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## RESEARCH ARTICLE

# MEASURING THE EFFECT OF TRADE OPENNESS ON ENTREPRENEURSHIP DEVELOPMENT IN CASE OF GEORGIA

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### ABSTRACT

In contemporary world it have been accepted that entrepreneurship is one of the main life-force of modern economic growth. It became extensively researched and an important concept in academic society. The Georgian government has been trying to encourage entrepreneurship development by supporting the development of small and medium enterprises in the country, conducting liberal reforms, and encouraging openness for doing business. The contribution of trade openness on economic growth has been the subject of several theoretical and empirical studies in the economic literature. The purpose of this paper is to investigate and empirically reveal the importance of trade openness on entrepreneurship development in case of Georgia.

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## INTRODUCTION

Georgia lie to the south of the principal Caucasian mountain range, and situated on the crossroads between Europe and Asia after 1917, it was absorbed by the Soviet Union and was made to bear the effect of 70 years centrally planned economic rule under the Soviet management. Gaining the independence in 1991. For the transition economies like Georgian economy which is on transformation the creation of private sector, development of entrepreneurship and establishment of small and medium-sized enterprises plays a vital role. It is considered as of the principal driving force in economic development. Entrepreneurship development encourages private ownership and stimulates entrepreneurial skills, the development of entrepreneurship generate employment, help to diversify economic activity and make a significant contribution to exports and trade as well. Entrepreneurship developments also stimulates innovation and the high-tech business. During the last decades, enormous progress was achieved in the transformation and transition process towards a market economy. Rapid economic growth and economic development in general are the macroeconomic objective of developing countries into the medium and long-term. In recent years,

Georgia has adopted trade reforms. These reforms have been implemented to ensure greater integration into the global economy, and achieve acceptable economic performance. This orientation opens up interesting prospects for development and also raises enormous challenges as a large part of the economy becomes sensitive to external evaluations. Following the signing of international agreements like agreement with EU on partnership, will increase trade and inflows of investment which will lead to greater economic integration, while facilitating a resumption of economic growth in the critical region. However, inadequate framework conditions and an unfavorable macroeconomic environment and instable political atmosphere in Georgia still have been impediments to entrepreneurship development.

The reforms conducted to liberalize the economy and making it more open lead some countries like, Singapore, South Korea and etc. to higher economic growth rates. In other parts of the world, as in Sub-Saharan Africa or Latin America, despite an increase in open rates, economic growth has not reached expected levels. The main goal of our paper is to analyze the links between the trade openness and entrepreneurship development, the influence of trade openness on

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entrepreneurship development in case of Georgia. The crucial question is what is the degree of influence of openness on entrepreneurship development? This paper is organized as follows: in the first place we will present a literature review of the entrepreneurship and trade openness. Subsequently, we will discuss our estimation method and present our empirical results.

### ***Entrepreneurship Literature***

There are enormous body of analysis that has been focused on entrepreneurship, entrepreneur and entrepreneurial activity. However, this research mainly focuses on developed countries rather than on developing countries due to lack of statistical data in that countries. The early entrepreneurship literature equated the idea of entrepreneurship with working for oneself rather than working for someone else for a wage. In a business context, it means to start a business. The Webster Dictionary presents the definition of an entrepreneur as one who organizes, manages, and assumes the risks of a business or enterprise.

