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## Peace, prosperity and pro-growth entrepreneurship

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Discussion Paper No. 2007/02

## **Peace, Prosperity, and Pro-Growth Entrepreneurship**

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August 2007

### **Abstract**

Support for entrepreneurship is widely seen as a mechanism to facilitate prosperity and peace in a growing number of post-conflict states. In this paper I critically evaluate this view. I argue that entrepreneurship is a ubiquitous quality in post-conflict states but not necessarily always for the good. Unproductive and destructive entrepreneurship may inhibit the resurgence of the private sector and might even cause a relapse into conflict. To limit unproductive and destructive entrepreneurship there are at least six dimensions which need to be taken into consideration, namely: the context of war, the relationship between institutions and entrepreneurship, the role played by ethnic/immigrant (minority) entrepreneurs and entrepreneurs in diaspora, the scope of the market, human and financial capital requirements, and appropriate forms of government support. Further research on entrepreneurship in post-conflict states is needed to overcome the current lack of data, which constrains policy design.

Keywords: entrepreneurship, peace, security, reconstruction, development

JEL classification: M13, O12, D21, L25

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## 1 Introduction

Security and prosperity eludes a large number of countries and their citizens, with almost a billion people living in countries that have in recent times been described as fragile, and even failed, states. In these states, the lack and/or unwillingness of governments to sustainably promote the progressive realization of security and prosperity is widely recognized as both cause and symptom of the perpetuation of poverty and conflict.<sup>1</sup> Although a significant number of these countries are still engaged in conflict, the total number of conflicts across the world, and particularly in Africa,<sup>2</sup> has been declining (Ndulu et al. 2007). A growing number of people in fragile states are entering post-conflict eras, and are having high expectations of economic development, not only to improve their material conditions, but also to consolidate and ensure sustainable peace. It is not surprising therefore that, in a context wherein state capacity is often lacking, and liberalization and other market-oriented reforms dominate the agenda (Addison 2001: 12), there are high expectations that entrepreneurship can make an important contribution towards economic growth and development (Baumol et al. 2007: 133). Calls for the development of entrepreneurship in poor and post-conflict states are often accompanied by claims that much of the difficulties that countries face are due to a lack of entrepreneurship (e.g. Iyigun and Rodrik 2004: 1-2; Munshi 2007: 1)<sup>3</sup> caused by a macroeconomic environment that discourages entrepreneurship (Schulpen and Gibbon 2002: 1).

Is it true that entrepreneurship can contribute to peace and prosperity in post-conflict states, and that the problem is one of a lack of entrepreneurship? In this paper I provide critical answers to these questions. I suggest that the concept of ‘entrepreneurship’ is perhaps too loosely used in the context of these countries, and show that a more nuanced understanding of what is meant by entrepreneurship would suggest that first, entrepreneurship is an ubiquitous quality in fragile and post-conflict states and therefore not lacking as some would claim, and second, that entrepreneurship may in itself be contributing to, and contributing from, the very conflict and poverty for which entrepreneurship is being prescribed as a panacea. Moreover, in this view the establishment of peace, the achievement of political and economic stability, will not automatically result in the appearance of growth-oriented entrepreneurial ventures<sup>4</sup> (see

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<sup>1</sup> There are a number of related definitions of fragile states. DFID defines fragile states as those where ‘government cannot or will not deliver the core functions to its people’ (Vallings and Moreno-Torres 2005: 4). The CIFP (2006: 3) defines fragility as ‘the extent to which a state can or cannot provide the basic functions of governance to its population’. The World Bank (2006) defines fragile states as those low-income countries that they had previously described as under ‘stress’ (LICUS). These are ‘countries with weak policies, institutions, and governance’. USAID (2005) sees fragile states as those in which the government is ‘unable or unwilling to adequately assure the provision of security and basic services to significant portions of their populations, and where the legitimacy of the government is in question’.

<sup>2</sup> The number of wars in Africa, though high, peaked in 1992, and since then a growing number of countries have been making the transition from war to peace (Ndulu et al. 2007: 111).

