ENTREPRENEURSHIP, ECONOMIC DEVELOPMENT AND THE BARRIERS IN BETWEEN

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Economic development is essential for welfare enhancement of many individuals living in poverty worldwide. Entrepreneurship is found to foster economic development through new entry and growth of entrepreneurial firms in developing countries. However obstacles are present that steer an entrepreneur on an unproductive path which does not contribute to long-run economic development. This study’s focus is on the identification of the barriers to entrepreneurship that impede economic development in developing countries. This is done through the use of secondary literature. Financial, Human Capital, Institutional, and Political constraints are the main entry- and post-entry barriers identified in this study. The barriers are explained separately, but are found to be considerably interrelated. Especially governments are found to play a significant role; they can both encourage these barriers or can help in the alleviation from them. NGO’s (Non-governmental Organizations) can have this same dual effect as governments have and careful analysis of new policies and ideas must be made as the short term gains might blur the long-term effects. Micro-credit is an example of one of these new implemented innovations to counter poverty, but without the simultaneous provision of non-credit services it is found to lead a country into a development trap. Furthermore this study generalizes the identified barriers to all developing countries and does not take the differences in economic development levels of these countries into account. More studies linking the entrepreneur to economic development are needed in multiple developing countries to diversify findings. This might bring new barriers to the surface and/or explain identified ones more effectively in the context of different development levels and/or cultures.
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5.1 Conclusion

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Appendix 1

Figure 1.1

Figure 1.2
1.1 PROBLEM INDICATION

Entrepreneurship is a fairly new field of study, and definitions of an entrepreneur are multiple. Davidsson (2008) suggested two perspectives after reviewing the mass of definitions provided; the societal phenomenon which describes entrepreneurship as “Entrepreneurship consists of the competitive behaviors that drive the market process” (p. 16), and the scholar domain which describes entrepreneurship as “The behaviors undertaken in the processes of discovery and exploitation of ideas for new business ventures” (p. 15). A well-known definition in the entrepreneurial academic community is the one described by Joseph Schumpeter, the entrepreneur “owns and directs an independent firm that innovatively and creatively destroys existing market structures” (as cited in Wennekers & Thurik, 1999, p. 48). He argued that entrepreneurship is essential for the continued dynamism of the modern market economy; through innovation older products and production methods are left behind and thus destroy existing markets. Later on new studies have shown that entrepreneurship can foster economic growth. Literature suggests that entrepreneurship contributes to economic growth through innovations, change, and competition (Wong, Ho & Autio, 2005). It is evident that many governments around the world want to foster entrepreneurship and new firm formations. A critical factor in determining the rate of entrepreneurship in a country, and its success is the business environment it finds itself in. The quality of property rights, financial market, and employee protection can influence a business environment (Klapper, Laeven, & Rajan, 2006). An article by Baumol (1996) suggests that the application of entrepreneurial talent can be distributed between productive and unproductive or even destructive activities, and that the result is significantly affected by the rewarding system in a country. In developing countries the business environment tends to be unfavorable. In recent years both the field of entrepreneurship and development economics have found that institutions in a country play an important role as it influences both entrepreneurs in developing countries, as well as the economic development of a developing country (Naudé, 2010).

Recent research also suggests that entrepreneurship “(i) drives structural change and economic growth, thereby opening up further opportunities for more productive wage employment,
specialization, and labor mobility; and (ii) allows people to escape from both absolute and relative poverty and informality” (Naudé, 2010, p. 5). Thus it is important to understand what barriers exist for new firm start-ups in developing countries, as well as barriers to growth of already established firms in these poor countries.

By examining the literature available it becomes clear that the topic of “barriers to entrepreneurship in developing countries” has seen increased interest in the last decade. Since the topic is relatively new, research has been done from different perspectives, both theoretical and empirical. A cohesiveness of the information provided can be useful. The information is still scattered and an overview of the main binding constraints for entrepreneurs in developing countries could shed light on were to pay extra attention and academic research, or rather to find solutions to improve the lives of the billions of people living in poverty. This leads to the following problem statement.

PROBLEM STATEMENT:

What are the barriers to entrepreneurship that impede economic development in developing countries?

RESEARCH QUESTIONS:

RQ 1: What is the role of entrepreneurship with respect to economic development in developing countries?

RQ 2: What entry barriers exist for entrepreneurs in developing countries?

RQ 3: What post-entry growth barriers exist for entrepreneurs in developing countries?
1.2 CONCEPTUAL MODEL

Economic Development in Developing Countries

1.3 RESEARCH DESIGN AND DATA COLLECTION

This research is of a descriptive nature by use of secondary literature studies; theoretical, empirical, and case studies. The main concepts to be studied are entrepreneurship and its role in developing countries, entry barriers, and post-entry growth barriers. The role of entrepreneurship in developing countries will be focused on the ability of entrepreneurs to create economic development. Entry barriers are factors that impede the rate of entrepreneurs in the developing countries. Post-Entry growth barriers are factors that impede the further growth of established small and medium sized firms in the developing countries. By order of answering the research questions the main points that
impede entrepreneurship in developing countries, and therefore the economic development of these countries, will be drawn out.

Secondary sources will be the main form of data collection. There will be a minimum of 15 high quality papers from prominent journals and additional data sources might be used, e.g. World Bank publications. As previously mentioned both theoretical and empirical data shall be used to bring the results to light. The sampling technique will be by searching for relevant papers in databases such as Web of Science, ABI/Inform etcetera. Main words that will be searched in the search engine will be “entrepreneurship and economic growth”, “entrepreneurship and economic development”, and “entrepreneurship and developing countries”. By means of this a main understanding can be formed on the role of entrepreneurship in developing countries and references of papers found will be used for further insight to answer all research questions.

