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Overview

This policy brief provides some fresh perspectives on the relationship between entrepreneurship and development, and considers policy design issues. It reports on the UNU-WIDER two-year research project "Promoting Entrepreneurial Capacity", which aimed to understand whether and how entrepreneurship matters for development, how it could derail development, how entrepreneurs function in high growth as well as in conflict environments, and how female entrepreneurship differs across countries at various stages of development.

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Promoting Entrepreneurship in Developing Countries: Policy Challenges

The recent enthusiasm of donors, development agencies and governments for promoting entrepreneurship as a route to development is perplexing. Entrepreneurs, called "heroes" by *The Economist* (14 March, 2009), appear upon closer scrutiny to be rather irrelevant and even impotent in many developing countries. Three decades ago, Nathan Leff was of the opinion that "entrepreneurship is no longer a problem" nor a "relevant constraint on the pace of development" in developing countries.[1] Development economists point out that the vast majority of entrepreneurs in developing countries are involved in micro and small enterprises (MSE), often informal, contributing little to poverty alleviation and growth. Moreover, only a few new start-up firms survive for a long time; the majority fail within the first two years.

The enthusiasm for promoting entrepreneurship is even more perplexing in the light of weak and ambiguous statistical evidence on whether entrepreneurship causes economic growth. Results do not seem to be very robust with regard to definitions, time-periods, quality of data, or estimation methods; reverse causality crops up. Some economists even report a negative relationship between entrepreneurial activity and economic growth.

Added to the apparent irrelevance and impotence of entrepreneurs is the danger that well-intentioned support policies for entrepreneurship may have unintended negative consequences. These include patronage, corruption and rent-seeking, and the prolonging of the life of inefficient and low-productivity firms. Moreover, policies that "place too much stress on entrepreneurship as the key to economic development can undermine collective and cumulative processes of organizational learning required for innovation".[2] In addition, general policies to facilitate the entry of entrepreneurs may disproportionately encourage entrepreneurs with low "entrepreneurial ability", leading banks to reduce their overall extension of credit. If low-ability entrepreneurs also employ less productive workers at lower wages, the opportunity cost of being self-employed will fall, leading to the entrance of even more low-ability entrepreneurs. If, as a result, economic growth slows down, high-ability entrepreneurs, with fewer incentives to innovate, will exit.

Given that entrepreneurs may be potentially irrelevant and/or impotent, and that entrepreneurship policies can be fraught with potential pitfalls, the role of entrepreneurship and entrepreneurship policies in the development process needs to be re-evaluated. This policy brief, based on a two-year UNU-WIDER research project entitled "Promoting Entrepreneurial Capacity", provides a fresh perspective on the relationship between entrepreneurship and development, and considers some pertinent policy design issues.

Defining Entrepreneurship

Entrepreneurs have been defined as "persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige".[3] This is a definition that has encouraged scholars to consider the allocation of talent (e.g. ingenuity and creativity) between productive, non-productive and destructive uses. This definition has also stimulated research on how institutions shape the incentives for individuals to engage in either productive activities, or in rent-seeking, corruption, organized crime or armed conflict. While highly topical, this is too broad a definition of entrepreneurship to be the most useful for studying the relationship between entrepreneurship and development. This is because there has never been any controversy over whether the allocation of talent into rent-seeking or criminal activities is harmful to development. However, as pointed out in the introduction of this brief, whether and how legitimately entrepreneurial activities contribute to development—and if policy has a role to play— remains contentious.

For present purposes entrepreneurship is the resource and process whereby individuals utilize opportunities in the market through the creation of new business firms. As a resource, entrepreneurship results in innovation, risk-taking and arbitrage—the classic functions of the entrepreneur as identified by Joseph Schumpeter, Israel Kirzner and others. Entrepreneurship is studied as the various activities undertaken by entrepreneurs throughout the lifecycle of a firm, from conception to exit.

