***The effect of environmental factor: corruption on sourcing financial resources by KIBS SMEs for new market pioneering in a developing economy.* A Paper presented at the** **26th Annual Conference of the British Academy of Management, Cardiff, United Kingdom, September 10-13**

# Abstract words

There prevailing environmental factor in a developing economy is the bribery and corruption menace in especially in acquisition of debt finances for businesses**.** Hence, **t**his study examines the effect of environmental factor, bribery and corruption on sourcing finance by Knowledge- Intensive Businesses (KIBs) SMEs new market pioneering in Nigeria. The study discusses the concept of KIBs, the new market pioneering and external debt financing and the menace of bribery and corruption. The study suggests that policy makers should back up the pioneering innovation with policies that can protect KIBs owners in obtaining debt-finances without being pressurised to give bribe. Also, the new government anti-corruption campaign should include every citizen involved in any form of economic transaction, whether private or public sectors. This study will contribute to the body of empirical study in entrepreneurial finance and innovation in developing economies.

Key words: Corruption, finance, knowledge-intensive business services, New market pioneering, SMEs

1. **Introduction**

As the political environment in Nigeria becomes stable there is a radical shift into the service sectors because technological and professional services are highly needed to complement the growth ([Becker et al., 2008](#_ENREF_83)). By 2000, there was a policy to shift to a knowledge-based economy which gave preference to Knowledge-Intensive Businesses (KIBs). The idea of KIBs originated from Miles et al. (1995) to describe private firms that generate, collect, analyse and distribute knowledge with the purpose of providing customised proficient service solutions to issues that client firms have not the capacity to perform. These firms offer highly intellectual value-added services mainly to other firms (Muller and Zenker, 2001). Thus, friendly policies fostering KIBs SMEs were promulgated in Nigeria to dive into *new market pioneering* (NMP) through venture creation or expansion into other markets (NPIT, 2000). This led to increase in the service sector importance and contribution to GDP and employment in Nigeria significantly from 29% and 42% respectively in 2000. Many reports (e.g. Boz et al, 2010; Lawal, 2009) in recent times confirmed that Nigeria is a recognised major and leading market for ICT services in Africa (CIA, 2012) and the present economic recession seems not to have impact on this sector. It transforms lives, work and creates new opportunities of demand (Yue, 2001) thus KIBs SMEs need to exploit these possibilities by NMP.

NMP is an indication that a positive change has happened in the composition of an organization or its strategy ([Hanks et al., 1993](#_ENREF_147)) which brought about a need for expansion into other places. Finance is very integral to the effective functioning of KIBs firms to implement NMP in Nigeria and is obtainable from the formal and informal institutions (Aryeetey, 1998). [Oswald (2003](#_ENREF_253)) expressed the importance of finance, whether equity or debt, in every operational stage of a firm. As business thrives, more financial resources are needed for expansion and implementation of innovation especially NMP. Nevertheless, the general consensus is that lack of finance can be a great constraint to the growth of SMEs (Levine, 2005; Papaloannou, 2007) but particularly for KIBs NMP because of the financial involvement especially in recruiting experts with creative skills. Hence the pecking order theory, that firms, including KIBs SMEs, primary preference is for cheapest source of funding, when exhausted, move to the second, until it ends up with a preference for external debt but not equity. Therefore, external finances are required for NMP but KIBS owners are hesitant in using a particular source of finance because of the supply restrictions ([Howorth, 2001](#_ENREF_286)). In addition, the problem of corruption with its negative cross-country effect on every facets of life, from the public to the private in Nigeria (Mambula, 2002; Oyefuga et al, 2008) deters access to debt financing by KIBs SMEs. Numerous empirical research (e.g. Oyefuga, et al 2008; Okpara, 2010, Umejei, 2011) have explored the matter of innovation in SMEs in Nigeria and also corruption in public places but existing gaps in knowledge is whether corruption affects access to finance for innovation into new market by KIBs SMEs.

Thus this study examines the effect of bribery and corruption on access to finance for new market pioneering in Nigeria. It is expected that the study will contribute significantly to literature on innovation financing in developing economies.

**2. Literature Review**

*2.1 Knowledge Intensive Business Services*

KIBS are special service firms whose operations are particularly executed by experts that can integrate different form of knowledge into composite knowledge. That is, they integrate simple acquired knowledge or competencies that are identified with a particular (technical) discipline or (technical) functional area into complex form. They also provide knowledge-based intermediate products (Miles et al.,1995; den Hertog, 2000; Xin et al., 2009). The employees use knowledge as inputs and outputs in client-participation oriented services and interactive process of consultancy. KIBs currently represents over 60% of the Gross National Income (GNI) in most developed countries ([Hazdra, 2010](#_ENREF_272)) with inadequate data in most developing economies as a new sector. However, there seems to be a shortfall in KIBs SMEs researches in both developed and developing economies and also in investigating access to finance needed for NMP, the gap this study attempts to fill.