1.4 ACADEMIC AND MANAGERIAL RELEVANCE

The fields of Entrepreneurship and Economic Development have experienced an increase in convergence of the two studies, mainly relating to the importance of institutions in both of the studies. From an academic perspective this research will be relevant because it will provide an overview of the main binding constraints entrepreneurs face in developing countries, how these constraints might impede economic development, and direct where further research is desirable.

The insights gained in this research will be useful in the entrepreneurs in developing countries. It highlights the problems entrepreneurs might face and highlighting the barriers should (in the distant future) ultimately provide the entrepreneur a better chance at entry and growth of his/her firm.
CHAPTER 2: ENTREPRENEURSHIP AND ECONOMIC DEVELOPMENT

In order to find out what role an entrepreneur plays in the development of a country a thorough understanding of the two concepts are needed. Section 2.1 will provide information on the concept of Economic Development. Section 2.2 will explain Entrepreneurship and its main definitions found in economic studies; 2.2.1 Occupational definition, 2.2.2 Behavioral definition and 2.2.3 Outcomes definition. In section 2.3 studies linking Entrepreneurship to Economic Development is discussed. Section 2.4 is a summary of the findings in the chapter.

The research question answered in this chapter will be:

*RQ 1: What is the role of entrepreneurship with respect to economic development in developing countries?*

2.1 ECONOMIC DEVELOPMENT

Economic development is a sub-discipline in economics. Multiple concepts or definitions of economic development exist. Economic development involves taking multiple indicators of development in perspective; sustainable growth, right allocation of scarce resources, the economic, social, political and institutional changes (Todaro & Smith, 2009). All these indicators are taken into account to bring about improvements in the lives of the poor living in developing countries. A prior study (Porter, Sachs, & McArthur, 2002) suggests that economic development is when an economy evolves from a resource based economy to a knowledge based economy. Three stages of development are distinguished; the factor-driven stage, the investment-driven stage and the innovation driven stage. In the first stage, the factor-driven stage, the production is based upon primary factors of production: land, primary commodities and unskilled labor. In the second stage, investment-driven stage, there is the rise of industrialization and the country has a middle-income status (Porter et al., 2002). To move from the first to the second stage capital accumulation is important, this enables the country to achieve “catch-up growth”. The third and highest level of economic development, the innovation-
driven stage, is when the country makes technological innovations in different sectors that are globally competitive, at this stage the country has a high-income status. To move from the investment stage to the innovation stage a country must be able to provide new knowledge (Porter et al., 2002). The move from the second to third stage has also been described as the transition from a ‘managed’ economy to an ‘entrepreneurial’ economy by Audretsch and Thurik (2001).

From the examples of economic development given above one can have a general understanding of the concept. However this paper will be using a more specific definition that is particularly relevant in its context described by Naudé (2008); Economic development deals with the growth and structural change of economies, it is the process of structural transformation of an economy from a traditional (rural and agricultural based) to a modern (manufacturing and services based) economy. This was described above as the move from a factor driven stage to ultimately the innovation driven stage. The process involves both qualitative and quantitative changes in the economy. Quantitative changes in terms of the productivity of inhabitants of a country, and qualitative changes in the production, distribution and consumption of products and services in a country (Naudé, 2008). The rule of thumb is that if these quantitative and qualitative changes result in improvement in human welfare in the country (promote the basic well-being of individuals in need) then it can be seen as development in that country or economic development (Naudé, 2008).

Thus economic development is a relevant study for bettering the lives of the bottom billion (people living on less than 2$ a day). The study field finds the determinants of growth and change which ultimately lead to improved human welfare. Entrepreneurship as a determinant has not been used abundantly in the models used in the study field of economic development but entrepreneurship has always simmered below the definitions provided in the field as technological change and new products (Naudé, 2010). Recently studies have contributed to this gap in science and models have been created which include entrepreneurship as a determinant. It is found that entrepreneurship is linked to economic growth by way of innovation, competitiveness and new business formations (Wennekers & Thurik, 1999). One must bear in mind that economic growth is significant for economic development but does not necessarily imply it. For example Brazil has experienced economic growth, but simultaneously with rising wealth inequality which implies there has been economic development in one indicator of development but it has deteriorated in another (Todaro &
Before explaining the linkages between entrepreneurship and economic development a thorough understanding of the entrepreneurship concept is needed.

### 2.2 ENTREPRENEURSHIP

The term entrepreneur has been given many definitions and it has served different roles throughout its study. The main reason for this given by Henrekson (as cited in Naudé, 2008) is that entrepreneurship has been studied in many disciplines ranging from social anthropology to organizational theory to mathematical economics. Entrepreneurship has gained interest as a concept after the expansion of small firms in the 1980's in industrialized economies. Furthermore the employment problem in Western Europe led to increased interest by politicians and economists in the way entrepreneurship could be able to foster innovation, growth and job creation through new firm start-ups (Wennekers & Thurik, 1999).

Wennekers and Thurik (1999) make a distinction of three entrepreneurs: The Shumpeterian entrepreneur, the Managerial Business Owners, and the Intrapreneur (see appendix figure 1.1 for the table presented in the paper). The first two kinds of entrepreneurs are self-employed. The difference between the Shumpeterian and the Managerial Business Owner is that the former contributes to innovation in the country while also managing his firm. Managerial Business Owners are for example franchisers and shopkeepers. In developing countries Managerial Business Owners are more prevalent than Schumpeterian entrepreneurs. The last kind of entrepreneurship, the Intrapreneur, is not self-employed but refers to entrepreneurial activity within existing firms. Most empirical studies linking entrepreneurship to economic growth or development use measures of self-employed entrepreneurs. Intrapreneur will be out of the scope of this paper, the focus is on the self-employed entrepreneurs.

