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EMERGING & DEVELOPED ECONOMIES

Learn From Each Other on the Path to Growth

By ROY THURIK

The model of the managed economy, characterized by large-scale production and the ingenious interplay between man and machine, dominated most developed economies until the late 1980s.

Today, due to the combined effect of the computer, telecommunications and globalization, there is no longer a guarantee that the managed economies of Western Europe and North America will grow and create jobs. Lower cost but highly educated and skill-intensive countries in Central and Eastern Europe and Asia are posing formidable competition. At the same time, the telecommunications and computer revolutions have drastically reduced the cost of shifting, not just capital, but information out of high-cost and into lower-cost locations.

This signals a shift in competitive advantage – from high-cost to knowledge-based activities. An economy where knowledge is the main source of competitive advantage is more consistent with the model of the entrepreneurial economy. The essence of the model of the entrepreneurial economy is not just creating knowledge, but exploiting it. High uncertainty and considerable diversity characterize this model.

Against this backdrop, emerging economies provide interesting insights. As a mix of managed and entrepreneurial, they have had some experience of what the new model aims to achieve. Emerging economies have many faces: success in East Asia and parts of Eastern Europe, or failure, for example, in areas of Africa and Latin America.

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So what can we learn from the more successful emerging economies in terms of factors that generate growth and encourage entrepreneurial energy more readily? To answer this, we first need to consider the new model.

Knowledge Is Power

Until the late 1980s, the business world in modern developed economies was characterized by capital and labor: These were the essential ingredients of large-scale production, and the transaction costs incurred by this model dictated that firm sizes invariably increased over time, to the extent that large enterprises ultimately came to dominate. At the same time, the importance assigned to self-employment and small businesses waned.

Starting in the early 1990s, an increasing number of business experts began to change their tune. Capital and labor were not the be-all and end-all explaining long-term growth, they said, but were to be supplemented by other factors, namely technological development, and increasingly, as the decade wore on, *knowledge*.

Typically, knowledge has been measured in terms of R&D, human capital and patented inventions. Although many scholars predicted the emergence of knowledge as an important determinant of growth and competitiveness in global markets, they maintained that it was restricted to the realm of giant firms. Self-employment and small firms were to be sidelined further: How else could one exploit R&D activities, employ highly trained knowledge workers and bring their efforts to the patent or commercial stage, if not for the muscle and might of global players? Small firms were thought to be at a disadvantage vis-à-vis larger firms because of the fixed costs of learning about foreign environments, communicating at long distances and negotiating with national governments.

Despite the naysayers, small and young firms have returned as the engine of economic and social development. Why? In their blinkered pursuit of capital as the prime source of competitive advantage, the guardians of the managed economy overlooked a different, yet complementary, kind of capital: *entrepreneurship capital*, or the capacity to engage in and generate entrepreneurial activity. The last decade has seen a dramatic switch from the managed economy to the entrepreneurial economy – an economy in which new and young firms play a greater role.

This new business reality holds important implications for both developed and emerging economies alike. On the one hand, developed economies that have been the traditional proponents of the old economic model need to better understand the role of entrepreneurship, its drivers, its consequences and its policy requirements, as they make the transition from a managed to an entrepreneurial economy.

Emerging economies, on the other hand, have a trickier challenge, since they are often a mixed model of the two economies: For them, both the managed element and the entrepreneurial element have to be encouraged. This is difficult, partly because the issues are so complex, but also because a "typical" emerging economy is under-researched and, therefore, lacks clear definition.

Having said that, there are several lessons we can draw, based on my own study of the situation, which was prepared within the Entrepreneurship and Development (Promoting Entrepreneurial Capacity) project of the United Nations University World Institute for Development Economics Research (UNU-WIDER), with government funding from Denmark, Finland, Norway, Sweden and the United Kingdom.

Regime Switch: From Large to Small

The decrease in the role of small business in developed countries after the Second World War is well documented. This is the era of mass production, where economies of scale become the decisive factor in dictating efficiency. Big business, big labor and big government were the order of the day, with stability, continuity and homogeneity becoming the cornerstones. Taylor, Ford and Keynes were the thought leaders. *The Economist* once described it as "hierarchical and bureaucratic organizations that were in the business of making long runs of standardized products. They introduced new and improved varieties with predictable regularity; they provided workers with lifetime employment; and enjoyed fairly good relations with the giant trade unions."

