

“Entrepreneurship and Economic Development: Theory, Evidence and Policy”

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ABSTRACT:

This paper provides an overview of the state of the art of the intersection of development economics and entrepreneurship. Given the relative neglect of entrepreneurship by development scholars it deals with (i) recent theoretical insights from the intersection of entrepreneurship and development studies; (ii) the empirical evidence on the relationship between entrepreneurship and development; and (iii) fresh insights for entrepreneurship policy for development that emerges from recent advanced in this area, including female entrepreneurship in developing countries.

KEYWORDS: Development Entrepreneurship, Small Business, Private Sector Development, Innovation, Business.

1. INTRODUCTION:

It is widely believed that entrepreneurship is beneficial for economic growth and development. Further, entrepreneurship has been remarkably resurgent over the past three decades in countries that achieved substantial poverty reduction, such as in China. Third, donors and international development agencies have turned to entrepreneurship to improve the effectiveness and sustainability of aid. However, the theoretical and empirical cases for understanding the role of entrepreneurship are not yet solid. Evidence on whether entrepreneurship matters for economic growth is not straightforward; how entrepreneurship has been promoted and how it contributed to development in countries like China and the East Asian Tigers is still a matter of contention; and whether and why private-sector development initiatives may be effective is not well understood.

2. THEORETICAL PERSPECTIVES ON ENTREPRENEURSHIP IN DEVELOPMENT:

2.1 CONCEPT, DEFINITIONS, EVOLUTION AND RELEVANCE FOR DEVELOPMENT:

The evolution in scholarly views of entrepreneurship is reflected in the categories of behavioral, occupational, and synthesis definitions. Schumpeter (1950; 1961) famously defined the entrepreneur as the coordinator of production and agent of change ('creative destruction'). As such the "Schumpeterian" entrepreneur is above else an innovator. Scholars who share this view of entrepreneurship do not consider entrepreneurship to be very important in earlier stages of economic development – they see the contribution of entrepreneurship to be much more important at later stages of development, where economic growth is driven by knowledge and competition. At earlier stages of development, entrepreneurship may play a less pronounced role because growth is largely driven by factor accumulation (Ács and Naudé, 2013).

Other behavioural definitions allow for a more substantial role for entrepreneurship in developing countries. Kirzner (1973) views the entrepreneur as someone who facilitates adjustment to change by spotting opportunities for profitable arbitrage (and 'disequilibrium' situations in the market). This view has resonated among scholars who emphasize the opportunity-grabbing-for-profit nature of entrepreneurship (Shane and Ventakaram 2000) particularly in developing countries where market disequilibria may be common. Behavioural

definitions also stress the risk-taking dimension of entrepreneurship. Kanbur (1979:773) described the entrepreneur as one who ‘manages the production function’ by paying workers wages (which are more certain than profits) and shouldering the risks and uncertainties of production. Such definitions are seen as very relevant for developing country contexts characterized by high risk and uncertainty.

According to Baumol (1990:895) entrepreneurial ability can be allocated towards productive, unproductive, or even destructive activities. He defines entrepreneurs as ‘persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige’).

2.2 STRUCTURAL ECONOMIC TRANSFORMATION AND ENTREPRENEURSHIP

One of the seminal contributions to development economics has been dual economy models, inspired by Lewis (1954), utilized to explain the structural transformation of underdeveloped economies. Gries and Naudé (2010) expand the Lewis-model distinction between a traditional and modern sector with the micro-foundations of optimizing households, firms and labour market matching. They also distinguish between mature and start-up entrepreneurs, between large firms and small firms, and between necessity and opportunity-driven entrepreneurship. In their model the transformation from a low-income, traditional economy to a modern economy involves significant changes to production methods, a process of change where entrepreneurs provide essential roles, including providing innovative intermediate inputs, permitting specialization and raising productivity and employment. The Gries-Naudé structural change model of entrepreneurship also builds on earlier work of Rada (2007), Peretto (1999) and Murphy et al (1991). In Rada (2007) entrepreneurs ‘trigger’ an investment in the modern sector once they have perceived profitable opportunities and facilitate the re-allocation of production factors from the traditional to the modern sector. Peretto (1999) provided a modified endogenous growth model that implied long-run structural transformation depends on the degree to which an economy can make a transition from a growth path driven by capital accumulation (‘the Solow economy’) to a growth path driven by knowledge accumulation (the ‘innovation-driven’ economy).