Entrepreneurship is most often measured by the rate of self-employment, business ownership or the rate of new start-ups. The International Labour Organization (ILO) publishes data on self-employment rates across countries, and the Global Entrepreneurship Monitor (GEM) publishes data on new firm start-up rates across a sample of countries (60 at present). The GEM also attempts to make a distinction between the motivations of entrepreneurs. Thus it categorizes these as "necessity" entrepreneurs, and "opportunity" entrepreneurs, wherein, the former is self-employed because of the lack of wage employment, while the latter is self-employed by choice, in order to exploit some perceived "opportunity".

Does Entrepreneurship Matter for Development?

Despite this rather pessimistic introduction, entrepreneurship can matter for development. The widespread prevalence of policies to promote entrepreneurship may be, after all, not so perplexing. Three questions arise: (i) Why do some suggest that entrepreneurship is irrelevant? (ii) Why is entrepreneurship, as measured, often found to be impotent in the empirical literature? And (iii) How can we be sure that entrepreneurship matters for development?

The first question can best be answered by pointing out that although many economists are dismissive of entrepreneurship in developing countries, many others are not. Many consider MSEs, including informal and "survivalist"-type entrepreneurs, to be important for poverty alleviation, for growth and for structural change. A special issue of *Small Business Economics*[4] (an outcome of the aforementioned UNU-WIDER project) focuses on this and uses both theoretical and empirical approaches. These approaches illustrate that entrepreneurs play an essential role in driving the structural transformation from a low-income, traditional economy to a modern economy by creating new firms outside the household, absorbing surplus labour from the traditional sector, providing innovative intermediate inputs to final-goods producing firms, enabling greater specialization in manufacturing, and by raising productivity and employment in both the modern and traditional sectors.

Studies elsewhere have found that employment growth in the MSE sector in developing countries is often substantial. Earnings from self-employment are often better than in the formal wage sector in many developing countries. The rapid rise in the number of small, private entrepreneurs in China has been an important contributor to rapid growth and declining poverty. The innovative behaviour and rapid adoptions of new innovations by small scale entrepreneurs in farming in developing countries has often been noted. With the majority of MSEs in developing countries owned by women, their contribution to female empowerment and to the health and welfare of households is important, as detailed in a special section of the *European Journal of Development Research* devoted to female entrepreneurship in development.[5]

It needs to be mentioned at this point that even though the above presents a convincing case in favour of entrepreneurship, the pessimistic note at the outset of this brief is a reminder of the complexity of the relationship between entrepreneurship and development specifically in terms of history and institutions.[2] Given that the role of entrepreneurship in development was, in the past, often neglected, more research is needed to understand the relationship between entrepreneurship, institutions and development.[4]

Moving to the second question, as to why entrepreneurship has been perceived in literature as impotent in promoting growth, despite the mixed evidence in empirical studies, it cannot be rejected that entrepreneurship matters as suggested above. First, almost all existing empirical studies measure economic development by analysing economic growth, per capita income, or productivity or employment growth. While these are important, economic development, and more broadly human development, is about more than just growth, or monetary measures of performance. It is appropriate to reflect on this on the twentieth anniversary of the Human Development Index (HDI). The HDI is premised on the realization that human development covers more than just raising incomes, and that human development is the "process of enlarg-

"Entrepreneurs play an essential role in driving the structural transformation from a low-income, traditional economy to a modern economy"

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ing people's choices".[10] People value being entrepreneurs for many reasons other than just material gain. It can offer substantial non-pecuniary returns; provide independence; a positive change in lifestyle; a sense of achievement, of identity and of being accepted. Studies have remarked on the fact that entrepreneurs tend to have higher levels of job satisfaction than wage employees. Very little research, however, has examined how entrepreneurship matters for human development. A further reason for the inconclusiveness of empirical studies is that the methodological difficulties involved in empirical work are substantial. Adequate time-series and longitudinal data on entrepreneurship in developing countries, and comparable data sets across countries are still lacking, despite progress over the past decade. Hence, the absence of evidence should not be taken as evidence of absence.