Small firms, if they were considered at all, were regarded more as something to be tolerated than celebrated, a niggling presence that

Western countries could call upon to absorb part-time and low-skilled labor, especially to prop up inner cities. And it wasn't just North America that championed the managed economy. At the opposite end of the political spectrum, many communist, centralized economies around the world thrived during this same period, based on not-so-radically-different ideas about the inexorable march toward greater uniformity and larger scale mass production. Entrepreneurship was, at best, hostile to the communist system and, at worst, criminal. How ironic, then, that these economies eventually broke down due to a total lack of decentralized, experimental, free, risky and small-scale economic activities.

Now, we are seeing a revival of small-scale operations. Data from the United States between 1947 and 1989 show a trend toward larger enterprises and a decreasing importance of small firms, but within the subsequent seven years the average real GDP per firm had fallen by about 14 percent, and the sales share of small firms had risen from one-fifth to over one-quarter. What is interesting to note is that the U-shaped evidence of a regime switch is not determined by calendar year but by the level of economic development of a country; in particular, the distinction between a managed and an entrepreneurial economy. See **Exhibit 1**.

Developed Economies, Take Note

The occurrence of a regime switch suggests different things for different people concerning the role of entrepreneurship. For the managed economies of developed nations, it

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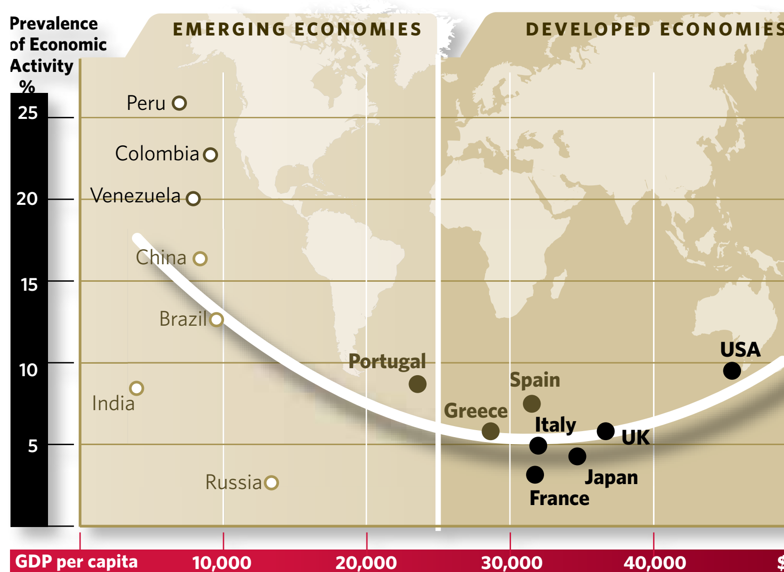
EXHIBIT 1

Signs of Regime Switch

Data on 42 countries from the Global Entrepreneurship Monitor shows the U-shaped relationship that exists between entrepreneurship, i.e., those taking steps to set up a business or businesses of less than three-and-a-half years old, and the level of economic development, measured in terms of gross domestic product (GDP) at purchasing power parity (PPP) per capita.

If they want to see more economic development and growth, the industrialized G-7 nations, such as the United States, United Kingdom, Japan, France and Italy, need to nurture even higher levels of entrepreneurial activity, as do the beleaguered euro zone countries of Greece, Portugal and Spain.

Among the emerging BRIC nations, Brazil, India and China show promising levels of entrepreneurial activity, with Russia standing to show even more, which may eventually see their economies matching those of the world's most developed ones.



However, even though entrepreneurial activity is high, other factors may stand in the way of progress, as is the case with certain Latin American countries such as Peru, Colombia and Venezuela, where growth remains low.

So, while those on the right need to concentrate on the switch from managed to entrepreneurial economy, those on the left need to mimic certain aspects of their industrialized counterparts, in order to move along the growth scale further.

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means reconsidering their love affair with stability, specialization, homogeneity, scale, certainty and predictability. To see growth, especially in the context of the global financial crisis, managers need to start paying closer attention to the links between flexibility, turbulence, diversity, novelty, innovation, linkages and clustering. In this, emerging economies hold some salient insights.

KEEP IT LOCAL. In the new entrepreneurial economy, as stated before, knowledge is king. By this, we are talking more than just hard, technical, scientific knowledge, but also softer aspects such as creativity, the ability to communicate, emotional intelligence, and so on. Competitive advantage is driven by innovative activity, especially the transfer and spillover effects of this activity.

Hence, local proximity is important. As knowledge tends to be developed in the context of localized production networks, which are embedded in innovative clusters, the regional setting becomes the most important locus of economic activity.