KIBs are very important to the economy especially in creating and implementing new products, services and processes as carriers, shapers, facilitators and creators of both technological and managerial innovations (Den hertog, 2000; [Kuusisto and Viljamaa, 2004](#_ENREF_337)). They structure the infrastructure of the knowledge economy by fostering knowledge and ideas mobility around the economy, and encouraging firms to exploit the use of new technologies and ideas (Brinkley, 2012). They provide support systems like information technology (IT) networks and legal or accountancy function for business operations (Strambach, 2008). KIBs expansion by accessing new opportunities through NMP would be beneficial as it would affect the economy positively on a general note and as a catalyst for a knowledge economy.

*2.2 New Market pioneering and external debt financing*

The concept of ‘innovation’ is very central to Schumpeter’s theory of entrepreneurship. [Schumpeter (1934](#_ENREF_271)) defined innovation as the ‘exploitation of a profitable opportunity’ and rephrased it in 1939 as the ‘setting up of new production functions’ or ‘carrying out new combinations’. He identified five dimensions of innovation by an entrepreneur - i*ntroduction of new products; introduction of new methods of production; identification of new sources of supply of raw materials; opening of new markets; and creation of new ways of organizing businesses.* Although, Schumpeter referred to opening of new market or market innovation and its importance, but more emphasis has often been placed on product and process innovation (Liebermann and Montgomery, 1988). His work also did not explore access to finance for new market opening despite innovative firms need for finance.

New market opening is the act of being one of the first (pioneer) to introduce your service into an existing market where the service has not been known or creating a market where none existed in order to better address customers’ needs and increasing firms’ credibility ([Klepper and Thompson, 2006](#_ENREF_329)). It is linked with structural changes in an economy which can produce a positive effect on development (Acs and Virgill, 2009). Innovation is only complete when there is a market place to convert it to economic rent ([OECD/Eurostat, 2005](#_ENREF_462); Adeyeye, Abubakar & Mitra, 2015). This emphasised the essence of regular pioneering of new market as it provides opportunities for dynamic operations by entrepreneurs for economic growth.

When KIBS firms go into a market as pioneer, it is an exclusive innovation in its ability for expansion into unreached geographic area (e.g. Feeser and Willard, 1990; Klepper and Thompson, 2006). It assists SMEs to obtain firm growth by capturing a new market share and enlarging the firm’s size (employees). Obviously, more finances will be required than they can generate internally, thus the need for external finances to meet the innovative challenge. However, KIBs SMEs need a lot of finance especially in this era of recession in Nigeria for a range of expenses which includes office rent and maintenance, specialised and general staff salaries and wages, purchase of assets including office equipment, expansion of operating systems, business site (or premises), publicity, advertisement and promotions, R&D, network and collaborations, and other things in embarking for the new market pioneering (Liebamann and Montgomery, 1998) and maintain a competitive advantage. According to the pecking order hierarchy, firms’ exhaustion of internal finance would lead to the demand for external debt finance as an option (Myers, 1984; Howorth, 2001). The question is: Will the corruption in Nigeria financial institutions interfere with the access to finance by KIBs SMEs for NMP or not?

Nevertheless, scholars seem not to have largely given attention to NMP (OECD/EUROSTAT, 2005) especially in KIBs SMEs and whether the menace of corruption can affect access to finance in Lagos. The reason might be because of the general neglect of literature on developing economies ([Egbetokun, 2011](#_ENREF_6)) as well as on sources of finance by KIBs SMEs in both developing and developed economies (Scarso and Bolisana, 2012).

*2.3 Problem of bribery and corruption*

There are problematic factors affecting KIBS SMEs’ ability to access finance for expansion. Such factors include collateral requirements by banks, high interest rate, paperwork/bureaucracy, personal connections with bank /financial institutions, bribery and corruption and others. However, researchers’ like Dike (2005), Beck and Demirguc-Kunt, (2006) and Fatoki and Smit (2011) identified bribery and corruption as major obstacles to SMEs development. Furthermore, the Business Environment and Enterprise Performance Survey (BEEPS) adjudged that more than 70% of SMEs owners’ in developing economies perceive corruption as an obstacle to their businesses. The World Economic Forum’s Global Competitiveness Index indicated lack of freedom from corruption as one of the malign factors that encumber an economy’s competitiveness. Corruption increases the overall cost of conducting business in terms of accessing capital as well as paying higher interest rates while operating in corrupt environments. Corruption is detrimental to all businesses but seems acute for KIBs SMEs located in the developing economies.

