



**UNLEASHING ENTREPRENEURSHIP**  
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***Session I: Facilitating Entrepreneurship's Contribution to  
Development  
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Today, few informed commentators question that the private sector plays a critical role in growth and poverty reduction. The ideological debates of the past are giving way to more pragmatic discussions about how best to unleash and expand that contribution while preserving other social values. New research is also providing fresh insights into what works and what doesn't. Many developing countries are making huge strides in acting on this agenda, and achieving dramatic reductions in poverty as a result. China and India provide the most dramatic examples, but important successes can also be seen in countries as diverse as Latvia, Uganda, Vietnam, and El Salvador.

This note presents a brief overview of what we have learned about the role of private sector development in growth and poverty reduction, and highlights the central role of government policies and behaviors in influencing the size of that contribution.

### **Entrepreneurship, Growth & Poverty Reduction**

When we think of "entrepreneurs" in the U.S. context, we often conjure up images of a young(er) Bill Gates heading towards his first million, or perhaps a range of successful businesspeople taking on significant risks in pursuit of greater rewards. Surely, they meet the test. But when assessing the contribution of entrepreneurship to development, we need a more encompassing view. We need to include peasant farmers toiling in their fields in Uganda and Bangladesh; street vendors peddling their wares in La Paz and Manila; and microenterprises in Cairo and Istanbul. There are small manufacturing

concerns, restaurants and florists. Even less romantically, perhaps, we also need to recognize the contributions of large and foreign enterprises that can make a significant contribution to growth and poverty reduction in developing countries.

How does such a diverse group of actors, driven by the quest for profit, contribute to growth and poverty reduction? Let's begin with economic growth, which is now understood to be critical to a sustained improvement in living standards. Aggregate level evidence shows that the key drivers of long-term growth are investment and productivity improvements (Figure 1). The private sector is the principal source of investment, with domestic private investment substantially overshadowing foreign investment across the developing world (Figure 2). While the relationship between investment and productivity can be difficult to disentangle, the evidence confirms the powerful role competition plays in driving productivity improvement in a process that Schumpeter famously referred to as "creative destruction".

Figure 1: Sources of Long-term Growth

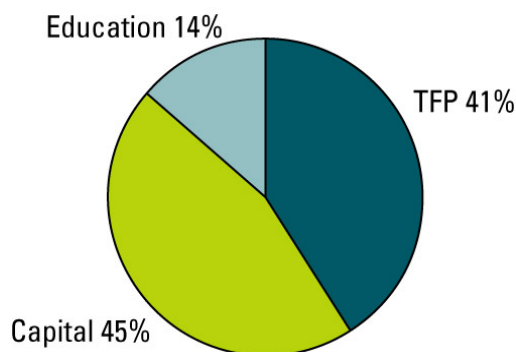
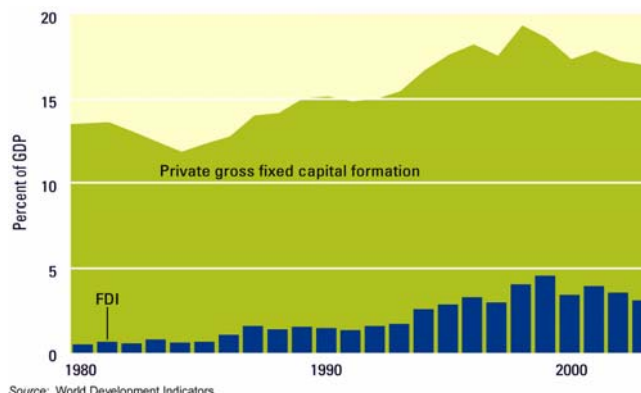


Figure 2: Domestic private investment and FDI in Developing Countries



How do investment and productivity improvements translate into poverty reduction? The most obvious mechanism is job creation. The private sector accounts for about 90 percent of jobs in developing countries, and poor people rate self-employment and jobs as the two most promising ways to improve their situation. But employment is not the only mechanism. A vibrant private sector expands the availability and reduces the prices of goods in society, including goods consumed by poor people. And firms and commercial transactions are the main source of taxes from which governments can empower the poor through investments in health, education and other public goods, as well as through direct income transfers.

## Entrepreneurship and the Investment Climate

Firms and entrepreneurs invest and make productivity improvements not out of any sense of philanthropy, but to make profits. Their decisions are thus influenced by the expected risks and rewards associated with alternative courses of action. Those risks and rewards are in turn shaped by the investment climate, which supplies the opportunities and incentives to invest productively, create jobs, and expand. But what shapes the investment climate?

