Economic Systems 34 (2010) 289–308

Contents lists available at ScienceDirect

Economic Systems

journal homepage: www.elsevier.com/locate/ecosys

A survey on institutions and new firm entry: How and why do entry rates differ in emerging markets?

Saul Estrin [a,*], Martha Prevezer [b]

[a] Department of Management, London School of Economics, United Kingdom
[b] Queen Mary University of London, United Kingdom

ARTICLE INFO

Article history:
Received 13 March 2009
Received in revised form 21 January 2010
Accepted 23 January 2010

JEL classification:
L26
O12
O17
P14
P52

Keywords:
New firm entry and exit
Entry rates
Formal and informal institutions
Emerging markets
Corruption

ABSTRACT

This paper considers the impact of institutions on new firm entry in emerging markets. In particular, it surveys the findings of a 2-year research project on the sources of success in terms of entry rates and conditions (including gross entry rates, exit rates and therefore net entry rates) across the BRIC countries (Brazil, Russia, India, China). These emerging market economies display widely varying entry and exit rates and a framework is developed to capture the interaction between key aspects of formal institutions, how those institutions play out in practice, and their impact on entry and exit rates. The country case studies reveal that, whilst different contingencies affect the relationships between institutions and entry in each country, there are some empirical regularities in the determinants of successful entry and conversely in its constraints. One such regularity is the critical interaction between formal rules and informal mechanisms. There is also variation in whether these works so as to compensate for deficiencies in formal institutions, as in China and India, or whether deficiencies in formal mechanisms are compounded by poor informal mechanisms, as is sometimes true in Brazil. Indeed, relatively good formal rules and structures can be undermined by informal mechanisms deterring or blocking entry, as is largely the case in Russia.

1. Introduction

Entrepreneurship and the process of new firm entry is recognized as an important element in economic development (Baumol, 1990; Wennekers and Turik, 1999). Mechanisms whereby the entry

* Corresponding author.
E-mail addresses: s.estrin@ac.uk, s.estrin@lse.ac.uk (S. Estrin).

0939-3625/$ – see front matter © 2010 Published by Elsevier B.V.
doi:10.1016/j.ecosys.2010.01.003

of new firms might contribute to economic growth and development include the generation, dissemination and application of innovative ideas enhancing efficiency and productivity (Nickell, 1996), increasing competition and providing diversity among firms (Cohen and Klepper, 1992). However, as Baumol (1990) shows, the various rules of the game through the system of respective rewards may divert entrepreneurial effort either to productive uses or to unproductive uses, which may even be destructive. De Soto (1990) has also highlighted the critical role of institutions – both formal and informal in the sense of North (1990) – in the process of entry in developing economies. In this paper, we survey the literature about the relevance of institutions for the entry of new firms in emerging markets. We draw in particular on the findings from a cross-country study in four major emerging markets – Brazil, Russia, India and China, the so-called BRIC economies.

1.1. What we know about entry and institutions

A large literature has developed to analyse the entry of new firms in developed and developing economies, including Geroski (1995), Caves (1998), Tybout (2000), Djankov et al. (2002), Klapper et al. (2006), and Bartelsman et al. (2004). From these, we know that gross entry rates in developed countries are generally high in most industries, that entry and exit rates are correlated in mature industries, and that net entry rates are generally low, reflecting structural and strategic barriers. For developing countries, the evidence on new firm entry is less well established. Tybout (2000) stresses the importance of regulatory barriers and Aw et al. (2003) finds that entry rates are relatively high in some developing countries but low in others.

It is now commonplace to argue that institutions matter for the development process and that they exert a strong determining effect on aggregate incomes in the context of developing countries (Hall and Jones, 1999; Acemoglu et al., 2001a; Rodrik et al., 2004). An innovative and important strand of this literature has attempted to quantify institutional barriers to new firm entry, using indices about the complexity of starting and doing business in different national contexts as well as about contract enforcement (Djankov et al., 2002). These data, available in the World Bank *Doing Business*, necessarily represent largely "formal" measures of institutions because they are constructed in a comparable fashion across 85 countries so as to facilitate the use of cross-country econometric methods. However, though it is widely recognized that institutions are complex and heterogeneous, these indicators are at best very coarse measures of the factors influencing entry in developing economies. This complexity of institutions in the literature includes a focus on property rights and historical legacies in their establishment (Acemoglu et al., 2002, 2003); on the political power of the elite and the relationship between the state and entrepreneur (Acemoglu and Robinson, 2000); and on the constraints on the elite and safeguards on state intervention and the independence of the judiciary (La Porta et al., 1999; Acemoglu et al., 2001b). All this work stresses the importance of clear property rights and legal framework and the independence of the judiciary from the political executive in the growth of countries. Easterly and Levine (1997) and Rodrik (1999) have also established the harmful effects of domestic social and ethnic conflict on the growth of developing countries. The literature on the grabbing hand of the state emphasizes the negative influence of state regulation and corruption, which is argued to motivate the growth of the informal sector (Mauro, 1995; Friedman et al., 2000; Johnson et al., 2000).

Regulatory barriers represent an important example of formal institutions. Djankov et al. (2002) find that higher regulation is not associated with positive outcomes such as better product quality but with higher levels of corruption and a greater relative size of the unofficial economy. In addition, there is a literature on the effect of regulatory conditions and bureaucracy on entry behaviour. Klapper et al. (2006) find that costly regulations hamper the creation of new firms, especially in industries with higher entry rates in the US and entry barriers. Moreover, regulations hinder entry more in countries with lower levels of corruption. Finally, there is a tradition concerned with lack of access to capital as a potential entry barrier. This stems from Bain's (1956) argument that capital requirements pose barriers for potential entrants. In the context of institutional development, one would include access to capital markets, access to bank loans and overdraft facilities as well as the importance of informal sources of finance through access to networks of family and friends (Aidis et al., 2008).