Main definitions of entrepreneurship used in economics are according to Naudé (2008) the occupational, behavioral and outcomes definition. These definitions will be further explained as they contribute to a better understanding of the multiple definitions of an entrepreneur and how these are linked to economic development.
2.2.1 OCCUPATIONAL DEFINITION

This definition of entrepreneurship sees entrepreneurs as the self-employed. A distinction that must be made between developed and developing countries is that in the latter there is a high rate of necessity entrepreneurs compared to opportunity entrepreneurs. Necessity entrepreneurs are people who seek self-employment because of lack of wage-employment while the opportunity entrepreneur is an entrepreneur by choice and seeks to exploit a perceived opportunity. The GEM (General Entrepreneurship Monitor) measures TEA (total entrepreneurial activity) within the scope of opportunity entrepreneurs, because it is essentially these entrepreneurs who are believed to contribute to economic progress (Wong et al., 2005). Banerjee and Duflo (2007) have found that there is a lack of interest of many poor people to seek out opportunities. The environment of living in poverty is such that there are more important matters at hand which fulfill the person more than seeking out opportunities in an unstable environment (Banerjee and Duflo, 2007). Examples given by Banerjee and Duflo (2007) are for example the fact that the poor prefer to spend more on entertainment than on more food, or that poor parents do not perceive the importance of education. Moreover managerial business owners or family businesses do not seek out opportunities because of the risks involved and thus have difficulty innovating (Naudé, 2008). The occupational entrepreneur is measured both statistically (number of self-employed) and dynamically (rate of start-ups).

2.2.2 BEHAVIORAL DEFINITION

The behavioral point of view focuses on the functions that are performed by the entrepreneur which relates to their traits. As mentioned in our introduction a famous definition which falls in this category is that of Schumpeter (as cited in Wennekers & Thurik, 1999); the entrepreneur owns and directs an independent firm that innovatively and creatively destroys existing market structures. According to Naudé (2008) Schumpeter thus describes the entrepreneur as an innovator. Other behavioral definitions of entrepreneurship are; someone who spots opportunities for arbitrage
(Kirzner, as cited in Naudé, 2008); Knight (as cited in Naudé, 2008) emphasizes the uncertainty involved and Schultz (as cited in Naudé, 2008) explains anyone who can perceive an economic disequilibrium evaluate its attributes and ultimately reallocate its resources. In the last example of Schultz it is not necessary to become an entrepreneur through the start-up of a new firm, this can thus be considered intrapreneurship.

2.2.3 OUTCOMES DEFINITION

Entrepreneurship can also be defined by the outcomes it produces. This definition is based on the findings that not all forms of entrepreneurship can contribute to economic development, and at times may be even bad for economic development given certain conditions. Autio et al. (2005) found that only high-potential entrepreneurs can contribute to economic growth. Baumol (1996) suggests that entrepreneurship can be productive, unproductive (e.g. rent-seeking) or even destructive (e.g. illegal activities).

2.3 LINKING ENTREPRENEURSHIP TO ECONOMIC DEVELOPMENT IN DEVELOPING COUNTRIES

Thurik & Wennekers (1999) have observed the role of entrepreneurship in fostering economic growth in various fields of study; historical views on entrepreneurship, macro-economic growth theory, industrial economics, evolutionary economics, history of economic growth and management literature. These authors have concluded “that newness through start-ups and innovations as well as competition are the most relevant factors linking entrepreneurship to economic growth” (Wennekers & Thurik, 1999, p. 34). Entrepreneurship thus plays two major roles in economic growth; the role of “new entry” and the role of “newness”. New entry has to do with “…someone who creates and then, perhaps, organizes and operates a new business firm, whether or not there is anything innovative in those acts”, and Newness has to do with “…the entrepreneur as the innovator- as the one who transforms inventions and ideas into economically viable entities, whether or not, in the course of doing so they create or operate a firm” (Wennekers & Thurik, 1999, pp. 32-
In developing countries the informal sector has mostly high rates. It has been found that economic growth can be fostered if it is made easier for entrepreneurs with high potential to cross over from the informal to the formal sector (Naudé, 2008).

Entrepreneurship can also have a negative effect on GDP growth of developing countries (van Stel, Carree & Thurik, 2005). The possible reasons for this given by the authors is that there are not enough large firms in these countries and that these countries have lower levels of human capital. Large firms are necessary to make the transition from a developing to a developed economy because they can exploit economies of scale and produce medium-tech products. In addition they can provide wage-employment which would be more productive than the necessity based entrepreneur struggling for survival. Besides all this it has been argued that it is still smart to advice entrepreneurship in developing countries if the alternative is unemployment (van Stel et al., 2005).

Wennekers, van Wennekers, Thurik and Reynolds (2005) suggests that the level of entrepreneurship is related to the level of economic development and that at more advanced levels of economic development there is observed a U-shaped relationship. The number of necessity based entrepreneurs will decline as there is more development, they can find better wage employment. At the more advanced level of development more business opportunities arise which again raises entrepreneurship. This study suggests that developing countries should not focus on the promotion of business start-ups but on the growth of already established firms through better management qualities, economies of scale etc.