The definition that takes root from the French word that means “to undertake”, according to Carl Menger (1870), an Austrian economist, entrepreneurship emerge as people who seek out and take advantage of opportunities for profit, creating goods that previously did not exist and finding new ways to create existing goods. Another Austrian economist Schumpeter’s *The Theory of Economic Development* (1912) places the entrepreneur at the center of the process of capitalist development. Entrepreneurs are responsible for the innovations (new products, new sources of supply, new production methods, and new forms of organization) that open up opportunities for profit, disturbing the system. Successful entrepreneurs will earn high profits and will attract imitators. Over time, imitation will eliminate the profits earned by the original innovator and the system will settle down to a new equilibrium until it, in its turn, is disturbed by another innovation. Schumpeter’s vision of capitalism was thus one of a system in continuous motion, the impetus for change coming from the entrepreneur. Entrepreneurship has been defined as the “purposeful and successful activity to initiate, maintain, or develop a profit-oriented business” Livesay, (1982, p.10). More recent definitions have explicitly incorporated the notions of risk and personal satisfaction as well. In lieu of a conclusive definition, it can be said that entrepreneurship is a type of behavior that includes: (a) initiative taking, (b) the innovative organizing and reorganizing of social/economic mechanisms to create greater value from resources and/or situations, and (c) risk-taking Hisrich and Peters (1992). It is important to note that the commonly accepted definitions of entrepreneurship have been developed in relatively advanced market economies. According to Kirzner (1973), entrepreneurship is not so much the ability to break away from routine as the ability to perceive new opportunities which others have not yet noticed. Entrepreneurs historically in Georgia often do exhibit the types of behavior described above, Although the term entrepreneurship does not necessarily was carrying the positive connotations in Soviet Georgia that it does in most

developed market economies, and may even be viewed negatively. The fact that many entrepreneurial ventures developed in what was commonly referred to under communism as the “unofficial economy” reinforced view of entrepreneurship as a “shady” activity. Since such activities often were considered illegal. It would be an oversimplification, however, to imply that entrepreneurship remains a “dirty word” after the collapse of Soviet Union. The 1990s brought dramatic changes to the region and, despite an ignominious past, attitudes toward entrepreneurship have also changed a great deal. As private sector development becomes increasingly important to economic growth, entrepreneurs are coming to be viewed in more capitalistic sense. That is they are viewed as one of the key “driving forces” in powering the transition from a planned to a market economy. Unfortunately there is growing concern among the researchers that the term definition takes the central role in works and debates are focusing on terminology itself rather than developing a distinctive theory on entrepreneurship. In our analysis we defined entrepreneurship as an important factor in creation of firms and in our work we consider it as a creator of new private businesses.

The reforms conducted with liberalization of the business (openness) creates attractive business climate for entrepreneurship and for entrepreneurial activity exert pressure on government to create comfortable business atmosphere to functioning of business sector in proper way. Thus, the openness of the business signals to investors that appropriate conditions and infrastructure is formed to operate in a specific market attracting investors and creating area of competition between domestic entrepreneurs and foreign entrepreneurs.

### ***Trade Openness***

The relationship between trade openness and entrepreneurship has not been theoretically established even though some researchers have found some, if not complete, support for the view that increasing economics openness plays a role in creating these entrepreneurial opportunities related to a country’s cyclical performance (Scholmana, G, Stela, A and Thurik, R , 2014). Economic literature mainly considers that trade liberalization leads to an increase in welfare derived from distribution of domestic resources. Import barriers and restrictions of any kind are the main reason for an anti-export bias that rises the price of importable goods relative to exportable goods.

Obviously, the effect of economic openness on entrepreneurship is a priori ambiguous. On one side, trade openness offers increased opportunities for new entrepreneurs, as give them access to wider product and input markets. At the same time, however, trade openness across countries raises the intensity of competition, resulting in lower incentives and higher barriers to entry for potential entrepreneurs. Different authors have mentioned the main two sources of impact at the theoretical level. The main contribution on this analysis have been made by Audretsch and Sanders (2007), Grossman (1984) and Markusen and Venables (1999). Audretsch and Sanders (2007) mention the positive

view of the relation between increased economic openness and domestic entrepreneurship they highlight the importance of the structural change in relation with the trade openness process, which is read as being triggered by two mutually reinforcing dynamics. The first is constituted by the political changes which have led the former USSR nations and other big countries such as China and India to join the global economic system. The second is the ICT revolution, which decreased the perceived distances and reformed companies' production and organizational practices. However, Grossman (1984) definitely emphasize that if trade is opened up, leading to a price decrease for the industrial traded goods, even fewer individuals will choose to become entrepreneurs. Indeed, opening to trade lowers the attractiveness of entrepreneurship relative to wage working, thus resulting in lower supply of entrepreneurs. Moreover, opening to foreign direct investment has also a negative impact on domestic entrepreneurship. In fact, as foreign affiliates enter the economy, domestic human resources must be released in order to provide them with the necessary labor force. Hence, in this framework, domestic entrepreneurship is crowded out by both international trade and FDI.

