



# Institutional and economic drivers of entrepreneurship: An international perspective



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## ABSTRACT

Entrepreneurial activity varies significantly across countries and over time. The economic and institutional context is a determining factor that can drive and lend shape to entrepreneurial activity. The search for a deeper understanding of the role of this factor constitutes a promising and important research stream. A thorough review of the specialist literature identifies groups of countries with similar economic and institutional environments. Subsequent analysis highlights differences in entrepreneurial activity and innovation outcomes between these homogeneous groups. Results indicate significant differences, not only in entrepreneurial activity, but also in the type of entrepreneurship and innovation results. These findings mark a relevant step forward in the identification of different environment types, and the effects of environment on entrepreneurial activity and innovation results.

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## 1. Introduction

Research into entrepreneurship dates back to 1755, when Cantillon introduced the term entrepreneur in his *Essai sur la nature du commerce en général*. The study of entrepreneurship is receiving increasing attention from researchers and policymakers because of the general view that entrepreneurship is essential to countries economic growth and development, driving employment and innovation (Cuervo, Ribeiro, & Roig, 2007; Pinillos & Reyes, 2011; Reynolds, Camp, Bygrave, Autio, & Hay, 2001; Schumpeter, 1934; Wennekers & Thurik, 1999).

Entrepreneurship scholars seem to agree that the level of entrepreneurial activity varies significantly across countries and over time (Verheul, Wennekers, Audretsch, & Thurik, 2002). Due to the great importance of entrepreneurship, the quest for a deeper understanding of the factors that drive and shape entrepreneurial activity constitutes an important and productive stream of research (Engle, Schlaegel, & Dimitriadi, 2011).

Following this line of thought, the environment in which new ventures emerge is an important field of research, not only because environmental variables open up opportunities to exploit market inefficiencies as the economic approach highlights – but also because different environments can be more or less favorable to the success of new ventures (Stevenson & Jarillo, 1990). Consequently, studying the role of environmental determinants of entrepreneurial activity is critical.

Unquestionably, economic factors matter. For example, the contributions of the Global Entrepreneurship Monitor (GEM) in this area

show that entrepreneurship activity is normally more prevalent in countries with greater income inequality. GEMs results also reveal that in developing countries, necessity entrepreneurship has a more pivotal function in the economy than opportunity entrepreneurship, apparently because finding paid work is more difficult than in other economic settings (Reynolds et al., 2001). Clearly, however, economic factors are not the only drivers of entrepreneurial activity. In fact, countries with similar economic conditions can have quite different rates of entrepreneurship (Van Stel, Storey, & Thurik, 2007).

Currently, institutional factors are receiving a great deal of attention in the subject specific literature. As Jackson and Deeg (2008, p.540) state, “institutions matter, but how they matter remains a hotly contested question.” Institutions differ significantly across countries, causing differences in the patterns of economic behavior and innovation results. North (1990) highlights that formal and informal institutions can promote or damage the entrepreneurial rate of a society, and affect the sustainability of new ventures. Institutions shape entrepreneurial activity via the reduction of uncertainty, establishing a structure that can limit the set of choices of individuals (Díaz-Casero, Urbano-Pulido, & Hernández-Mogollón, 2005; North, 1993). Different countries distinct institutional frameworks thus affect entrepreneurial activity differently, as the results of Stephen, Urbano, and Van Hemmen (2005) show.

Studies that analyze a sample of countries with different environmental conditions in an attempt to gain a better understanding of the role that economic, and formal and informal institutional factors play as drivers of entrepreneurial activity are scarce. Therefore, using a sample of 62 countries, this study aims to identify a typology of environments, with the ultimate goal of advancing knowledge of how environmental conditions affect the level of entrepreneurial activity, the kind of entrepreneurial activity, and the innovation performance of countries.

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The remainder of the paper has the following structure. **Section 2** analyzes the economic and institutional factors as determinants of entrepreneurial activity. **Section 3** describes the methodology and **Section 4** presents the results. These two sections identify groups of countries with similar economic and institutional environmental conditions and examine differences in entrepreneurial activity and innovation between these homogenous groups. Finally, **Section 5** addresses the conclusions, implications, and limitations of the research.

## 2. Economic and institutional drivers of entrepreneurship

### 2.1. Economic drivers of entrepreneurship

The contributions of the GEM to the field of Economics highlight the generally higher rate of entrepreneurship in countries whose economic development is relatively low, and greater income inequality prevails (Kelley, Bosma, & Amorós, 2010; Reynolds et al., 2001). Although least developed countries might be expected to provide more opportunities for potential entrepreneurs (Smallbone & Welter, 2006), other explanations seem to be more accurate. In this respect, GEM results show that, in developing countries, necessity entrepreneurship has a stronger function in the economy than opportunity entrepreneurship. This situation may owe to difficulties in finding paid work in developing countries, with people tending to undertake business ventures in order to avoid unemployment (Reynolds et al., 2001). Conversely, an abundance of job opportunities and a high degree of social security are factors that increase the opportunity costs of entrepreneurship for individuals in developed countries (Bosma & Schutjens, 2011). Baptista and Thurik (2007), Baptista and Torres (2006), and Thurik, Carree, Van Stel, and Audretsch (2008) point out that the relationship between unemployment and entrepreneurial activity is more complex. On the one hand, higher unemployment may lead to more entrepreneurial activity. On the other hand, low rates of start-up companies may also have an association with low economic growth rates, which correlate to higher levels of unemployment. In any case, as previous discussion intimates, necessity entrepreneurship seems to be more prevalent than opportunity entrepreneurship in countries with low levels of development, growth and employment, and higher inequality.