A substantial body of research has looked at the role of **geography**—including natural resource endowments, climate, and market size. While such factors can play a role, they are rarely decisive. For example, substantial resource endowments can prove more of a curse than a blessing when they lead societies to be consumed by rent-seeking or civil conflict, and countries such as Japan and Singapore have prospered with limited natural resources. Similarly, relatively small and remote economies including Mauritius and New Zealand have grown by taking advantage of international trade. More generally, advances in transport and communications technology are doing much to overcome the tyranny of distance, not only between countries, but also within countries.

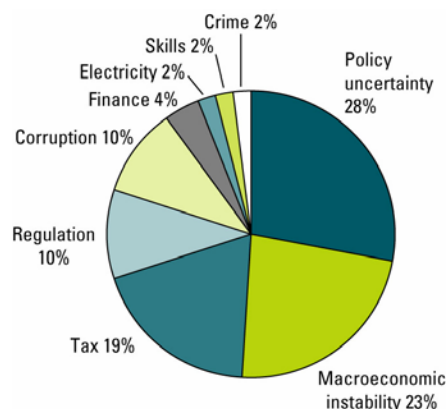
The role played by **culture** and **social attitudes** has also attracted significant research attention. At the level of individuals, we know that investment and other decisions do not always conform to the presumed “rational actor” model of traditional economics. For example, people tend to be loss-averse—willing to accept more risk to avoid a loss than to realize a gain of the same size. Similarly, attitudes towards risk-taking, innovation, and pro-activity vary between individuals in any society, and possibly between societies as well. The latter can be shaped by a range of factors, including traditions and related social institutions. But even these influences are not immutable, with attitudes and related institutions evolving in response to new experiences and new information, including the demonstration effects provided by successful entrepreneurs.

While geography and social attitudes are difficult to change over at least the short run, governments have far more decisive influence over their own policies and behaviors. And new research highlights the critical role **government policies and behaviors** play in shaping the investment climate and hence the private sector’s contribution to growth and poverty reduction. Relevant policies and behaviors cover a broad terrain, including stability and security (including the security of property rights); regulation and taxation, both at and within a country’s borders; the adequacy of basic infrastructure; the functioning of finance markets; workers skills and the operation of labor markets; and broader governance features, including corruption. Policies and behaviors in these areas influence the investment climate via the risks, costs, and barriers to competition faced by firms.

## **Reducing Risks, Costs, and Barriers to Competition**

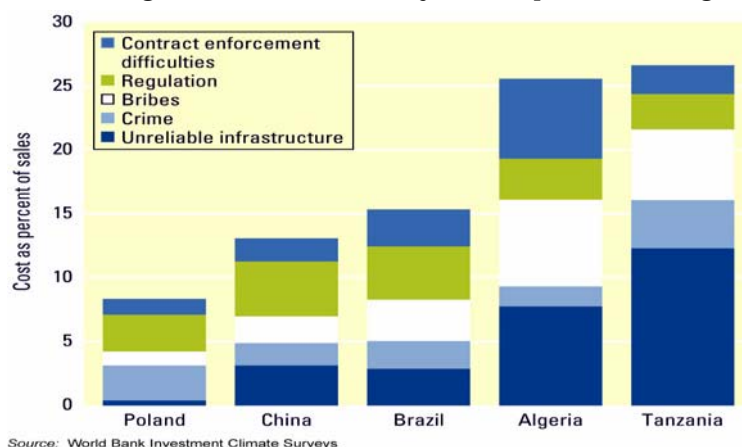
Because investment is forward looking, **risks** play a critical role in shaping investment behavior. While some risks are inherent in any commercial endeavor—such as the risk that customers will prefer the products of competitors—many are directly influenced by government. Indeed, surveys undertaken by the World Bank show that policy-related risk (particularly policy uncertainty and macroeconomic instability) dominates the concerns of firms in developing countries (Figure 3). Our work also suggests that improving policy certainty alone could increase the likelihood of new investment by over 30 percent.

The surveys also show large variations in the level of individual risks perceived between countries. For example, 90 percent of firms in Guatemala reported that the interpretation of regulation was unpredictable, but less than one-third of firms in China reported the same. Confidence in the courts to enforce contracts also varied widely, with over 80 percent of firms in Bangladesh reporting a lack of confidence, but less than 20 percent of firms in Malaysia doing so.



**Costs.** Government policies and behaviors influence the level of costs faced by firms, and hence the range of opportunities that might potentially be profitable. While firms in every country complain about taxes, the survey data show that taxes are rarely the biggest obstacle. Indeed, in some countries poor infrastructure, burdensome regulation, contract enforcement difficulties, crime, and corruption can amount to over 25 percent of sales—or more than three times what firms typically pay in taxes (Figure 4).