External sources of finance normally attract transactional cost such that additional cost of corruption could rather lead to liquidation after NMP than expansion. All these support Mambula (2002) ,and Oyefuga et al’s,(2008) assertion that corruption permeates every sector of many developing countries and a threat to SMEs realization of optimum growth capacities, profitability and effective job creation especially through NMP.

The efforts directed towards SMEs are generally based on the assertion that they are engines of economic growth but flaws and market inefficiencies attached to formal institutions stand as barriers (Mambula, 2002). The inadequacies of the formal institutions pressurized some SMEs owners into corrupt practices because previous studies ([Dike, 2005](#_ENREF_186)) shows a positive relationship between the probability of becoming engaged in corruption, and a lack of confidence in the judicial system. For instance, in view of the KIBs SMEs owners’ high level of educational background, they possess all the required documents and collateral needed for debt finance from the bank but still experienced denial or undue delays. The bank officials might request for more unrelated documents to frustrate the entrepreneur. Sometimes, the bank officials might demand for ‘additional payment’ or payment without a receipt. Others who paid the additional payments were sometimes able to obtain the loan while the ones for due process are left out.

However, the time factor is a strong determinant in this respect. Compliance with regulations and red tapes cause delays that, in turn, create financial costs that are disproportionately high comparatively for SMEs than large firms (Rune, 2012). Consequently, SMEs often resort to corrupt practices to expedite actions thereby reducing the cost of delays. Research data revealed that the more time are needed to deal with bureaucracy and red tapes, the higher the likelihood that SMEs will engage in corruption. Empirical research also showed the availability of legal alternatives to bribes (Dike, 2005; Demirguc-Kunt, 2006) in a corrupt society sometimes would lead to more loss of time and money. If entrepreneurs supposed their environment as wholly corrupt, and there are no legal alternatives for certain transactions, the likelihood of joining the wagon and being involved in corruption is very high.

Generally, some SMEs owners are almost convinced that corruption forms part of daily businesses and it is almost impossible to survive without it ([Safavian and Wimpey, 2007](#_ENREF_539); Okpara, 2011). One possible explanation for this attitude could be the fact that in a region where corruption is endemic ([Agbu, 2003](#_ENREF_16)), KIBs owners that refused to provide officials with additional payments, while other competitors do, will sooner or later face problems. Consequently, the competitive position in the market might be threatened, experiencing severe decline and inability to proceed on the dynamic NMP innovation. However, the apparent quick way of due process is by paying the bribe which ultimately can become an expensive scheme with uncertain outcomes.

The price and risks of corruption are economically inefficient and are great impediments to growth prospects ([UNIDO, 2006](#_ENREF_629)). The bribes paid are uneconomical transaction costs: rent paid without values added to business (Rune, 2012). If such monies are invested in the business, more NMP might be possible, more jobs created with greater and better services for clients, higher incomes generated and a general contribution to better standard of living for the community. So many businesses face this problem and the negative effect on the local economy can be significant.

Safavian and Wimpey, (2007) in their study of 29 countries found that KIBS SMEs prefer the course of informal financing to formal financing to evade paying bribes to corrupt government and bank officials. They were willing to accept the extra costs of informal financing if there is the advantage of avoiding a bribe (Rune, 2012). Informal sources may not be completely free of corruption but direct demand for bribe is seldom done because the relationship is often based on network and trust hence it could damage the long established relationship and reputation in the community (Ayyagari et al. 2010). Whilst it is clear that some KIBs SMEs, in certain conditions intentionally choose either to participate or not to participate in corrupt practices. It is essential to recognize instances where KIBs SMEs have little or no choice ([UNIDO, 2012](#_ENREF_630)). However, if these environmental factors are minimised in a developing economy, KIBs SMEs will be able to access external financial resources for NMP.

**5. Conclusion and Recommendations**

This research is very relevant at this particular time that Nigeria is encouraging SMEs especially in KIBs despite the economic recession, to expand into more areas as the country advances as a knowledge- based economy in this era of technological advancement. Therefore, in view of the national policy to foster innovation and SMEs growth, a new policy might be necessary to provide direction for sourcing financial resources for NMP. Also, the new government anti-corruption campaign should not only be limited to the politicians but include every facet of the economy with a focus on commercial banks.

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