Institutional intermediaries and entrepreneurship in emerging markets

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Executive Summary

- Institutional intermediaries can help mitigate institutional voids in emerging markets to benefit business growth.
- Entrepreneurs in these economies can leverage institutional intermediaries to signal their quality and to build business capabilities. Different entrepreneurs can benefit differently from the same intermediary. Entrepreneurs should be clear about their goals when they plan to leverage intermediaries to scale up the business.
- Since institutional intermediaries are supplementary to existing settings, their impact depends on their fitness to the institutional environment. While leveraging the strength of existing institutions can help maximize the returns of public resources, intermediaries that conflict with existing institutions may hinder firm growth instead.

Institutional intermediaries in emerging markets

While entrepreneurial activity in emerging markets has risen in recent years, entrepreneurs in these economies are still facing severe challenges to survive and scale up their businesses. Many of the challenges come from institutional failures (Khanna & Palepu, 1997; Maguire et al., 2004; Mair & Marti, 2009). Weak financing institutions (Aidis & Estrin, 2006), inefficient legal systems and asymmetric information in product markets (Khana & Palepu, 1997) are other factors that cripple the ambitions of entrepreneurs in emerging markets.

The necessity of mitigating institutional voids induces the development of institutional intermediaries. Institutional intermediaries link two or more parties from the private and public sectors to create and develop a benign institutional environment in which to facilitate business activities (Dutt et al., 2016). There are multiple forms of institutional intermediaries, such as accelerators (Leatherbee and Eesley, 2014), development organizations (Mair et al., 2012) and business incubators (Dutt et al., 2016). Different forms of institutional intermediaries share similar objectives: to help entrepreneurs, develop market infrastructure and build up business capabilities (Dutt et al., 2016).

Many institutional intermediaries have had great success (Sine et al., 2007; Hallen et al., 2016), while others have had only a limited or even negative impact (Eberhart et al., 2018). The heterogeneity in the effects of institutional intermediaries on business growth reminds both practitioners and policymakers to be careful about the leveraging, design, and introduction of intermediaries as supplements to existing institutional system.

How can entrepreneurs in developing countries leverage institutional intermediaries?

Capital markets, legal systems, labor markets and other institutions in emerging markets are in the transition toward economic liberalization (Eesley, 2016; Hoskisson et al. 2000). During this process, market mechanisms have not yet matured, and entrepreneurs are operating in markets with asymmetric information and lack of access to resources to build up their business capability.

Accordingly, institutional intermediaries can benefit entrepreneurs in two ways: certification and capability-building. Certification is to confer quality and status signals, which can help entrepreneurs overcome information asymmetry in immature markets. Other than signaling, intermediaries can also help entrepreneurs build business capability by providing education and social connections (Hallen et al., 2016). A study by Dutt et al. (2016) looked at 133 business incubators in 68 emerging markets. They found the business capabilities of entrepreneurs joining an incubation program were significantly improved. Similar results are also found in Argentina, China, India and other emerging markets (McDermott et al., 2009; Armanios et al., 2016).

Different entrepreneurs could benefit differently from the same institutional intermediary. In a study of Chinese science parks, Armanios et al. (2016) found that less-connected entrepreneurs can leverage science parks to acquire public funding. For returnees with ample experience abroad, locating in science parks is a signal for good quality. For technically skilled local entrepreneurs who lack business skills, science parks can help build such skills, which then ease the path to government funding.

Designing institutional intermediaries to facilitate entrepreneurial activities in emerging markets

While governments of developing countries and international organizations expect institutional intermediaries to facilitate entrepreneurial activities, many projects making use of considerable public resources have only a limited impact. Some good-intentioned interventions even backfire.

Efficient institutional intermediaries need to mitigate gaps in the existing institutional system with limited resources. Understanding local institutions, formal and informal ones, is essential for good design. Emerging markets are usually lacking in formal institutional arrangements, but rich in informal institutional settings. Norms, cognitions, identities and social networks can all be leveraged to facilitate business creation. In a recent study in Maharashtra, India (Hussam, Rigol, and Roth, 2020), researchers found that community knowledge embedded in social networks can help overcome information asymmetries prevalent in poorly developed financial markets. Delicately extracted information from community reports are more accurate and predictive of entrepreneurs' capital return. Entrepreneurs ranked in the top third of firms earn returns of 23 percent per month, which is three times the average return within the sample.

In contrast, introducing an institutional intermediary without fully considering its interaction with existing institutional systems may hinder new firm growth. Eberhart et al. (2018) examined the impact of junior stock exchanges. Although the intermediary is commonly formed to facilitate entrepreneurial growth, the newly introduced exchanges conflict with existing institutions. They distort the investment incentive, encouraging investors to finance high-tech industries at the expense of other sectors. As the result of these distortions, financial resources are not efficiently allocated. The aggregated effect of junior stock exchanges on business growth is negative. Although the study was conducted in the U.S. context, its lessons can also be applied to emerging markets. In fact, compared to developed countries with well-established institutions, which are somewhat standardized, the institutional arrangements in emerging markets are more complicated. Take Africa, for example. As Dr. Samuel Mathey, president and founder of the African Foundation for Entrepreneurship and Economic Development, argues, "people living in Africa speak more than 2,000 languages, have various religious beliefs, and are mixed in races. It is such an evolving continent that there is little chance that a unique, static model can fit everywhere every time." The heterogeneity and dynamic nature of the institutional environment in emerging markets makes it even more challenging to introduce proper institutional intermediaries. Practitioners and policymakers must fully understand both formal and informal existing institutional arrangements, and think through potential side effects before allocating limited public resources to institutional intermediaries.

Policy and/or Practitioner Takeaways

- Institutional intermediaries can help fill institutional voids in emerging markets to foster business creation.
- Entrepreneurs in emerging markets can leverage institutional intermediaries to gain access to public resources. Different entrepreneurs may benefit from the same intermediary in different ways.
- Policymakers in developing countries need to consider both formal and informal existing institutional settings when introducing intermediaries to facilitate business creation. While leveraging local social capital can help maximize returns to public resources, introducing intermediaries that are misaligned with existing institutional environment may instead hinder local business growth.

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