Figure 4: Taxes are often just the tip of the iceberg



Our *Doing Business* project also highlights huge variations in regulatory compliance costs across countries. Registering a new business takes 2 days in Australia, but 203 days in Haiti. Enforcing a simple contract takes 48 days in the Netherlands, but 1,459 days in Guatemala. A basic bankruptcy procedure takes less than a year in Singapore, but 10 years in India and Brazil. Burdensome procedures of this kind contribute to informality, reduce incentives to enter contracts with strangers, and discourage lending to firms.

**Barriers to Competition.** Productivity improvements play a central role in growth processes. And competitive pressures drive firms to improve their productivity. Yet government policies often hinder rather than facilitate competition, whether through the erection of trade barriers, licensing regimes, or the sanctioning of monopolies or cartels. While the beneficiary firms are unlikely to complain, the evidence shows that firms facing stronger competitive pressure are at least fifty percent more likely to introduce new products, upgrade existing products, or introduce new technologies.

## Four Underlying Challenges

If a good investment climate plays such a key role in growth and poverty reduction, and is now more widely understood to do so, why do such huge variations in investment climate conditions persist?

Part of the answer undoubtedly lies in the breadth of the agenda. Indeed, for this reason alone thoroughgoing reforms may take decades or longer. But there are also four deeper challenges that can frustrate progress in rich and poor countries alike: rent-seeking and corruption; credibility gaps; lack of social consensus; and poor institutional fits.

***Rent-seeking and corruption.*** Government policies shaping the investment climate are an enticing target for firms seeking special privileges and for politicians and officials seeking to benefit from the exchange. No country can claim to be immune from such pressures. But countries with less established checks on government behavior, including many developing countries, can be particularly handicapped by these problems, leading to deep distortions in investment climate policymaking. Firms benefiting from special privileges; officials benefiting from the income opportunities from onerous, ambiguous and opaque regulations; and politicians benefiting from ability to punish and reward particular groups, have strong incentives to resist reform.

***Building credibility.*** Firms and entrepreneurs do not make investment decisions based on the formal content of laws and policy pronouncements alone, but rather on their expectations of whether those laws and policies will be implemented and sustained over time. The credibility of reforms is thus critical to their impact. While this is true in all countries, many developing countries must deal with the legacy of past government behaviors, and so take special efforts to convince firms of their commitment to reform.

***Social consensus and legitimacy.*** Broad public support plays an important role in enabling and sustaining reforms in this area. It may be necessary to overcome the resistance of those who benefit from the status quo. And it may be necessary to sustain the reforms in the face of short-term adjustment costs or more concerted opposition from disaffected groups. A high level of transparency and consultation in the design and implementation of reforms may reduce policy uncertainty and concerns about corruption or rent-seeking. But it is also important to take account of the impact of reforms on disadvantaged groups in society, and to be sensitive to distributional concerns more generally.

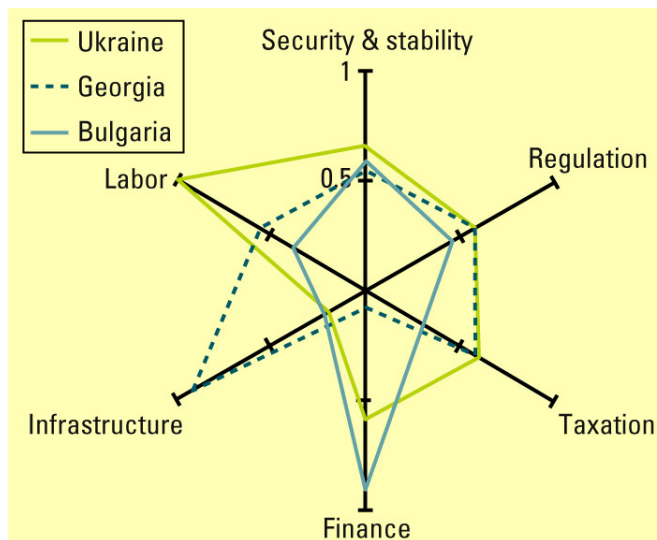
***Ensuring a good institutional fit.*** Improving laws and policies requires more than the adoption of approaches copied from successful countries. To function effectively, laws and policies often require significant adaptation to the local environment, including factors such as administrative capacity and safeguards against the misuse of discretion. In the absence of sufficient adaptation, so-called reforms may have negligible or even perverse results. This has important implications for consultants from rich countries, who can have a tendency to recommend adoption of laws and policies from their home country, regardless of where they are recommending them.