<sup>3</sup> According to Iyigun and Rodrik (2004: 1-2) ‘a key obstacle to growth in low-income environments is an inadequate level of entrepreneurship in non-traditional activities’.

<sup>4</sup> Even the achievement of the so-called peace dividend is not a foregone conclusion in post-conflict societies. Collier (1999) shows that there is no automatic peace dividend from the end of a civil war,

also Schramm 2004: 10). If one takes the implied and more limiting view that only certain kinds of entrepreneurial activity is good for peace and prosperity, say productive, pro-poor entrepreneurship, then the question arises how can such entrepreneurship contribute towards ensuring peace and development? And if the right conditions can be created for productive, pro-growth entrepreneurship to flourish, what is the prognosis for private sector resurgence in these fragile states?

Concluding that there are various channels through which productive and pro-growth entrepreneurship, as well as survivalist (necessity) entrepreneurship can play a role in security and prosperity, and that the prognosis for entrepreneurial resurgence in post-conflict states is good, I move on to discuss the various factors that need to be considered in creating conditions for the allocation of entrepreneurship towards productive, pro-growth activities. Entrepreneurship in developing countries is a relatively under-researched phenomenon. Lingelbach et al. (2005: 1) recently pointed out 'Entrepreneurship in developing countries is arguably the least studied significant economic and social phenomenon in the world today'. This and the resulting lack of sufficient data on entrepreneurship in these countries complicate the discussion on policy responses to promote pro-growth entrepreneurship. Given this lack, I approach the task by considering various strands of literature through the lenses of entrepreneurship theory and empirics, in particular the strand of literature on the economic transition of countries of Eastern Europe and the former Soviet Union (EE-FSU), and the strands of literature on Africa's economic performance (and in particular its firm performance).

I conclude that there are six dimensions that need to be taken into consideration in creating better conditions for the right type of entrepreneurship to emerge in post-conflict countries. First, the context of war and conflict which characterize many fragile states, or that preceded peace agreements, needs to be understood, as this environment may not only contain the seeds of its future destruction, but also an understanding of the incentives that affect the behaviour of various sources of entrepreneurship. Second, the relationship between institutions and entrepreneurship, and the evolution of institutional reform need to be better understood. Third, particular characteristics of entrepreneurship in poor and conflict countries need to be taken into consideration, in particular the role played by ethnic/immigrant (minority) entrepreneurs and entrepreneurs in diaspora. Fourth, attention needs to be given to the scope of the market in these countries, particularly so in the light of the dominance of small businesses (not in itself synonymous with entrepreneurship). Fifth, human and financial capital requirements are critical inputs into the entrepreneurial process, but the kind and type of requirements cannot easily be transplanted from other contexts or countries. Finally, the relationship between government and the private sector in fragile post-conflict states needs to be put on an appropriate footing, argued to be that of a developmental state, wherein governments remove barriers to business development, provide support on the input side of the entrepreneurial process and decentralize the provision of support measures and economic decision-making as much as possible.

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and that there could also be a 'war overhang effect'. Whichever effect holds may depend on the length of the preceding war, with longer wars more likely to result in a peace dividend as it would have allowed for desired adjustments to the capital stock in face of the uncertainties that the very occurrence of war in the first place had created.

## 2 Defining entrepreneurship

In the previous section I alluded to the possibility that the term ‘entrepreneurship’ may be loosely used in the context of fragile and post-conflict states, but did not offer a definition of ‘entrepreneurship’. The reason is that a separate discussion on the definition or concept of entrepreneurship is required, since a distinction needs to be made between the definition of entrepreneurship *as it is*, and how it *ought to be* (for policy objectives). Different understandings of the terms might lead to different policy implications, so that it becomes important to understand what should be seen as entrepreneurship in fragile states, and states emerging from conflict.