Markusen and Venables (1999) show that the entry of multinationals entrepreneurs can be ultimately beneficial for domestic entrepreneurship, especially if multinationals entrepreneurs export increasing shares of their output a broad (lower competition effect). FDI might even trigger industrial development in sectors which were absent in the host country, and the growth of indigenous firms might be so strong that multinational entrepreneurs are forced out of the domestic market in the long run. However, negative effects might prevail if multinationals entrepreneurs mostly rely on their international supply network, as limited linkages with respect to domestic producers of intermediates are created.

Krugman (1991) summarized the reasons why trade liberalization is good for growth in developing countries. Firstly, Developing countries have production patterns that are skewed towards labor intensive service, agriculture and manufacturing. People have low per capita incomes and markets in such countries are usually small. A liberalized trade regime allows low-cost producers to expand their output well beyond that demanded in the domestic market. Secondly, whereas industrialization based on protection of domestic industries thus results in even-higher capital intensity of production, the open trade regime permits enjoyment of constant returns to scale over a much wider range and finally import substitution regimes normally give bureaucrats considerable discretion either in determining which industries should be encouraged or in allocating scarce foreign exchange in a regime of quantitative restrictions, leading to serious efficiency losses. At the end we can say that, the reviewed literature provides a good evaluation of potential positive and negative effects of trade openness on entrepreneurship development.

**DATA AND METHODOLOGY**

Data is taken from Georgian Department of Statistics and consists of years from 2000 to 2013.

The possible relationship between openness and entrepreneurship will be investigated by the following models:

$$Ln(EN)_t = \alpha_{1t} + \beta_{1t} * openness_{1t} + u_{1t}$$

$Ln(FDI)_t = \alpha_{2t} + \beta_{2t} * openness_{2t} + u_{2t}$  where EN is the number of entrepreneurship and FDI is the foreign direct investment.

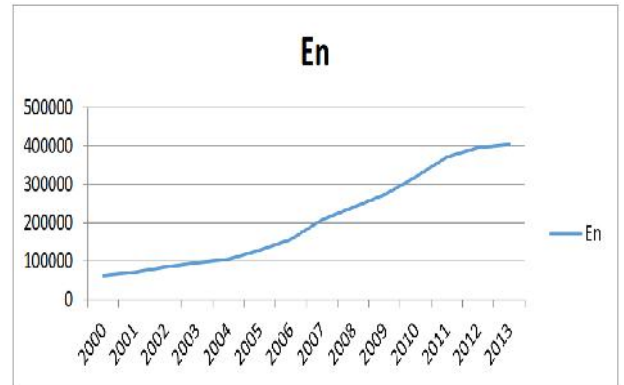


Figure 1 The number of entrepreneurship in Georgia during the period between 2000 and 2013

The number of entrepreneurship increased linearly between 2000 and 2013, this result motivated the researchers to apply linear model to explain the possible relationship between openness and economic indicators such as FDI and entrepreneurship.

Table 1  $Ln(EN)_t = \alpha_{1t} + \beta_{1t} * openness_{1t} + u_{1t}$

Variable	Coefficient	Std. Error	t-Statistic	p-value
C	11.29	0.13	84.45	0.00
OPENNESS	6093.71	847.94	7.19	0.00

R-squared 0.81  
Adjusted R-squared 0.80

The coefficients in the model of  $Ln(EN)_t = \alpha_{1t} + \beta_{1t} * openness_{1t} + u_{1t}$  are significant at 5% significance level. 79.6% of the dependent variable Ln (EN) is also explained by openness. These results show that there is empirical evidence to believe that openness and number of entrepreneurship in Georgia between 2000 and 2013 are related. It is observed from the results given in table 2 that the model does not suffer from either autocorrelation or heteroskedasticity at 5% significance level. 1t Breusch-Godfrey Serial Correlation LM Test:

