# Is entrepreneurship important for developing countries, and, if so, what is the best way to support it?

Entrepreneurs, called "heroes" by *The Economist* in 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. As development economists like to point out, 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. 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 this 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, as Professor William Lazonick has noted, 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". Also, 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.

Given that entrepreneurs may be potentially irrelevant and/or impotent, and that entrepreneurship policies can be fraught with potential pitfalls, governments, donors, the UN-system, and development agencies need to tread carefully. A two-year WIDER research project has investigated how entrepreneurship can be promoted for development, and why entrepreneurship matters for development. This article shares some of the ideas emanating from the project.

**Why entrepreneurship matters**

Despite this rather pessimistic introduction, the project confirmed that entrepreneurship does matter. The reason that the relationship between entrepreneurship and economic development is so precarious in empirical studies is because these studies very often use either inadequate measures of entrepreneurship and development, or relatively small sample sizes. Most measure economic development in terms of economic growth, per capita income, or productivity. While these are important, economic development, and, more broadly, human development, are about more than just growth or monetary measures of performance. With data and measurements problems continuing to bedevil policy research in entrepreneurship, the small but steady recent trend towards randomized field experiments and studying entrepreneurship and human well-being is to be welcomed.

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. Employment growth in the MSE sector in developing countries is often substantial. 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 potentially important.

The WIDER project studied entrepreneurship across a spectrum of circumstances that entrepreneurs could face: from high growth, innovative situations, to those marred by armed conflict and economic stagnation. The tenacity and dynamism of entrepreneurs was clear – from driving innovation in developing countries, to providing survival and resilience in conflict situations. High-growth entrepreneurship was found to be prevalent even in the least developed countries. 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 they contribute towards the firms' survival. And firm survival during conflict situations is important because entrepreneurial activity may quickly rebound once hostilities cease.

**What role for policy?**

The fact that entrepreneurship may matter for development does not automatically imply that government policies should support it. Designing policies for development through the promotion of entrepreneurship is complicated. To avoid a number of potential pitfalls, it may be helpful to underpin policies by answering at least two questions.

First, what is the rationale for wanting to support entrepreneurs? Many see the rationale to be market failures. Markets fail in many respects but particularly where there are externalities. Entrepreneurs' innovation may have more benefits to society as a whole than to the individual entrepreneur; entrepreneurs may furthermore create incentives for people to invest in their human capital because they demand skilled labour; entrepreneurs illustrate to followers the adoption of new technology, they provide information to external parties on what kind of business may be profitable in a particular location, and they may influence the general business environment for everybody by pressuring or lobbying government for regulatory changes. Understanding the main rationale is important in thinking about how the positive externalities associated with entrepreneurship can be maximized – and how the negative externalities of supporting entrepreneurs (such as that the quality of the pool of entrepreneurship may be lowered by too easy access) can be minimized.

Second, can entrepreneurs in a particular context be practically supported, even if there is a rationale? One view is that governments cannot raise the supply of entrepreneurs, but can merely influence the allocation thereof. Accordingly, all that a 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. Others argue that governments' best course of action is to improve the environment for 'doing business'. The World Bank publishes a set of *Doing Business*indicators, and countries are encouraged to improve on these, *inter alia* for the sake of encouraging entrepreneurship.

**Good institutions**

Important as it no doubt is, building appropriate institutions in developing countries is notoriously difficult. Institutions are endogenous and relatively little is known about the co-evolution of institutions and entrepreneurial behaviour. Well-intended institutional reform itself may create uncertainties that can have unwanted outcomes, such as the entrenchment of former elites and rent-seeking behaviour.

Moreover, not everybody agrees that encouraging the building of 'good institutions' is all that should be done. The range of entrepreneurship rates across countries, even when controlled for variations in institutional quality, suggests that specific policies may have an influence on the supply and quality of entrepreneurs. And just restricting government's role to improving the environment for 'doing business' may not work. Entrepreneurship has been vital in the rise of such emerging economies as Brazil, China, and India. What all three of these countries have in common is a very low score and rank on the World Bank's *Doing Business* index. Brazil is ranked 122nd, China 83rd and India 120th, out of 178 countries in 2008. But their development success may be argued to be at least partly due to proactive government support for entrepreneurs.

In India, venture capital funding stands out; in China, the transformation and privatization of state-owned enterprises, learning from foreign firms through encouraging the inflow of FDI, the explicit encouragement of high-tech entrepreneurship, and huge investments in infrastructure, particularly trade and transport-related infrastructure, provided examples. The cases of India and China are illuminating, but by no means unique. Countries which are seen as 'entrepreneurial' today – particularly the USA, had important proactive state support for private sector development.

**'Industrial policy'**

Such 'industrial policy' is, in this perspective, a form of entrepreneurship development. Selective industrial policies – whether explicitly termed as such, or referred to as 'competitiveness' policies – will increasingly take centre stage after the global economic and financial crisis, as governments grapple with the impacts of rising commodity prices, growing inequality, sluggish growth, murky protectionism, and the imperative to adopt low-carbon methods of industrialization. The dangers inherent in broader selective industrial policy are well-known, and in many cases are similar to what has been discussed here. Hence, extreme caution is required. A strong case emerges for a new debate on industrial policy, in particular supported by new research and a more nuanced understanding of how to support entrepreneurship as a central plank of industrial development.

A measure of the success of entrepreneurship development policies in developing countries is that one would see an initial *reduction* in the rate of entrepreneurship. This would reflect the fact that fewer people have to become entrepreneurs by necessity, and can instead choose to enter wage employment. Good entrepreneurship policy gets people with low entrepreneurial ability *out* of entrepreneurship and into jobs. It does this by creating the conditions where people with a strong ability for entrepreneurship will see it in their interest to start up new firms, to create jobs, to grow their firms in size, to raise the incentives for education and migration to urban agglomerations by demanding skilled labour, contribute towards diversifying an economy by uncovering its production possibilities, and demonstrate and facilitate the adoption of new technology.

Ultimately, such successful entrepreneurship would result in an economy whose structure is dominated by the service sector, populated by high-technology firms and highly educated workers. Entrepreneurial flourishing, and appropriate support for entrepreneurship, is at the heart of the process of structural development and industrialization. The failure of structural development and industrialization, and the failure of many countries to compete, is therefore ultimately a failure of entrepreneurship development policy.