EXECUTIVE SUMMARY

Those who manage companies in developing countries find themselves in a time of transition. Faced with the prospect of declining growth, small and young firms are leading the way forward from the previous, managed economic model toward an important new driver of growth: the entrepreneurial economy. Given that differences in growth rates in developing countries are related to differences in the speed with which these countries embrace entrepreneurial energy, the pressure is on to study effective ways of cultivating and managing this newly significant engine of growth.

An economy based upon managing production requires very different conditions from one where entrepreneurship capital needs stimulating. It can even be that policies and institutions that made the managed economy successful are counterproductive in an entrepreneurial economy.

Emerging economies provide many lessons. In many ways, these countries are familiar with entrepreneurship: most work a mix of old and new models. Therefore, we have an opportunity to observe those who are halfway there, including those who have faltered along the way. At the same time, those from emerging economies need to learn from their counterparts in developed countries how to manage more effectively the dual process of development and growth. Using examples, the author considers the factors that help cultivate entrepreneurial energy – and those that constrain it.

Take Indonesia. Granted, it has many traits unfriendly to business, such as centralized policy making and a history of promoting certain industries while constraining others. Yet where entrepreneurial policy is concerned, it is worth looking at Indonesia's attitude toward fostering the development of small and medium enterprises (SMEs).

Typically, SMEs in Indonesia, and particularly Java, tend to cluster. A number of such firms have become successful exporters of rattan furniture and garments, using the strength of subcontracting relationships with foreign investors and buyers, as well as agglomeration economies achieved by clustering in selected locations. Indonesian SMEs that participate in clusters are more likely to export and adopt product and process innovations in comparison with more dispersed and isolated firms. This is a direct result of the BIPIK program, which was started in the late 1970s to stimulate the geographic concentration of small businesses. Such a concentration facilitates relatively cheap training in basic entrepreneurial skills for many SMEs at the same time.

Given the localized nature of knowledge, public policy needs to understand local idiosyncrasies. Small, local firms should be attractive to governments, as they do not pose any oligopolistic threats in national or international markets. Governments should be motivated by the opportunities to create jobs through such ventures. Growth and job creation – two prime motivations underlying any government policy – need to move from the national or federal level, as favored under the managed economy, and become decentralized and regional or local in nature, as befits the entrepreneurial economy.

Whether local governments are actually equipped to design and implement policy, which stimulates businesses to capitalize on local advantages and mitigate local disadvantages, is a different story. It is important to assess whether an appropriate system of checks and balances is in place to ensure that policy makers act in the most efficient manner, including not imposing external costs on consumers in the form of higher prices.

The Technológico de Monterrey in Mexico is an example of decentralization in action. This university is cooperating with regional

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government and potential foreign investors to assess the skills needed by businesses in the region and then adapting its curriculum and enrollment procedures accordingly, in order to provide appropriate skilled labor. In addition, the university is working together with the corporate world to create new products and new companies.

Ever since the fall of the Berlin Wall, the diverse countries of the Baltic Sea region have been cooperating with the objective of developing a highly entrepreneurial region. Connecting economic actors through networking and information sharing makes it possible to enhance business and foreign direct investment opportunities, thus helping poorer countries to catch up more quickly and the richer to penetrate a large market more easily.

Another interesting example of localization is the phenomenon of "special economic zones" in China. These geographic entities integrate science with industry and trade. Special rules were set up to ensure that local governments adapted policy making toward achieving the strategic goals that the central government had set for these particular areas. In this way, China has pioneered the process of opening up to foreign investment since the 1980s.

RETAIN TALENT. Under the old model, more jobs meant lower wages. In the entrepreneurial economy, high employment can be compatible with high wages. Though the conventional wisdom said it couldn't de done, small firms have proven that they can create both more jobs *and* higher wages.

An indication of the absence of a trade-off between high wages and employment is the large variance in unemployment rates across OECD countries, although corporate downsizing has been ubiquitous. Small firms, in general, and new ventures, in particular, are the engine, not only of employment creation, but also of productivity. This is not due to the wage differential between small and large firms. On the contrary, new firm growth ensures that higher employment does not come at a cost of lower wages, but rather the opposite – higher wages. India serves as a good case in point.