$y_t = \alpha_c + \alpha_1 x_{1t} + \alpha_2 x_{2t} + \dots + \alpha_k x_{kt} + u_t$  where  $u_t$  is obtained from the following equation:

$$u_t = \rho_1 u_{t-1} + \rho_2 u_{t-2} + \dots + \rho_n u_{t-n} + \epsilon_t$$

These two equations are combined to perform Breusch-Godfrey Serial Correlation LM Test.

$$y_t = \alpha_0 + \alpha_1 x_{1t} + \alpha_2 x_{2t} + \dots + \alpha_k x_{kt} + \rho_1 u_{t-1} + \rho_2 u_{t-2} + \dots + \rho_n u_{t-n} + \epsilon_t$$

$H_0: \rho_1 = \rho_2 = \dots = \rho_n = 0$  no autocorrelation

$H_1$ : at least one of the  $\rho$ s is not zero, therefore serial correlation exists.

The Breusch-Pagan Heteroskedasticity Test:

$y_t = \alpha_0 + \alpha_1 x_{1t} + \alpha_2 x_{2t} + \dots + \alpha_k x_{kt} + u_t$  is estimated then the following auxiliary regression is estimated

$$u_t^2 = \alpha_0 + \alpha_1 x_{1t} + \alpha_2 x_{2t} + \dots + \alpha_k x_{kt} + \varepsilon_t$$

$H_0$ : There is no heteroscedasticity that is homoscedasticity exists.

$H_1$ : There is heteroskedasticity

**Table 2** Autocorrelation and Heteroskedasticity tests for the model  $\ln(EN)_t = \alpha_1 t + \beta_1 t * openness_t + u_t$   
Breusch-Godfrey Serial Correlation LM Test

<b>F-statistic</b>	<b>3.19</b>	<b>Prob. F(2,10)</b>	<b>0.09</b>
Sample size*R-squared	5.44	Prob. Chi-Square(2)	0.07

Heteroskedasticity Test: The Breusch-Pagan Test

<b>F-statistic</b>	<b>0.88</b>	<b>Prob. F(2,11)</b>	<b>0.77</b>
Sample size*R-squared	0.10	Prob. Chi-Square(2)	0.75

In the second model the possible relationship between FDI and number of entrepreneurs is investigated. It is found that the coefficient of openness in the model is not significant at 5% but it is significant at 10%. Adjusted R-squared is 21.6% which is much lower than previous model. Therefore FDI is mostly affected by the parameters which are not included in the model. The limitation of the results in this empirical paper is the low number of observations. Due to transition period in Georgia at that time and for some definite other problems we could not get data for early years that's why our paper is constrained by this data.

The models are run by only 14 data points.

**Table 3** Run by only 14 data points.

Variable	Coefficient	Std. Error	t-Statistic	P-value
C	10.06	0.25	40.31	0.00
OPENNES	-3386.18	1582.78	-2.14	0.05

R-squared 0.28

Adjusted R-squared 0.22

## CONCLUSION

In the contemporary world entrepreneurship plays an important role and for countries in transitions like Georgia the development of entrepreneurship is very important not only because it can help to solve many economic problems but at the same time other social problems that stem from it. It has been more than two decade that Georgian economy as well as the developing economies have undertaken economic reforms to liberalize its economy in order to restore their trade and develop entrepreneurship. They, at the same time, opened their economic borders by lowering trade barriers. The entrepreneurship-openness relationship is interesting to analyze empirically since most theoretical works have failed to resolve the positive or negative effect of openness on entrepreneurship development.

Our paper found out that trade openness positively affects entrepreneurship development in case of Georgia, but remains weakly significant for the Georgian economy is not fully liberalized. Thus, trade liberalization and trade openness in Georgia has played a vital role in the process of development of entrepreneurship. Hence, with the empirical evidence the study tries to reveal the overall effect of trade openness on entrepreneurship development in Georgia. Finally, we believe this research can be a positive contribution of trade openness and entrepreneurship development policy study in developing countries.

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