## Setting Priorities

It is always tempting for specialists to declare that their particular subject area should be the top priority for developing countries. From time-to-time we also see various fashions in this as in other fields, whether the theme du jour be industrial clusters, public-private partnerships, or special schemes to facilitate access to finance. Alas, such universal recipes must confront some serious realities.

The first is that the main obstacles facing entrepreneurs can vary widely across countries. Indeed, surveys show that firms even in neighboring countries with many similar characteristics can perceive very different constraints, as a simple comparison between Bulgaria, Georgia, and Ukraine shows (Figure 5). An aggregate indicator of investment climate quality would obscure such differences.

Fig. 5: No universal priorities...even in the same region



Second, the surveys show that there are often big variations in the constraints faced by firms in different locations within the one country. Thus, firms in cities in China and states in India and Brazil report large variations in investment climate conditions, whether it is the reliability of infrastructure or burdens of regulatory compliance.

Third, the same investment conditions can affect firms even in identical locations very differently. Thus, the same investment climate may affect firms differently depending on whether they are engaged in exporting as opposed to serving the local market, or are capital or labor intensive. The survey data show that there are also some systematic differences between firms based on their size, with smaller firms generally facing the most severe constraints. Larger firms are typically better equipped to deal with distorted finance markets (due to sources of internal finance, assets to pledge as collateral, and established reputations); to cope with poor infrastructure through self-provision; and to cope with potential policy uncertainty through better access to politicians and officials. One implication is that efforts to improve the overall

investment climate will tend to deliver disproportionate benefits to smaller firms. This is encouraging news, particularly given the poor track-record of many schemes intended to confer special benefits on smaller firms.

Reflecting these considerations, there is no substitute for undertaking a thorough analysis in each environment to identify the most important constraints. An effective dialogue with firms themselves is an important part of this process, and that dialogue that needs to extend beyond representatives of large and influential firms to include the perspectives of a broader range of actors.

### **Where does finance fit in?**

A common challenge facing small entrepreneurs everywhere is access to finance to fund their ventures. Since they typically have limited credit histories, and few assets to pledge as collateral, they are often seen as high risk customers for banks. As a result, they tend to rely more heavily than larger firms on internal funds to finance their investments, and also rely more on family and friends for external funding.

The situation facing small entrepreneurs in developing countries is often even more challenging, for several reasons:

- The banking sector is often not very competitive, and in many cases still dominated by state-owned banks pursuing political mandates and with weak credit appraisal skills. They often focus on meeting the financing needs of governments, and regulations restrict interest rates.
- Entrepreneurs often lack formal title to land and other property that might otherwise be used as collateral.
- Weak contract enforcement mechanisms increase the risk of lending without collateral.
- In many cases there are no mechanisms to help entrepreneurs establish and demonstrate their credit-worthiness.

Until recently, governments interested in helping smaller entrepreneurs focused on addressing the symptoms rather than the underlying causes. They instituted a range of special programs offering directed or subsidized credit, or special loan guarantees. The track record of such interventions in developing countries has been dismal. While more credit was indeed often provided, it typically went to connected firms, and the additional distortions to credit markets exacerbated the underlying difficulties.

Newer approaches focus on addressing the underlying problems. Banking sectors are being deregulated and privatized, and new bank and non-bank financial intermediaries are entering the market to respond to under-served clients. Schemes to secure rights to land are being implemented, and registries for moveable property are being established as well. Credit information bureaux are being established to help firms establish their credit records, and more countries are addressing issues related to the enforcement of smaller claims. Taken together, these approaches are expanding opportunities for smaller firms to access credit, without the costs and distortions of earlier approaches.

## **A Process, Not an Event**

The nature and breadth of the investment climate agenda mean that progress requires more than the one-off, “stroke-of-the-pen” privatization and trade reforms pursued in the early 1990s. Reforms in this area require ongoing attention to identify and address binding constraints. And the nature of those constraints will evolve over time as earlier constraints are relaxed and markets evolve. It is a process, not an event.

Successful reformers recognize this and create specialist institutions to support an ongoing process of reform. They create institutions to manage consultations with firms and other stakeholders. They establish mechanisms to systematically review existing constraints, and often complement these with mechanisms to help ensure that new policy or regulatory proposals do not introduce unjustified burdens. And they actively reach out to their communities to build consensus for reform, including by ensuring the benefits of reform are shared widely in society.

## **References**

Sources for all data and supporting references can be found in:

World Bank. 2004. *World Development Report 2005: A Better Investment Climate for Everyone* (World Bank and Oxford University Press).