In this section I therefore first distinguish between productive, unproductive, and destructive entrepreneurship in the context of fragile and post-conflict states, pointing out that in its broadest sense substantial entrepreneurial activity characterize these states. Second, I distinguish between entrepreneurship, or entrepreneurial ventures, and small businesses, noting that in the context of fragile and post-conflict states an emphasis on small business may be important, and that policymakers should understand the dynamics of firm size and development. Moreover, I argue that the creation of new businesses—i.e. firm start-ups—may perhaps be even more important than existing firms for development and growth in post-conflict states.

### 2.1 Productive, unproductive, and destructive entrepreneurship

There are many different definitions of entrepreneurship (see Davidsson 2004: 1). Wennekers and Thurik (1999: 30) identify thirteen distinct roles of an entrepreneur. More broadly, however, entrepreneurship is seen as involving either/or risk-taking, innovation, arbitrage, and co-ordination of production factors in the creation of a new business. (Fogel et al. 2006: 542). An example of this view is Hart (2003: 5) who defines entrepreneurship as ‘the process of starting and continuing to expand new businesses’.

Entrepreneurs in post-conflict states perform all of these functions. As will be shown below (Section 3) risk-taking and arbitrage (being a ‘middleman’) are important functions during early stages of development. However, as an enlightening definition that assists in understanding the persistence of certain forms of economic activities in fragile and conflict /post-conflict states, the definition of entrepreneurship by Baumol (1990: 987) is preferable. Accordingly, ‘Entrepreneurs are defined, simply, to be persons who are ingenious and creative in finding ways that add to their own wealth, power, and prestige’. In this definition, entrepreneurship is a quality that is always present in any country or population, and all that changes is the particular allocation or application of that quality. Thus entrepreneurship can be channelled into productive, unproductive (e.g. rent-seeking), or even destructive (e.g. illegal) activities (Baumol 1990: 895). As such entrepreneurship in itself is not necessarily always a positive force in an economy. Wong et al. (2005) using empirical evidence from 37 countries participating in the 2002 Global Entrepreneurship Monitor finds significant evidence for ‘the existence of entrepreneurial activities that do not contribute to economic growth’. Baumol (1990: 894) moreover goes further and remarks ‘at times the entrepreneur may even lead a parasitical existence that is actually damaging to the economy’. To make the moral position regarding entrepreneurship even more ambiguous, destructive entrepreneurship may differ from context to context and from position of the observer, and might, depending on the position, even have a positive impact on economic growth

in a country. Baumol (1990: 904) refers to the links between growth and warfare in Middle Age Europe, and in the ‘unprecedented prosperity enjoyed afterwards by the countries on the losing side of the Second World War’. Ruttan (2006) argues that much of the USA’s growth since 1945 could have been due to technologies emerging from war contexts. Nafzinger (2006: 16) describes how foreign firms and entrepreneurs have played an active role in many African conflicts by keeping elites in power and providing essential state services such as security, and moreover finding it in their interest to weaken local government capacity (see also Cooper 2006). ‘Destructive’ entrepreneurship might have positive effects on development, either over time or in other economies. Even during periods of war and conflict there is evidence of substantial entrepreneurship at work, fulfilling a threefold role in sourcing funds to sustain conflicts, overcoming the adverse impacts of conflict, and exploiting profitable opportunities arising from conflict. Addison (2001: 7) notes that during the Mozambican 18-year civil war, private entrepreneurs continued to supply the government army with much of its food requirements. In Colombia, the FARC developed social safety nets for coca farmers and combatants in the forms of minimum wages and pensions (Cooper 2006: 20). In Sri Lanka, the rebel Tamil Tigers manage to generate between US\$200 million and US\$350 million annually for expenditure in its civil war (Collier et al. 2006: 5). Nenova (2004) documents the inventiveness of entrepreneurs in Somalia, where government is almost absent, and where five private airline carriers emerged after the collapse of the state and the national airline in 1991 (Pineau 2005: B02). In Liberia, the warlord Charles Taylor used patronage to create an own currency, a banking system, telecommunications network, airfields and a deepwater port for in the territory under his control (Nafzinger 2006: 16). Many war participants, including rulers, warlords, and smugglers—described by Cooper (2006) as ‘conflict entrepreneurs’—develop substantial business interests.<sup>5</sup> This not only makes the achievement of peace in many cases difficult (as these participants profit more from war than peace) but will also have a significant impact on the post-conflict economic success. This is because many wartime entrepreneurial activities provide capital for post-war investment, provide a means for wartime actors to obtain political power after the war (Addison 2001) and provide incentives for entrepreneurs to undermine government institutions (Nafzinger 2006: 16).

