

“The Business Start-up Financing, Institutional Environment and Characteristics of the Entrepreneurs”

Extended abstract

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The lack of credit history and valuable reputation typically distinguish small and medium sized enterprises from established firms, creating a disadvantage for the former when it comes to the issue of funding. Given a higher asymmetry in information, financial institutions find costly to monitor small businesses. As a result, the cost of financing is higher for them compared to large firms. Furthermore, the higher risk of failure further restrains small firms' accessibility of finance and the relative cost of different financial options. This situation affects both the volume and the structure of finance that the entrepreneur is seeking.

Accordingly, this paper aims to investigate the determinants of the financial structure of business start-ups. We will examine how the business environment interacts with the individual characteristics of entrepreneurs such as education, experience and social capital in affecting entrepreneurial financing decisions.

Entrepreneurs in developing countries and transition economies typically exhibit a moderately low level of external financing, largely relying on own equity, family and friends' funds. Although to less extent, they also tend to use leasing and short-term bank credit in financing their ventures. This is primarily attributed to an underdevelopment of the financial system, in the first instance of the banking sector, as finance in these countries is more bank-rather than market-based. External equity in the form of business angels and venture capital is poorly developed in the majority of these countries. Furthermore venture capital tends to be more concentrated in high-tech branches such as IT, telecommunications, and biotechnology that makes it unevenly distributed across industries.

Along with an underdevelopment of the financial system, a poorly functioning legal environment is also expected to restrain entrepreneurs' choice of finance. More specifically, we hypothesize that poor collateral law

and weak contract enforcement are likely to discourage banks to lend to smaller firms, limiting an entrepreneur's access to bank credit. Poor contract enforcement is also hypothesized to constrain the use of trade credit, as an entrepreneur may find difficult to enforce contract in a court of law. A low quality of corporate governance legal system and weak protection of shareholders against expropriation may lead to a high cost of equity lowering its attractiveness for the new venture. Thus, we hypothesise that the different features of the institutional environment will affect particular financial options in dissimilar way.

As mentioned at the beginning, our key hypotheses are related not just to the impact of business environment and the quality of the financial system on availability of finance to entrepreneurs. More importantly, we investigate the interaction between the characteristics of entrepreneurs and the institutional features in the environment. We hypothesize that in a weak institutional environment, it is not only that access to finance is more limited, but also that it becomes more uneven, in a sense that entrepreneurs with significant amount of social and human capital are more like to obtain some particular types of finance. Another words in a poor environment, a situation of 'insider entrepreneurship' that we described elsewhere (Aidis *et al.* 2008a; Aidis *et al.* 2008b) is also reflected along the financial dimension.

To explore the determinants of financial structure of business start-ups, we will use the data collected through the Global Entrepreneurship Monitor (GEM) surveys. The GEM data have some advantages such as the absence of selectivity bias. The data consist of representative 2,000-strong samples drawn from the working age population, unlike other studies which focus on the existing entrepreneurs only. Moreover, the institutional country-level variables as explanatory factors can safely be used without being concerned with simultaneity bias, as the individual decision of a potential entrepreneur does not affect country-level institutions.

References:

Aidis, R., Estrin, S. and Mickiewicz, T. (2008a) "Institutions and Entrepreneurship Development in Russia: A Comparative Perspective", *Journal of Business Venturing*, forthcoming.

Aidis, A., J. Korosteleva and T. Mickiewicz (2008b) "Entrepreneurship in Russia" in L. Dana, I. Welpel, V. Ratten and M. Han (eds.) *Entrepreneurship and internationalisation of SMEs in Asia* (Cheltenham: Edward Elgar).