The trick is to make sure the knowledge embodied in your country's well-educated citizens stays at home and is exploited, rather than enticed abroad. Incentives have to be created. In India, many sectors offer wages and working conditions that are much higher than the national average to make sure their knowledge workers do not move abroad. In this way, India has managed to retain numerous IT specialists who carry out work for global clients while based in Bangalore, and has recruited educated MBA graduates to crunch numbers for major investment banks in London and New York from offices in Chennai.

Without incentives, there is a high risk of a brain drain. The mass exodus of skilled workers from Poland, for example, has forced businesses there to import labor from Ukraine and other surrounding countries. Letting go of your most talented and creative individuals is not the best basis for fostering a new entrepreneurial economy.

There are cautionary lessons here for the United States, which has been showing signs of a "reverse brain drain" from its shores. Homeland Security measures implemented in the wake of the September 11, 2001, terrorist attacks to toughen up immigration policies have had the chilling effect of dissuading many talented scientists and engineers from all over the world who had formerly flocked to "the land of opportunity." Moreover, the U.S. trend of shifting blue-collar manufacturing jobs overseas has also been applied to white-collar jobs in engineering, software, product design and tech development. The big political debate of the next year is shaping up to be President Obama's pledge to overhaul im-

migration laws to address the United States' flagging competitiveness and to stop hemorrhaging its talent.

EMBRACE CHANGE. Each year, many new firms are started, but only a subset of these firms survives. Turbulence, diversity and heterogeneity are central to the model of the entrepreneurial economy. Though many managers recognize this, their efforts to incorporate "change management" into their firms' routines frequently reveal their bias for stability, specialization and homogeneity.

In the model of the managed economy, R&D activities are usually organized and scheduled in departments devoted to developing novel products and services, which more often than not preempts many entrepreneurial opportunities. Innovation is pursued – so long as it is compatible with the core competence and technological trajectory of the firm or industry in question. Innovative activities are neatly absorbed within given paradigms, so that even the largest R&D investments only ever generate modest, incremental gains. This is why start-up rates are so notoriously low within stable industrial structures.

The entrepreneurial economy, on the other hand, demands the capacity to break out of the lock-in imposed by existing paradigms and to incorporate new, previously unexplored perspectives. Generating new ideas is, by definition, a turbulent process based upon different and changing opinions about different and changing ideas. In short, the innovation process must be open, not closed as it is in the managed economy.

Developing economies are familiar with flux. Moreover, the phenomenon of the diaspora or immigrant mindset implies an inherent openness to risk. They thrive on change, even provoke it. This is the opposite of the cocooned mentality found in the R&D departments of most large corporations.

Similarly, emerging economies abound with examples of how entrepreneurial ideas can be "exported" to another economy, thus creating the right conditions for growth. Consider the so-called "new argonauts," those highly skilled foreign citizens who return from abroad to set up new, innovative businesses, or invest venture capital in other start-ups. These individuals often take on the role of advisers to their governments, thus spreading the knowledge and ideas gleaned through formative experiences abroad. They can influence the managed economy to become more sophisticated, or create an entrepreneurial economy alongside the managed one. They also have the advantage of learning from mistakes observed elsewhere, and going one better. Again, India, and also Israel and Taiwan, are excellent examples of this.

Emerging Economies: Room for Improvement

Though emerging economies contain good examples, they have not fully finished the consolidation stage of the managed economy and are caught between a mix of the old and new. Witness the inefficient and highly fragmented retail, hotel and catering sectors still in existence in many emerging economies. In many ways, emerging economies face a tougher task than their developed counterparts, since they are juggling both models at the same time. Given this tricky situation, I daresay there are certain elements of managed, developed economies that emerging economies would do well to nurture, as they continue their journey toward the entrepreneurial economy.

A HEALTHY DEGREE OF FORMALITY. While insisting that growth in the new economy means we need to stop marching to the beat of the old drum – i.e., formalized systems, rigid structures – this needs to be qualified. Many emerging economies routinely function with a high degree of *informality*,

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> How governments choose to regulate business plays a fundamental role. Rather than always seeking to constrain, public policy should be trying to stimulate the development and performance of firms.

but such business informality can, in fact, complicate growth, depending on the circumstances.

The business informality we see in emerging economies is often a reaction to tax systems that place heavy administrative and financial burdens on entrepreneurs, and stringent regulations with regard to labor, products and services. The consequent informality that arises to navigate around this can be harmful. The state loses out by way of missed revenue. Businesses miss the opportunity to take part in programs to stimulate innovation and employee training; they have no access to formal credit and enjoy no legal protection.

