THE ROLE OF THE INFORMAL SECTOR FOR THE VALUE CREATION POTENTIAL OF ENTREPRENEURS - A SIMPLE EVOLUTIONARY MODEL

(ENTREPRENEURSHIP AND INSTITUTIONS OUTSIDE RULE OF LAW)

Abstract

A model of the entrepreneurial firm’s decision to choose entry into informality outside rule of law is presented. The World Bank’s enterprise survey data is used to test the model. Official firm sizes are adopted as a proxy to estimate the importance of informality to entrepreneurs. Firm-level data is joined with country level data towards testing the main hypothesis: competition policy acts to regulate firm size downards by lowering the barriers to entry into the formal sector. Results for the national competition policy variable lend some support to this hypothesis, but as in previous research international trade places a stronger downward pressure on firm size. An unusual proxy for the institutional environment facing entrepreneurs (number of endangered species) also indirectly supports the hypothesised relationships.

Keywords: Entrepreneurship, Institutions, Barriers to entry, Informal sector, Competition policy

JEL Codes: L13, L26, F13, F23, O12, O43, P51

Summary

The challenges of operating outside a rule of law context may be markedly different. I develop a model to show how country-level institutions or a competition policy could matter to entrepreneurs in this setting. Absent other data, the relationship is investigated relating official firm size (which will be higher when entrepreneurs choose to enter the informal sector) with a country-level indicator of competition policy. Controlling for international trade suggests that the impact of openness to the outside world has a stronger effect. However, using another indicator which is not internal to the economic system (number of endangered species), the research shows that there may indeed be a very strong relationship between firm size and hence new firm entry and the national institutional environment.