However new business entry has been found to play an important role in economic development. Start up firms are the ones most likely to grow, to create new jobs and foster reforms by improving economic conditions, as for example in China where there was no private sector a couple of decades ago, new firms strengthened reforms by improving the economy (Naudé, 2008). McMillan and Woodruff (2002) found that in transition economies entrepreneurs acted as reformers and created self-help mechanisms where there was lack of courts and financial markets. New entry of entrepreneurs creates new products, and growing firms make use of scale economies and provide wage employment, both contribute to the structural transformation (Naudé, 2008). Ultimately a
paper by Naudé (2010) which analyses recent papers that include entrepreneurship in the models used in economic development, suggest that all the papers lead to an optimistic conclusion concerning entrepreneurship as a driver of economic development and welfare-enhancement. Thus offering people in developing countries the choice of entrepreneurship through self-employment will be welfare-enhancing.

However the wrong allocation of entrepreneurial abilities will lead to the opposite of economic development as suggested by Wong et al. (2005) and Baumol (1996). This was briefly explained in section 2.2.3 outcomes definition of entrepreneurship. A more thorough understanding of this is useful. Wong et al. (2005) studied the impact of different entrepreneur levels on economic growth. The GEM data differed between high growth potential entrepreneurs, necessity entrepreneurs, opportunity entrepreneurs and the sum of all entrepreneurs. It was found that only high growth potential entrepreneurs has an explanatory effect on differing rates of economic growth across nations. It supports the idea that only a small portion of entrepreneurs contribute to technological innovation and economic growth and not the general view of the self-employed entrepreneur. A caveat in the study is that this does not mean that only high potential entrepreneurial activity can contribute to economic growth but only they can differentiate the rate between countries. It might still be the case that opportunity entrepreneurs contribute to economic growth as suggested by other studies. Baumol (1996) suggest that the allocation of entrepreneurship to productive, unproductive or destructive uses is determined by institutional influences. The “rules of the game” or the reward system in an economy influences whether entrepreneurs will decide to participate in an unproductive activity such as rent-seeking behavior. Rent-seeking behavior is prominent in abundant natural resource countries which have weak property rights and corruption, especially Africa (Mehlum, Moene, & Torvik, 2006). The study of Baumol (1996) concludes that policies can steer the entrepreneur to the productive path that positively influences economic productivity growth through innovation (not only technology but introducing new products, new markets etc.). Banerjee and Newman (1993) found that the reason some countries are affluent with self-employment whilst others with entrepreneurship is due to the wealth distribution in a country which is influenced by financial market imperfections. Entrepreneurial skills have also been found to affect long-run economic development (Lloyd-Ellis & Bernhardt, 2000). Naudé (2010) suggests that the main link between the study field of entrepreneurship and economic development is the importance of institutions for the outcomes of both. There are different factors that lead to a failure of
entrepreneurship enforcing economic development. Thus the identification of barriers to the right allocation of entrepreneurship that will lead to economic development is of importance to understand and make good policies.

Or as Naudé (2008, p. 34) puts it “The relative rates of return to being self-employed, and obstacles such as start-up costs and credit market imperfections will determine the quantity and quality of entrepreneurship in a region or country”.

2.4 SUMMARY OF CHAPTER 2

Economic development is the structural change of an economy from a factor-driven stage to an investment-driven stage and ultimately the innovation driven-stage. Changes are made in the economy that is welfare enhancing and if there is economic growth without an enhancement in welfare then it may not be called economic development. Entrepreneurship can be defined in three different perspectives in the economic literature. The Occupational definition as the self-employed; the Behavioral definition as an innovator and/or risk taker and/or identifier of opportunities; and the Outcomes definition as the productivity it delivers to the economy. There is a big difference to be noted between the occupational definition and the outcomes definition. In developing countries there are many people self-employed out of necessity which is accord with the occupational definition of an entrepreneur, but they do not make part of the outcomes definition of an entrepreneur as they do not contribute to economic growth and development. The behavioral definition explains the functions of an entrepreneur that are needed to ultimately improve an economy as for example being able to innovate.

Entrepreneurship is found to influence economic growth both positively and negatively. Positively through “new entry and “newness”, and negatively in developing countries since there are not many large firms that can contribute to substantial growth. The discussion on the link between entrepreneurship and economic growth is important since economic growth is significant to economic development. Next it was discussed how entrepreneurship has a u-based relationship with
economic development leading to the suggestion that policies should focus on already existing firms and not new entry. Still it is found as evidence in different countries that new entry fosters reforms and improves the institutions present in an economy for example in China. Ultimately offering the chance of self-employment in developing countries will be welfare enhancing. Entrepreneurship influences economic development positively but the allocation of entrepreneurs is important for this to happen and thus obstacles in the way of allocating entrepreneurs towards the productive path are important matters for the development of an economy. It is found in the literature that institutions play a very important role in driving entrepreneurs to the right path to economic development, as do financial and other constraints. The next two chapters will identify and explain these constraints.
In Chapter 2 it was concluded that entrepreneurship can contribute significantly to the development of lower income countries. However there are still obstacles that make it more difficult for the people living in these countries to become an entrepreneur and thus contribute to the economic development of their country. For example the amount of procedures one must go through to open one’s own business. One must keep in mind though that although there are obstacles that hinder the rate of entry of entrepreneurs, not all entrepreneurs are productive and can contribute to the development of a country. The latter was also concluded in the former chapter but addressing this will be postponed to Chapter 4 were the focus will be on the growth barriers of entrepreneurs. This chapter’s focus is on identifying the barriers that hinder the rate of entry of entrepreneur in developing countries. In section 3.1 Entry Regulation is addressed as an institutional barrier. In section 3.2 there is the discussion on Financial Constraints, with 3.2.1 giving detail on Micro-credit as alleviation from Financial Constraints. Section 3.3 explains Entrepreneurial ability as a barrier. Lastly in section 3.4 a summary of chapter 3 is given.