An important step forward would be to extend government programs to stimulate innovation, or to train employees of all SMEs, including those operating informally, on the condition that they start participating in the formal system. The announcement of such programs alone would help convince informal business owners to take the step toward formalizing their activities.

BUSINESS-FRIENDLY PUBLIC POLICY. How governments choose to regulate business activities also plays a fundamental role in the development, performance and growth of individual companies and entire industries. Most public policies are essentially restrictive in nature, preoccupied with constraining market power and excess profits, rather than focusing on issues of international competitiveness, growth and employment. Though the governments of developed economies are just as guilty of spending a disproportionate amount of their time and energy clamping down on market abuses – now more than ever, in the wake of the financial crisis – emerging economies are egregious in this regard.

Striking examples of how *not* to deal with this topic are abundant in almost every emerging country. The most obvious one is Venezuela, which forced foreign investors to accept significantly less advantageous conditions in the oil sector. In addition, it has renationalized oil, cement and steel companies. Bolivia also nationalized its oil and gas industry.

Other examples are regulation in Mexico pertaining to telecommunication, electricity and oil. Argentina has been trying to dictate what prices companies should ask for their products, as witnessed when the former President Kirchner urged the population to boycott Shell gas stations when the company tried to raise oil prices.

Brazil, which created independent regulators in many sectors during the privatization boom of the 1990s, has adopted a more interventionist approach since the current president took office in 2003. A prime example was the introduction of HD-television. In deciding which standard the country should adopt, the government ultimately opted for the Japanese ISDB standard, in a swap for Japanese investment in Brazilian industries. This is a classic case of the old thinking at work: target outputs rather than inputs; and inputs that are capital-based rather than related to the creation and commercialization of knowledge.

Government intervention of this sort has negative effects on growth. The questions that governments should really be asking are: How can we create an environment that fosters the success and viability of firms? How can we stimulate the development and performance of firms or industries through *enabling policies*?

MODERN FORMS OF FINANCING. Entrepreneurs require a system of finance that is different, given the uncertainty involved. In this regard, the developed countries have useful lessons to offer. Foreign financial institutions have acquired or set up businesses in many emerging countries. In many cases, this has meant that local banks have lost most of their large corporate business to these foreign parties. But the cozy connection that exists in those countries between banks and firms remains part of the managed mindset,

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which says, to foster growth, just provide existing companies with liquidity for investment.

Emerging countries could enhance the entrepreneurial part of their economy by stimulating local financial institutions to adopt modern ways of financing innovative new local business. For example, they could learn from the venture and informal capital markets that provide finance for high-risk and innovative new firms. They could also learn how financing in these markets is often coupled with forms of advice, knowledge and changing levels of involvement, such as happens with business angels and incubators.

If not managed properly, funds will simply veer toward activities that are personally profitable but socially undesirable, or the quality of entrepreneurship will be low. The negative consequences of this can be seen in many cases in Russia and in some African states.

Starting on the Path

Throughout this discussion, I do not mean to imply that the managed economy is totally obsolete. There are large parts of developed and emerging economies where routinized production is essential for completely mature products such as conventional light bulbs or hard disks. Closed forms of innovation still play an important role for process innovations of products such as cars, operating systems and cell phones. But the fact remains that the modern economy is no longer the same as it was 20 years ago, and managers in both developing and emerging economies have much to learn from each other.

Although the learning goes both ways, emerging economies are in an inherently more complicated situation. Apart from the challenges already mentioned, the weaker democratic pressures in emerging economies may further frustrate the transition to an entrepreneurial economy, in which originality and diversity are the main drivers, and concentrated power systems, conformity and homogeneity must learn to take a back seat.

However, these disadvantages are offset by the many advantages of emerging economies, including the opportunities of learning from the mistakes of the developed economies, various catching-up mechanisms, the return of highly skilled workers and the informal cultural features, which have given rise to such innovations as the microcredit system. Granted, the variety among the emerging economies necessitates a more precise analysis, but hopefully what we have learned so far is enough to start shaping and justifying policy measures about what should be done to promote elements of the new entrepreneurial economy and stimulate growth.☐

Tima Batstone served as editor for this article.

TO KNOW MORE

This article is based, among others, on an earlier contribution, "Entrepreneurship, Economic Growth and Policy in Emerging Economies," written for the World Institute for Development Economics Research of the United Nations University (UNU-WIDER), as part of its project on Promoting Entrepreneurial Capacity. An extended version will appear as a chapter in *Entrepreneurship and Economic Development*, edited by Wim Naudé, due to be published by Palgrave Macmillan later in 2010.