So, does entrepreneurship matter for development and, if so, how can we be sure? The UNU-WIDER "Promoting Entrepreneurial Capacity" project attempted to study the relationship between entrepreneurship and development across a spectrum of circumstances that entrepreneurs could face: from high growth, innovative situations to those marred by armed conflict and economic stagnation. Throughout the project, the tenacity and dynamism of entrepreneurs was documented from driving innovation in developing countries to providing survival and resilience in conflict situations. A UNU-WIDER workshop entitled "Entrepreneurship, Technological Innovation and Development", held in Maastricht in October 2008 in collaboration with UNU-MERIT (UNU Maastricht Economic and social Research training centre on Innovation and Technology) detailed the important role—perhaps inadequately appreciated—played by entrepreneurs in driving technological innovation in developing countries. The importance of technological innovation for human development is clear—as convincingly described by Richard Lipsey[6] and co-authors:

> People living in the first decade of the twentieth century did not know modern dental and medical equipment, penicillin, bypass operations, safe births, control of genetically transmitted diseases, personal computers, compact discs, television sets, automobiles, opportunities for fast and cheap worldwide travel, affordable universities, central heating, air conditioning . . . technological change has transformed the quality of our lives.

On the other end of the spectrum, entrepreneurs in countries racked by armed conflict do not always have the same opportunities as those in stable, growing and highly innovative milieus. This dimension was examined at the UNU-WIDER workshop "Entrepreneurship and Conflict" held in March 2009 in Londonderry, Northern Ireland. Case studies from Afghanistan, Burundi, Colombia, Iraq, Rwanda, Sierra Leone, Liberia and elsewhere detailed the terrible toll that armed conflict inflicts on business activity. Despite this, the case studies also suggested that entrepreneurs are remarkably tenacious and resilient. Even in Afghanistan, where a whole generation has been affected by conflict, MSEs provide income for more than nine per cent of households. Firms that survive persistent conflict do so because of entrepreneurs who are able to adjust their business models in the face of conflict, for instance by reducing technological sophistication, relocating supply chains and production locations, or reducing long-term investment. These adjustments may reduce profitability or even the size of firms, but ultimately contribute towards the firms' survival. And firm survival during conflict situations may be important because, as the UNU-WIDER project established, entrepreneurial activity may quickly rebound once hostilities cease.

tives for people to invest in their human capital through the demand for skilled labour; they illustrate the adoption of new technology, and provide information on what kind of business may be profitable; and they may influence, through policy advocacy, the general business environment.

"Designing policies for development through the promotion of entrepreneurship is a challenge"

Implications for Policy Design

Entrepreneurs in developing countries are neither irrelevant nor impotent. However, the relationship between entrepreneurs and development outcomes is complex, with entrepreneurship as much depending on economic development and growth and vice versa. Designing policies for development through the promotion of entrepreneurship is complicated. In relation to policy design, three questions need to be considered alongside each country's context: first, whether entrepreneurship *should* be supported; second, whether entrepreneurship *can* be supported; and third, establishment of the most effective means of support, taking into consideration a country's level of development.

The fact that entrepreneurship may matter for development does not automatically imply that government policies should support it. This policy brief started out by noting a number of potential pitfalls. However, in the case of entrepreneurship, market failures may justify policy intervention. In the developing countries context, a number of cases can be mentioned, for instance, the private benefits of entrepreneurs' innovation may be much less than social benefits, which reduce the incentive for entrepreneurs to provide these "services"; entrepreneurs create incentives for people to invest in their human capital through the demand for skilled labour; they illustrate the adoption of new technology, and provide information on what kind of business may be profitable; and they may influence, through policy advocacy, the general business environment.

Even if based only on the positive spillovers described above, a case exists for supporting entrepreneurs. It is also prudent to ask whether entrepreneurs *could* practically be supported. There is a strand of literature which posits that governments cannot raise the supply or quantity of entrepreneurship, but can merely influence the allocation of entrepreneurial ability.[3] In this view, all that the government should do is "get the institutions right", i.e. ensure the protection of property rights and a well-functioning legal system, and maintain macroeconomic and political stability and competitive tax rates. Not all scholars agree. The wide range of entrepreneurship rates across countries, even when controlled for variations in institutional quality, would suggest that specific policies, interventions and regulations—relating to start-up costs or innovative activities—may have an influence on the supply of entrepreneurs.