The research question answered in this chapter will be:

*RQ 2: What are the entry barriers that impede entrepreneurship in developing countries?*

### 3.1 ENTRY REGULATION AN INSTITUTIONAL CONSTRAINT

The World Economic Forum addressed in 2001 (as cited in Djankov, La Porta, Lopez-de-Silanes & Shleifer, 2002) that business people find that the administrative regulations are an important obstacle to forming new businesses. Costly regulation is found to influence the opening of a new firm (Klapper et al., 2006). Thus the procedures for starting one’s own business are an important aspect when searching for barriers to potential entrepreneurs. These procedures are for example going to the state or local government offices or the hiring of a lawyer or notary. In some countries bribes are used or facilitators are paid to speed up the process of becoming a legal business entity. Countries
differ a lot in the way they regulate new entrants. One particular study of Djankov et al. (2002), involving 85 countries in total, from high-, middle-, to low income countries, studied the number of procedures an entrepreneur must go through, the time it takes, and the total cost of entry. The focus was on the official regulation procedure and thus not on the possibility of bribes or speeded up alternatives.

Differences found in the number of procedures were for example Canada and Australia having 2 and Mozambique 19 and the highest with 21 procedures is the Dominican Republic. Developing countries face more procedures than developed countries. Also a high difference in the time it takes to finish the process is found with Australia and Canada having 2 business days needed and the highest with 152 business days Madagascar. Rich countries average about 24.5 business days, this is significantly lower than the rest of the countries which is 55.4 days. Cost-per-capita of GDP ratio to entry is significantly different in the countries scoring highest on GDP per capita than the ones scoring the lowest. The highest quartile has a cost-per-capita GDP ratio of 10% and the bottom quartile has a cost-per-capita GDP ratio of 108%. Meaning lowest per capita income scoring countries have to pay 108% of their yearly per capita GDP in order to formally open a business. All in all the number of procedures, the time it takes and the cost-per-capita of GDP ratio are all higher in lower income countries (Djankov et al., 2002). Especially countries in Sub-Saharan African and South Asia rank the lowest on the ease of doing business (see appendix figure 1.2, World Bank, 2010).

The public interest theory on regulation suggest that higher regulation leads to better quality products in the interest of consumers, whilst the findings are that this is generally not the case (Djankov et al. 2002). As the number of procedures rise, the quality standards of products decline, there is evidence of larger unofficial economies, competition is less intense, and it is associated with worse corruption. Less free and representative governments (governments which do not have an open access to political power, unlimited executive power, and less political rights) are found to have more procedures (Djankov et al. 2002). To conclude, poorer countries which have more procedures (which also take more time and cost-per-capita of GDP) that do not lead to better social outcomes or competition, are worse off than rich countries which have few procedures.
3.2 FINANCIAL CONSTRAINTS

Financial market imperfections are constraints that are found to influence the occupational choice of becoming self-employed or a wage worker. There is talk of two types of financial constraints in the literature, limited-liability and moral hazard (Paulson, Townsend, & Karaivanov, 2006). Limited-liability was addressed by Evans and Jovanovic (1989). Limited-liability is a financial constraint in the sense that borrowers can lend up to fixed amount depending on their wealth which will serve as collateral. Low-wealth households, which have little or no collateral, may be prevented from borrowing to become entrepreneurs or prevented from borrowing the optimal amount of capital needed in order not to be constrained. The second type of financial constraint is moral hazard which was presented in an occupational choice model by Aghion and Bolton (1997). Moral hazard arises because the entrepreneurial effort cannot be observed without cost by the lender. These are costs of screening, monitoring and enforcement if the borrower fails to repay the lender. Because of this the market responds by charging higher interest rates, and therefore poor borrowers or in other words potential entrepreneurs cannot borrow or are subjected to a constraint if they do (Aghion and Bolton, 1997). In contrast to limited-liability all who borrow when moral hazard is present are constrained, whilst limited liability is not a constraint if one can borrow the optimal amount needed (Paulson et al., 2006). These frictions in the financial market impede the poor to borrow and foster income inequality and thus impede economic development in developing countries.

Paulson et al. (2006) found that both constraints are relevant, but that moral hazard is the main underlying financial constraint. Limited liability plays a role in constraining potential entrepreneurs only when coupled up with moral hazard. The study was done in Thailand within two regions the central semi-urban region and the more rural and poorer region. The authors specify that the results can provide direction into policy discussion but not necessarily policy intervention to alleviate the financial constraints since they emphasize that because of the financial market imperfections the existing number of contracts may be the optimal amount. They suggest that the BAAC (Bank for Agriculture and Agricultural Cooperatives) lending groups (which is a micro-credit bank that lends capital to groups of people whom otherwise would find it difficult to borrow from commercial banks) can help alleviate moral hazard for poor farmers and this could be extended to more households.
3.2.1 EVIDENCE ON MICRO-CREDIT

Micro-credit is a way to provide credit to the poor who otherwise would not be able to from commercial banks. It is widely considered to be an innovation that contributes to poverty alleviation and human welfare. It is a system of joint liability which enforces group members to screen and monitor each other to make sure repayments are made (McKernan, 2002). In a group each individual receives a loan, but the whole group is liable if any member of the group defaults. The moral hazard problem is overcome since villagers choose their own peers, whom they find acceptable, to take on the contract with. Thus the problem of ensuring that borrowers take the actions needed which makes repayment more likely is overcome by group lending. In this way the financial constraint of moral hazard is overcome and entry to self-employment is easier in this respect.