Seen in this way ‘entrepreneurship’ is not necessarily intrinsically good or bad, but depends for its effects on the structure of incentives that a particular time and society offers. These structures and incentives can result in either a ‘rent economy’ or a ‘productive economy’ (Stiglitz 2006: 7). In a rent economy the distribution of resources is often a zero-sum game which leads to conflict. According to Stiglitz (2006: 7) it is precisely because Africa has so many of its countries as rent economies (being dependent on natural resource exports) that conflicts are so frequent.<sup>6</sup> Given this understanding of entrepreneurship, the policy implication is that efforts to increase the supply of entrepreneurship itself may be less important than efforts to change the allocation of entrepreneurial effort into productive entrepreneurship (Baumol 1990:

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<sup>5</sup> These business interests and business systems includes entrepreneurial activities oriented towards illegal mining and smuggling (e.g. conflict diamonds), preferential rationing systems, theft of humanitarian supplies, banditry and predation on civilians.

<sup>6</sup> Gallagher (1991) found that rents generated by import licenses in African countries ranges between 6 per cent and 37 per cent of GDP.

895). In this paper some guidelines for domestic and international efforts to achieve such a shift is explored—see specifically Section 4.

Productive entrepreneurship itself need to be distinguished from non-productive entrepreneurship, such as rent-seeking, but also from forms of entrepreneurship that are not unproductive in Baumol's sense but which contribute little to economic growth. Into this category fall many informal firms, firms aimed at maintaining lifestyles, as well as survivalist firms which have been created out of necessity. The Global Entrepreneurship Monitor (GEM) distinguishes necessity entrepreneurship from opportunity entrepreneurship. Not all types of opportunity entrepreneurship contribute significantly to economic growth. This has led the GEM to coin the term 'high-potential growth entrepreneurship',<sup>7</sup> which corresponds with the notion of technologically innovative, pro-growth entrepreneurship that should be advanced by governments and development agencies—primarily in developed countries. The GEM does not include in its sample of 37 countries any fragile state and include only two developing countries from Africa—South Africa and Uganda. The GEM's limited sample does however reflect that in developing countries (such as Peru, Uganda, South Africa, and India) necessity entrepreneurship rates tend to be higher, and a high preponderance of small and even micro-enterprises is found (Banerjee and Duflo 2007). This suggests that the connection between small (including micro) businesses and entrepreneurship needs to be understood.

## 2.2 Entrepreneurship and small business

Many policymakers see small business promotion as synonymous with entrepreneurial support. Although small firms no doubt can be entrepreneurial, and may have crucial advantages in the modern global economy (Audretsch and Thurik 2004), they are not necessarily, synonymous with entrepreneurship or entrepreneurial ventures (Wennekers and Thurik 1999: 29). Indeed, most of the small businesses that dominate in fragile states, especially in Africa, have been described as survivalist firms, characterized by necessity and lifestyle entrepreneurship rather than opportunity and growth-oriented entrepreneurship. Many small businesses in developed countries share some of these features, and a sizable proportion of small firms have been described as being dominated by managerial business owners rather than entrepreneurs (Carree et al. 2002: 271). Small firms may be more risk-averse and less inclined to innovate and experiment than larger firms, given that risk is borne by a smaller number of individuals in such firms (McCann 2006: 654). For these reasons, many have expressed pessimism over the much discussed small business promotion programmes of many governments, donors and NGOs. Schramm (2004: 105) for instance describes most of these small business support programmes as poverty and livelihood oriented, tending to 'involve cottage industries that add little to the economy in terms of productivity or growth'. Empirical evidence that small business development *per se* is good for growth is lacking. Beck et al. (2003) find no evidence that small business firm growth is associated with higher