In structural change, entrepreneurial ability has been accorded center stage. Murphy et al (1991) provided a model that described firm size and the growth of the economy as a function of entrepreneurial ability. Nelson and Pack (1999) assigns a key role to the ‘effectiveness of entrepreneurial ability’ which they see as a vital determinant of the rate of assimilation of technology (1999:420) – as in Michelacci (2003) where entrepreneurial ability is vital for R&D. In Nelson and Pack (1999) a ‘rapid’ expansion of skilled labour can only be absorbed if entrepreneurial ability is high, and that without entrepreneurial ability the returns to physical and human capital is low.

2.3 MULTI-DIMENSIONAL DEVELOPMENT AND ENTREPRENEURSHIP:

The entrepreneurship literature generally takes a restricted view of development. Most empirical studies on the relationship between entrepreneurship and development have similarly been limited to GDP, productivity and employment growth as proxies for development – and not multi-dimensional development (Ács et al. 2008, van Praag and Versloot 2007). Yet entrepreneurship can also contribute to multi-dimensional well-being by what people can achieve through their capabilities (Gries and Naudé, 2011). This notion of human development -or human flourishing - has been pioneered by Sen (2000), Nussbaum (2000) and others. This capabilities approach can inform both theoretical thinking on and measurement of entrepreneurship. It views entrepreneurship is a human functioning² that can be valued as an end, and not just as a means to other ends. It can enrich human capabilities if people’s complementary capabilities are expanded so that they can choose not to be entrepreneurs. An important implication is that the demand for entrepreneurs is not a derived demand as in the instrumentalist view (as e.g. in Casson et al., 2006).

2.4 MARKET FAILURES, THE STATE AND ENTREPRENEURSHIP:

The third “grand idea” in development economics concerns market and state failures. In the aftermath of World War II, when development economics was founded, the belief was that market failures were important to understand underdevelopment. During the 1980s, the government was seen as similarly subject to failure. Hence, under a set of principles for market oriented reform described as the ‘Washington Consensus’, a reduction of the role of the state and the liberalization of markets. The implicit assumption was that the supply of entrepreneurship would be forthcoming once the constraints imposed by state interference were loosened. After the global financial crises of 2008 and 2009 wherein market

liberalization and ‘Washington Consensus’ type policies were found to be complicit, the regulatory role of the state has been revived. One role of the state that has received more attention is in industrial policy (Szirmai et al. 2013; Ács and Naudé, 2013). Here, old models of import-protection and state-owned enterprises have made place for policies that rely more on the private sector and entrepreneurship, but with government still playing an important role to address market failures in the entrepreneurial start up and growth process. For example some have argued that entrepreneurial entry may be suboptimal due to the externalities that may justify ‘self-discovery’ through supporting innovation by SMEs and new firm start-ups, for example by reducing regulations and requirements or providing subsidized credit (Hausmann and Rodrik 2003). In contrast, others have argued for taxing (regulating) entrepreneurship because it may cast negative externalities. De Meza and Webb (1987) make the case that credit market imperfections may lead to ‘overinvestment’ when banks cannot accurately judge entrepreneurial ability. Because banks cannot observe any entrepreneur’s ability *ex ante*, interest rates on start-up capital will reflect average entrepreneurial ability. If the proportion of entrepreneurs of low ability increases, it will result in higher borrowing costs, which impose a negative externality on entrepreneurs of high ability, who will consequently borrow and invest less.