Given that governments should and can influence entrepreneurship, what shape and format should policies or interventions take? The "Promoting Entrepreneurial Capacity" project identified policies aimed at raising entrepreneurial ability, at raising the non-pecuniary benefits of entrepreneurship, and those addressing the levels of start-up costs and business regulation. A full discussion of these is contained in the book *Entrepreneurship and Economic Development*.[7]

The nature and capability of the state vis-à-vis a country's level of economic development needs to be considered in the design of these policies. At an early stage of development a country's entrepreneurial base will still be small, with private sector activity in dispersed, low-productivity traditional activities. At this stage, states are very often fragile, and a major development challenge is to build state capacity to establish and maintain an environment conducive for business so as to allow core entrepreneurship to emerge in accordance with the country's comparative advantage.

At the intermediate stages of development, efficiency-driven growth may be pursued by the state to expand its intervention in the economy in order to "defy" the comparative advantage. Examples from East Asia, but also the USA and Europe spring to mind.[2] During this stage firms will grow in size, and state-owned enterprises (SOEs) and multinational enterprises (MNEs) will play an increasing role. It may also be important for policy to take into account the nature and profile of indigenous entrepreneurs at this time. For example in the 1950s and 1960s in Singapore and Korea, where a strong local entrepreneurial base was judged to be lacking, policies at first aimed to complement and strengthen the domestic entrepreneurial base, through encouraging much more foreign entrepreneurship and by providing much financial support to allow entrepreneurs to take on more risks in imitation and foreign technology adoption. In Taiwan and Japan, where the entrepreneurial base was fairly strong to begin with, more limitations were initially placed on foreign entrepreneurs.

At some point, the country's development will have progressed to the extent that further growth will increasingly depend on highly-innovative entrepreneurship. For this, a shift from being interventionists and selective, towards being less interventionist is needed, as this is often a requirement for creativity and innovation to flourish. Many countries embark on trade liberalization during this phase. Examples include the EU, the USA and India. China's two-track approach since 1978 can be seen as a variant of this shift, whereby the shift is gradually introduced by allowing a more liberalized private-sector economy to develop without dismantling state-owned enterprises. China's growing class of entrepreneurs has also had an impact on policy—a form of "institutional" entrepreneurship. During this stage, also described as the "entrepreneurial economy",[8] where the economy is dominated by knowledge, policies have focused on the formation and function of regional clusters and their linkages with the rest of the economy, on technological innovation, and on venture capital support; MSEs have returned to again assume a leading role in the economy.

"Can non-state sovereign entrepreneurs contribute towards effectively addressing global challenges?"

Concluding Remarks

The policy challenges in promoting entrepreneurship in developing countries are already substantial and are likely to become even more complex in the future. This is partly due to the essential limitations of the nation-state in dealing with the growing number of global challenges, including global climate change, insecurity, violent conflict and terrorism, migration, and the vulnerability to financial and economic shocks magnified by globalization.

In a forward-looking chapter found in *Entrepreneurship and Economic Development*, Jurgen Brauer and Robert Haywood[9] discuss the increasing prominence of social entrepreneurs, and include discussion on "social entrepreneur" organizations working across sovereign states, such as Amnesty International and Greenpeace. However, as these "have no legitimate source from which they could derive rule-making and rule-enforcing authority . . . they lack supremacy within their issue domain". Accordingly, Brauer and Haywood call for non-state "sovereign" entrepreneurs that have the ability to make and enforce rules. Would such non-state sovereign entrepreneurs be able to make progress in terms of providing more effective governance of global challenges? These authors provide intriguing examples from ICANN (Internet Corporation for Assigned Names and Numbers) and FIFA (Fédération Internationale de Football Association) and ask how and under what conditions such entrepreneurship can arise, how it can be promoted and by whom, and what the relationship between non-state sovereign entrepreneurs and sovereign states would involve once the former start to pose threats to the perceived "internal matters" of the latter. Clearly, a large research agenda remains, but one that is important in light of the growing global public good nature of many of the world's current economic development challenges.

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INSIDE:

Policy Brief

Promoting Entrepreneurship in Developing Countries: Policy Challenges

The complexity of promoting entrepreneurship for development should not be underestimated

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