### 2.2. Institutional drivers of entrepreneurship

A common perception of institutions is that they define the rules of the game that shape the economic behavior of a society (Baumol, 1990). The structure of institutions will influence and may help explain differences in entrepreneurial activity between countries. According to North (1992) and Redding (2005), institutions fall into two broad categories: formal and informal. Formal institutions consist of statute law, common law, and regulations. Informal institutions, which Scott (2001) divides into socially driven normative and cognitive pillars of institutionalization, consist of, “conventions, norms of behavior, and self-imposed rules of behavior” (North, 1992, p. 4).

#### 2.2.1. Formal institutions: the regulatory pillar of institutionalization

Economic rules, “establish the hierarchical structure of governments, their basic structure of decision” (Díaz-Casero et al., 2005, p. 213). Formal institutions generally address property rights protection regimes, and the constituents of this body of regulation that receive the most citations are rules of law, political and economic freedom, and corruption (El Harbi & Anderson, 2010).

Van Stel et al. (2007) explain that, through institutions, governments can spur on entrepreneurship by cheaply enabling the constitution and functioning of new ventures, and by minimizing the number of formalities that entrepreneurs have to follow to undertake an activity. In this sense, Stephen et al. (2005) point out that the institutions that affect entrepreneurial activity the most are bureaucratic formalities. Furthermore, a government can foster entrepreneurial activity of a

country by rewarding entrepreneurs. These rewards can take the form of the following types of aids: advisory services, business incubators, and financial support (Toledano-Garrido & Urbano-Pulido, 2007).

Institutions appear to have direct and indirect effects on entrepreneurship, and these effects may vary depending on a number of conditions such as economic development, the level of unemployment, the type of entrepreneurship measured, and so on. For instance, looking at the impact of tax levels on entrepreneurship, high tax rates reduce the financial returns for entrepreneurs, which may have a negative effect on entrepreneurial activity. On the other hand, self-employment may offer greater opportunities to avoid tax liabilities. As Verheul et al. (2002) state, the case of social security is similar, increasing the cost of entrepreneurship while at the same time exerting a potentially positive effect on entrepreneurial activity by creating a safety net in case of business failure.

Finally, Estrin, Aidis, and Mickiewicz (2007) claim that countries with strong formal institutions, that is with tight protection of property rights or high levels of economic freedom, show better results in terms of opportunity entrepreneurship and innovation.

#### 2.2.2. Culture: the normative pillar of institutionalization

A fundamental part of societies, informal institutions work to provide cues to shape behavior (El Harbi & Anderson, 2010), and do not represent codified or implicit attitudes. They develop informally over time, and are the embodiment of cultural norms, belief systems, practices, and customs (Hofstede, 1990).

An extensive body of literature links national culture, entrepreneurship, and innovativeness (Shane, 1992; Thomas & Mueller, 2000; Van de Ven, 1993). Culture receives scholars attention not only because of the restrictions this factor imposes on entrepreneurs, but also because of its role as an enhancer of business opportunities (Aldrich & Fiol, 1994). Hofstede defines culture, “in the anthropological sense of broad patterns of thinking, feeling, and acting” (Hofstede, 1990, p. 5). The first models include four dimensions of national culture: power distance, individualism, masculinity, and uncertainty avoidance. (The two additional measures appearing in later models are outside the scope of this study due to a lack of data and theoretical background.)

Owing to the high correlation between the entrepreneurial traits of independence, individual achievement and tolerance for ambiguity and uncertainty, and Hofstede's measures of individualism and uncertainty avoidance, much research focuses on the individualism and uncertainty avoidance dimensions of national culture. The literature shows some consensus on the idea that entrepreneurial activity may share a positive relation with individualism and have a positive link to uncertainty avoidance.

In individualistic cultures, people put their own interests before group interests (Thornton, Ribeiro-Soriano, & Urbano-Pulido, 2011). Given that the need for individual achievement characterizes entrepreneurs (Shane, Locke, & Collins, 2003), the expectation is that individualistic cultures tend to be more entrepreneurial.

Uncertainty avoidance has a relation with norms, values, and beliefs regarding tolerance for ambiguity and risk. According to Shane et al. (2003), when entrepreneurs embark on an economic activity, certain characteristics of their own personality guide them. Two of the most important of these characteristics are risk-taking and tolerance for ambiguity. Thus, the higher the uncertainty avoidance index, the lower the risk-taking propensity of individuals.

Research analyzing the relationship between power distance, masculinity, and entrepreneurial activity is scarce. Nevertheless, if power distance represents the extent to which the less powerful members of organizations and other institutions accept and expect that the spread of power is uneven (Hofstede, 1990), when power distance is high, nations ought to be more entrepreneurial, because inhabitants seek greater independence. In other words, the pressure that individuals in such nations experience leads them to seek other ways of obtaining economic gains.

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