3. EMPIRICAL EVIDENCE:

3.1 MACRO-LEVEL RELATIONSHIP:

Three important databases describe the entrepreneurial activity of countries: the International Labour Organization (ILO) measures self-employment, the Global Entrepreneurship Monitor (GEM) measures start-up rates of new firms, and the World Bank measures the registration of new firms. It is worth noting that these databases are concerned with formal as opposed to informal firms (for comparison of these databases, see Desai 2010). Studies using these databases have uncovered two sets of results. First, there is a lack of clear empirical evidence of whether entrepreneurship drives economic growth, productivity, or employment. Studies find a mixed bag of results. Second, there seems to be a U-shaped relationship between entrepreneurship and a country’s level of economic development, as measured by GDP per capita (Naudé, 2010b). The U-shaped relationship implies a higher rate of entrepreneurial activity in low-income countries than in middle-income countries (Wennekers et al. 2005). This result may reflect that entrepreneurs in developing countries are less innovative and tend to be proportionately more ‘necessity’

motivated (Ács et al., 2008, Gollin 2008). Higher levels of GDP may therefore be associated with more ‘innovative’ forms of entrepreneurship. Another implication is that rather than causality running from entrepreneurship to development, the causality may also run from development to entrepreneurship.

3.2 MICRO-LEVEL RELATIONSHIP:

Most micro-level studies focus on the why and how of entrepreneurship, not its impact on development. Nevertheless studies on the productivity, innovativeness, and growth and female entrepreneurs provide insights on whether and how entrepreneurship matter for development. One lesson is that innovative entrepreneurship matters most for development. Van Praag and Versloot (2007) consider the literature on the impact of entrepreneurship on employment, innovation and productivity growth. They find that entrepreneurs do not spend more on R&D than their counterparts, although the quality and efficiency of their innovation is higher, and that their contribution to productivity growth is low. The majority of entrepreneurs would earn higher incomes as wage employees, and while entrepreneurs create more jobs relative to non-entrepreneurs, the quality of jobs they create is lower. Hence not all entrepreneurs drive development, and not all entrepreneurs are innovative (Shane 2009, Stam and Wennberg 2009). As these findings refer to the impact of the average entrepreneur, it perhaps suggests that focusing on the average entrepreneur may not be the best policy stance. It may be better to focus on the small subset of innovative entrepreneurs that do make a difference. Studies find that innovative firms, particularly in high-tech sectors, have on average higher levels of productivity, tend to do enjoy higher employment growth, and cause positive spillovers for other firms (Stam and Wennberg 2009).

4. ENHANCING THE DEVELOPMENTAL IMPACT OF ENTREPRENEURSHIP:

Given the “grand ideas” in development economics the main policy considerations for enhancing the developmental impact of entrepreneurship are to improve the quality and allocation of entrepreneurial ability; and reduce the need for necessity entrepreneurship. Both considerations require better quality and quantity of research and data-generation. Improving the quality of entrepreneurial ability means not only improving the skills and education of entrepreneurs, their ‘human capital’, but focusing on the innovative abilities of entrepreneurs. It is innovative entrepreneurship that is most desirable for growth. Innovation policy ought

therefore to be a central focus of entrepreneurship promotion in developing countries as it is in advanced economies. Entrepreneurs in developing countries have a much greater propensity for innovation than is often recognized in the literature or by policy-makers. Stimulation of innovation has not been paramount in most development agencies or donor's private-sector development programs, nor in national entrepreneurship support programmes. The only innovation relevant aspects of such support programs have been their concern to improve the general business environment, a prerequisite for innovation, and to argue for patent protection - and to a lesser extent basic research. Such policies tend to be more concerned with improving static and allocative efficiency, and not dynamic efficiency, which is more important for job creation and growth (Evenett 2005). Attempting to improve dynamic market efficiency through raising innovation, and aiming to limit necessity entrepreneurship, may have implications for policy that runs counter to many current policies..

5. CONCLUSION:

Reconsidering entrepreneurship's role in development leads to the conclusion that the entrepreneurship a valid and important subject of study for development scholars, and development is a worthwhile subject of study for entrepreneurship and management scholars. The growing availability of more and better data from emerging and developing economies, the increasing adoption of rigorous evaluation methods in policy assessments, and likelihood and desirability of closer collaboration across disciplines, are all boding well for on the intersection of development and entrepreneurship.

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