrepreneurship and the regulatory framework operates in practice. The first belief posits that tight regulatory control acts to impede chaos within the marketplace, undermining confidence in the market and thereby engendering entrepreneurship (DiTella & McCulloch, 2006; Djankov, Glaeser, La Porta, Lopez-de-Silanes, & Shleifer, 2003; Glaeser & Shleifer, 2003). The counterargument is that too stringent a regulatory system goes hand-in-hand with higher levels of bureaucracy, paves the way for corruption, and impedes new business creation and expansion of existing ones. Studies support the notion that regulation favors fledgling businesses (Stigler, 1971), and the regulators themselves (Krueger, 1974; Shleifer & Vishny, 1998). Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002) confirm that in countries where regulation inhibits entry to new businesses, there also happens to be higher levels of corruption. Desai et al. (2003), Klapper, Laeven, and Rajan (2006), and Parker (2007) have found that industries that are generally attractive to would-be entrepreneurs across the board are less appealing in countries where the system is more bureaucratic and the regulatory costs more significant.

2.2.2. Fiscal freedom

The findings in McMullen, Bagby, and Palich (2008) indicate tax hikes have a direct impact upon entrepreneurial activity, as potential entrepreneurs weigh the risks in setting up a business and regard this as a further impediment. Complex tax structures deter entrepreneurial activity even for those who are risk-averse as they will eventually feel the effect of continuing tax hikes (Gentry & Hubbard, 2000; Kanbur, 1980). But, Feldstein and Slemrod (1980), Gordon (1998), and Cullen and Gordon (2002), highlight that fiscal systems are complex and their interrelationships cannot be easily predicted; and for that reason, the relationship between fiscal freedom and entrepreneurship can vary depending on existing factors such as capital gains tax, income tax and corporate tax.

2.2.3. International trade freedom

Some studies mention how international markets benefit larger companies while smaller companies are disadvantaged by fixed costs, their limited knowledge of international markets, and limited skills and wherewithal to negotiate with other governments (Gomez-Casseres, 1997; Vernon, 1970). It has been stated also that intensified international competition induces many firms to seek government protection but pressures to employ protectionist measures may result in net welfare losses (Zhou & Vertinsky, 2002). Other studies contend that business creation and free international trade enjoy a symbiotic relationship (Bartlett & Ghoshal, 1999; Sobel, Clark, & Lee, 2007). The last conclusion supports the World Bank's thesis (World Bank, 2005) indicating that protectionist limitations to international trade impede specialization and free market participation, favor known products over innovation, and limit entrepreneurship activity because new opportunities to make money are excluded from local entrepreneurs' alternatives.

2.2.4. Freedom to invest

The importance of sourcing capital as a prerequisite to starting a business is no secret. Many researchers have suggested that restrictions on the flow of capital inhibit the growth rate of business formation (Blanchflower & Oswald, 1998; Di Patti & Dell'Ariccia, 2004; Holtz-Eakin, Joulfaian, & Rosen, 1994). There is also extensive research asserting that the availability of financial resources, especially venture capital, is vital to entrepreneurial development (Gompers & Lerner, 2001; Henderson, 2002). Investment freedom provides fertile ground