Beside the fact that micro-credit has been found to have positive effects in the short run, the long-run GDP on a country has been found to be negatively affected by it if micro-saving is not available simultaneously with micro-credit (Ahlin & Jiang, 2008). Thus in order to have economic development it has been found that taking away the entry barrier to obtaining capital is not enough. Non-credit services seem to have much importance in the productivity of the self-employed (McKernan, 2002) and returns to capital depends on the ability of the entrepreneur (Mel, McKenzie & Woodruff, 2008). This will be explained further in Chapter 4, which deals with growth barriers of entrepreneurs in developing countries.

3.3 ENTREPRENEURIAL ABILITY

Entrepreneurial ability influences occupational choice models, as the one discussed in financial constraints by Evans and Jovanovic (1989). The ability of the entrepreneur influences the choice because by having more ability the individual receives more benefits from choosing to become self-employed. Entrepreneurial ability has to do with people having different abilities to spot opportunities and run a business (Naudé, 2008). Sleuwaegen and Goedhuys (2002) held a study in
Cote D’Ivoire that found that formal education improves entrepreneurial ability by improving the cognitive abilities. Education levels are low in developing countries, it is a barrier to start-up rates. However education is not the only important factor determining entrepreneurial ability. Baptista et al. (2007) find that age and experience can compensate for the lack of education concerning start-up rates. Astebro and Bernhardt (2005) find that the impact of financial market imperfections is reduced through entrepreneurs with high human capital (education and experience). This was found to be the case because most entrepreneurs with higher human capital also have greater financial wealth and more start-up capital, implying that human capital can influence start-up rates (Astebro & Bernhardt, 2005). Many Micro-credit banks offer non-credit services which are meant to improve the entrepreneurial ability of the borrowers. Still today education levels are low in developing countries and plays a barrier role to entry into entrepreneurship, and thus to deliver products and services that will ultimately enhance the economy and reach a innovation-driven stage.

3.4 SUMMARY OF CHAPTER 3

Starting an official business involves going through different procedures that take time and cost money. The cost plays an important role in the decision for opening up a business, especially in developing countries were income is low for the biggest part of the population. The number of procedures, the time and the cost-per-capita of GDP ratio are all higher in developing countries. As the number of procedures rise there is evidence of larger unofficial economies, less competition, more corruption, the quality of products go down and the government is less free or representative of the public. Financial constraints such as limited-liability and moral hazard limit the poor to borrow and this fosters income inequality in countries. Especially moral hazard is found to be the main underlying constraint. Micro-credit enables group-lending and in this way helps alleviate these barriers that the poor face with commercial banks. Even though micro-credit alleviates these financial barriers it does not guarantee to influence economic development positively. Taking away these financial entry barriers do not ensure productive entrepreneurs and this will be further addressed in chapter 4. The choice of becoming self-employed is influenced by the entrepreneurial ability of a person. Education levels are found to improve entrepreneurial ability. Age and experience can compensate for the lack of education. In developing countries education levels are low which impedes the rate of the self-employed. Entrepreneurs with higher human capital which is described
as education and experience had also higher start-up capital and thus having higher human capital alleviates the lack of credit. NGO’s (non-governmental organizations) contribute to the developments in education levels but much improvement is still to be made to reach the economic development level in which most of the population lives above a subsistence level. It might seem odd to conclude that only three entry barriers exist, this is of course not the realistic case. Literature provides these three as the most important ones which have the greatest influence on entry and ultimately will have the greatest influence on economic development.
CHAPTER 4: POST-ENTRY GROWTH BARRIERS

In Chapter 2 it was concluded that the allocation of entrepreneurs on a productive path is important. Firms must be able to grow to contribute productive and innovative products which lead to economic development. The barriers that impede the growth of entrepreneurs in developing countries are thus important and will be identified and explained in this chapter. As concluded in chapter 3 on the entry barriers one cannot say that only these identified barriers exist, but they are the most important ones in literature and the ones that are found to contribute to economic development. In section 4.1 Financial constraints to growth of firms, Micro-credit and Entrepreneurial ability are discussed. Section 4.2 discusses the importance of Institutions. Section 4.3 explains the Political Implications and how they influence growth of firms in developing countries. Lastly a summary of the chapter is given in section 4.4.

The research question answered in this chapter will be:

RQ 3: What post-entry growth barriers exist for entrepreneurs in developing countries?

4.1 FINANCIAL CONSTRAINT, MICRO-CREDIT & ENTREPRENEURIAL ABILITY

De Mel et al. (2008) have studied the impact of randomized grants to 408 firms in Sri-Lanka. With this they find out if the return to capital was significant enough for the growth of a firm. If the return to capital was low for low levels of capital stock then firms would fall into a poverty trap, whilst if the returns are high at low level of capital stock a firm will be able to invest and grow (de Mel et al, 2008). The study concluded that the returns were generally high but with much variation. The effects of the grants were higher for more able entrepreneurs; an additional year of study raises profits. De Mel et al. (2008) also gathered data on the opinion of constraints of these firms and the two main constraints found were the lack of finance and the uncertainty of the returns. Because of these two constraints formal credit is scarcely used, sources of funds are personal savings and family loans (de Mel et al., 2008). Ahlin and Jiang (2008) found that micro-credit could both raise and lower
development in the long-run. Firstly they address that the self-employed (less efficient with only his own labor) can “graduate” and become an entrepreneur (operation of a full-scale firm with workers) in two ways; the “winner” graduation and the “saver” graduation. Winner graduation refers to micro-credit opening up the opportunity to graduate because of high returns in self-employment, and saver graduation would refer to those who graduate because of saving up average returns in self-employment over time. If micro-credit programmes support winner graduation but not saver graduation then economic development is not possible through micro-credit (Ahlin & Jiang, 2008). The study concludes that micro-credit without micro-saving as an additional service will lead to a trap in the development process and that in the long-run levels of poverty will be higher. It gives support to the idea of micro-finance instead of just micro-credit. Micro-finance involves micro-credit and non-credit services. Examples of non-credit services are; micro-saving, insurance, money transfer services and social development programs. Through non-credit services the average return to entrepreneurs will be higher and allow for saver graduation. McKernan (2002) found that social development programs (e.g. vocational training, information on health/civil responsibilities/rights) raise the productivity level of self-employment. This supports the idea that human capital (education and experience) is both a barrier to entry and a barrier to growth of firms, and that the broader services of micro-finance can contribute to the alleviation of this entrepreneurial ability constraint as well as the financial constraints. Ahlin and Jiang (2008) find in their model that human capital is an important concern that will have a similar effect as physical capital. The returns to micro-finance should be high enough to enable graduation through the accumulation of human and physical capital (Ahlin & Jiang, 2008).

4.2 INSTITUTION AND INFRA-STRUCTURE CONSTRAINTS

It is has been argued in excess that institutions can affect the income of a country through the investment in human and physical capital (Acemoglu, Johnson, & Robinson, 2001). Physical capital refers to the infrastructure in a country. Large effects have been found of institutions influencing GDP per capita in a country, e.g. Nigeria could have a 7-fold increase in income in the long-run if their institutions are improved to the levels in Chile (Acemoglu et al., 2001). Weak property rights in a country are found to reduce investments by firms (Johnson, McMillan, & Woodruff, 2002). Investments are essential for a company’s growth and to take advantage of rising opportunities.
Johnson et al. (2002) find that, in transition economies (e.g. Ukraine, Russia, Poland etc.), even when there is the possibility for finance firms reinvest much less of their profits if they perceive property rights to be weak (bribes for government service is common, courts are inefficient). A better legal system leads to bigger firm sizes in a study done in Mexico (Laeven & Woodruff, 2007). This is so because a better legal system reduces idiosyncratic risk which will allow capital to be better allocated by the entrepreneurs (Laeven & Woodruff, 2007). Idiosyncratic risk refers to the perceived risk entrepreneurs bear due to a weak legal environment. Thus by improving the institutional environment (lowering idiosyncratic risk) entrepreneurs will invest more in their firms. Trade is also a factor for economic development and firms in developing countries will be more able to take part in this if there is good institutions and a well-developed infrastructure, especially transport and communication (Francois & Manchin, 2007). In transition economies self-help mechanisms were developed by entrepreneurs to fill in for the lack of courts, e.g. by creating strong relationships between firms (McMillan & Woodruff, 2002). These self-help mechanisms have limitations, in order for firms to grow into corporations market-supporting institutions are needed, and thus entrepreneurs need from the state better courts which enforce better contract laws in order to make greater investment deals (McMillan & Woodruff, 2002).

4.3 POLITICAL IMPLICATIONS

Baumol (1996) finds throughout history that the economic rewarding system will influence if an entrepreneur will assist in productive innovation or unproductive rent-seeking behavior. Rent-seeking behavior has to do with connections between entrepreneurs and politicians. Murphy, Shleifer and Vishny (1991) gives support to Baumol’s (1996) findings through a choice model between being a productive or an unproductive entrepreneur. They find that in rent-seeking economies the entrepreneur will choose to be unproductive (returns are higher in rent-seeking activities in contrast to productive activities) and thus affecting growth negatively. The data found in Djankov et al (2002) supports the public choice theory, which states that regulators seek rents for their own industry or politician incumbent firms. Especially the tollbooth theory is found to be supported by the data which states that regulations are constructed in such a way that they benefit politicians and bureaucrats. This is inefficient because distortionary policies are used to increase rents, which is not beneficial to the economy. As found in chapter 3 most developing countries are
associated with less free and representative governments (governments which do not have an open access to political power, unlimited executive power, and less political rights). In Brazil it was found that firms that contributed to political campaigns received higher stock return through preferential access to credit (Cleassens, Feijen, & Laeven, 2008). Faccio (2006) finds that countries with higher political connections have higher levels of corruption, higher restrictions on foreign investment by residents and that the number of connections rises with larger firm sizes. Better government is needed to limit rent-seeking behavior and to align outcomes with the preference of the public (Djankov et al., 2002).

4.4 SUMMARY OF CHAPTER 4

There is evidence that at low levels of capital stock the returns to micro-credit are high but with much variation. The variation is partially explained by the differing entrepreneurial abilities of entrepreneurs in developing countries. In the long-run micro-credit has to be delivered along with micro-saving to allow for economic development. Micro-finance and its broad services, especially social development programmes foster the entrepreneurial ability of entrepreneurs and help deliver higher returns. Entrepreneurial ability is evidently also a growth constraint to firms in developing countries. The institutional environment and the infrastructure in a country are important for the growth of firms. Institutions can foster the GDP of a country through investment in human and physical capital (infra-structure). Countries were property rights and the legal system are perceived as weak experience less investment of firms and smaller firms sizes. Self-help mechanisms are created by entrepreneurs in transition economies which help in the lack of courts and financial markets, but in the longer-run the state is needed if significant firm growth is to be achieved. Trade is also affected by institutions and infrastructure. Furthermore the government of a country can impede post-entry growth of entrepreneurs through fostering a rent-seeking economy. There is evidence of politicians and bureaucrats seeking rents, especially in developing countries were governments are less free and representative of the public. As firms grow the political connections rise, but governments need to limit rent-seeking as this is correlated with higher corruption levels and negatively affects economic development of a country.
CHAPTER 5: CONCLUSION, DISCUSSION AND RECOMMENDATIONS

In this chapter the problem statement of this study is answered. The conclusion of the study is given in section 5.1. Section 5.2 is the discussion paragraph of this study. Lastly section 5.3 gives academic and practical recommendations.

Problem Statement:

What are the barriers to entrepreneurship that impede economic development in developing countries?

5.1 CONCLUSION

Economic development as a field of study has seen increased interest in the last decades as has Entrepreneurship. The two fields are linked as entrepreneurship can positively influence economic development. This is possible only through the right allocation of entrepreneurs to productive activities. This study identifies the main barriers to entrepreneurship that impede economic development in developing countries. Both entry barriers to entrepreneurship and post-entry growth barriers are found to be important. New Entry fosters economic growth and reforms in a country and Firm Growth allows for innovative and productive products in the nature of an economy.

The main entry barriers identified are; Entry regulation which is an institutional constraint that affects the ease of starting a business; Financial constraint as limited-liability and moral hazard which influences the lack of finance to the poor; and the Entrepreneurial ability of the poor described as educational levels, experience or the human capital one possesses.
The main post-entry growth barriers identified are; Financial constraints as the lack of finance to invest further in ones firm and the uncertainty of the returns from investment; Institutional constraints as perceiving the institutional environment and the infrastructure in a country as weak which lowers investment of firms and firm sizes and international trade; Entrepreneurial ability to run and foster ones business is a constraint in developing countries where education levels are low; and Governments are found to constrain entrepreneurs from expanding there firms through the habit of forming rent-seeking economies which foster corruption and impede economic development.

The different barriers identified as entry and post-entry growth barriers are very much interrelated. Solutions for one constraint may well be a solution for another as is the case with micro-finance programmes. Governments seem to play a crucial role as they can influence the institutions, the infrastructure as well as the provision of education for entrepreneurial ability in a country. Alas it is exactly the governments of developing countries that are found to be weak (less free and representative of their public) with higher corruption levels, which in itself might explain the lag in economic development. NGO’s can partially fill this gap of the government through their development programmes, but even so policies and ideas do not always lead to better economic development if not implemented correctly as is the case with micro-credit. Nonetheless the government of a country is important to economic development through entrepreneurship.

Micro-finance programmes are found to alleviate the financial constraint and the entrepreneurial ability constraint through the simultaneous service of micro-credit, micro-saving and other non-credit services, such as social development programmes which foster the returns of the firm. Without the non-credit services micro-credit is found to lead a country into a development trap with certain conditions actually leading to worse poverty levels. It is apparent that the solutions provided by policies and innovative ideas, such as Nobel Prize winner Muhammad Yunus’s idea of micro-credit for the Grameen bank as an instrument countering poverty, should be analyzed thoroughly for their long-term effects on an economy since these “solutions” if not implemented correctly can affect an economy’s development negatively.
5.2 DISCUSSION

This research has not focused on the different economic development levels found in developing countries. Some developing countries are further in their development than others; some might be in the factor-driven stage whilst others are in the investment-driven stage. Barriers have been identified in this study as generalising to all developing countries, but it might be the case that some barriers have more importance and are more prevalent in one level of development than the other. This information was not found in the literature. Another important aspect to mention is that in chapter 2 there is consecutive use of the works of Naudé (2008, 2010). These studies provide an overview of the main contributions made by academics linking entrepreneurship and economic development. As the topic is relatively new other authors have not yet contributed to an overview of these links. It becomes clear in the subsequent chapters of this study which identify and explain the barriers how truly there is a link between entrepreneurship and economic development. Thus this study as a whole can properly provide an understanding of the link between entrepreneurs in developing countries and economic development. In addition some of the studies used in this research are conducted in one developing country or a couple adjacent to each other with similar cultures. It might also be the case that conducting these studies in differing cultures might bring about differing results.

5.3 RECOMMENDATION

It will be interesting to find out if there are differing barriers to entrepreneurs at differing levels of economic development in developing countries. For example there might be differences in barriers for the transitions economies of Eastern Europe and the former Soviet Union which also form part of developing countries. In this way better fitting policies might be drawn up to improve these issues. In addition the behavior of the poor with respect to seeking opportunities is of interest to find out if another barrier might be impeding entry into entrepreneurship. More studies need to be done in more developing countries linking the entrepreneur to economic development as this might bring new barriers to the surface or explain identified ones better.
Policies to foster entrepreneurship in developing countries have existed for a while and the importance is apparent in this paper, but careful analysis must be given to new ideas and policies. For example the Fina Bank in East Africa is planning to use psychometric testing to screen new borrowers. The commercial banks use collateral, micro-credit banks use group lending techniques, and psychometrics is a new development by the Entrepreneurial Finance Lab at Harvard University which will measures the entrepreneurial ability by the intelligence, ethics, personality and cognition of the borrower. Will this method be more stringent towards borrowers? Or will it screen out, low potential entrepreneurs and foster economic development through allowing only high potential entrepreneurs the opportunity to finance? As these new innovative ideas arise academics in the fields of economic development and entrepreneurship must look at the long-term effects of these ideas on economic development.
REFERENCES


### APPENDIX 1

#### FIGURE 1.1

**TABLE IV**

Three types of entrepreneurs

<table>
<thead>
<tr>
<th></th>
<th>Self-employed</th>
<th>Employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entrepreneurial</td>
<td><strong>Schumpeterian Entrepreneur</strong></td>
<td><strong>Intrapreneurs</strong></td>
</tr>
<tr>
<td>Managerial</td>
<td><strong>Managerial Business Owners</strong></td>
<td>Executive managers</td>
</tr>
</tbody>
</table>


#### FIGURE 1.2

*Which regions have some of the most business-friendly regulations?*

DB2010 ranking on the ease of doing business (1–183)