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<sup>7</sup> The measurement of entrepreneurship is a contentious issue. Generally, measured in a static framework it refers to the rate of business ownership and in a dynamic framework to the rate of start-ups. According to GEM certain start-ups can be seen as high-potential growth entrepreneurial ventures, namely those that (a) plan to employ no fewer than 20 employees within five years; (b) have indicated at least some impact on market creation; (c) have at least 25 per cent of their customers live abroad and (d) use technologies that have not been available for more than a year (Wong et al. 2005: 345).



growth levels, and Parker (2006: 453) reports that there is no unambiguous empirical relationship between the rate of self-employment (often taken as a measure of entrepreneurship) and unemployment rates. Audretsch and Thurik (2004: 1) point out that many small business support programmes are in fact undertaken for social and political reasons rather than for economic motivations.

The question that arises is: why do we see so many small and even micro-firms in the least developed countries? The answer is that there might be certain features of the environment which constrains the emergence of medium-sized and larger firms, rather than factors that make small firms more or less desirable.

Small firm size may be a symptom of economy-wide uncertainty, imperfect information and high transaction costs—conditions which will make transactions within the boundary of the firm less efficient than market transactions. These conditions characterize many fragile states and post-conflict societies. One example is that the liquidity constraints that a firm face is a negatively associated with firm size (Audretsch et al. 2006: 147). It may also be a symptom of personal management/family ownership of firms which without the right environment (as for instance in Japan) could reduce growth. This is because in many such firms the objective is for a firm to maintain the entrepreneur's lifestyle, be it survivalist or merely to ensure sufficient cash flow (Teece 1993: 208). Small firms may also be a symptom of the fact that firms cannot exploit economies of scale of scope—not only due to liquidity constraints but because of a lack of transport infrastructure and transport services (Tirole 1988; Acs 2006; Banerjee and Duflo 2007). In many fragile countries these are seen as being due to the limited size of local markets. However, following Chandler (1990) it may also be due to limited managerial and organizational abilities. Indeed, firm size in Africa has been found to be positively related to the education- and skill-level of the entrepreneur (Ndulu et al. 2007: 68). The preponderance of small firms in Africa and other fragile states may be due to path-dependence and the fact that other countries exploited a first-mover advantage in the exploitation of technologies that provided for large-scale production (Chandler 1990).

Certainly much of the pessimism that small and micro-enterprises will drive growth in developing countries is not misplaced. However, a fair amount also arises due to the perceived disadvantages of small firms seen against the huge impact of large firms from the developed world on economic growth in developing countries during the twentieth century (see for e.g. Chandler 1990). Audretsch and Thurik (2001, 2004) argue that the global economy has changed in the meantime, and that during the era when size was important competitive advantages were due to capital and unskilled labour. In contrast, they argue that in the modern economy the critical production factor is knowledge—which is generated through innovation, often faster in smaller, more flexible firms. Brock and Evans (1989) also note the increased importance of innovation as a source of growth in the modern economy as a reason why smallness may not be a disadvantage anymore, and also notes a number of other structural changes in many countries which are calling for the flexibility of smaller firms such as technological change which reduce the need for economies of scale, changes in labour force demographics which require greater employment flexibility, and changes in consumer tastes.

The fact that most firms in fragile states and post-conflict societies are small firms is therefore not problematic or a cause for concern. Indeed, as argued by a number of

authors these firms may have the flexibility to utilize opportunities that larger firms, including state-owned enterprises and multinational firms, cannot. Smallness of firms reflects the under-developed state of an economy, where lack of formal sector employment lowers the opportunity costs of entrepreneurship (self-employment) (Acs 2006). As the economy develops, relatively more people will shift into labour employment, so that the entrepreneurship rate (as measured by self-employment) will fall. As a result average firm size will increase, given further impetus by improvements in transport infrastructure. After a certain level of development, which brings with it technological advances and a proportionately larger service industry, self-employment and smaller firms will again start to increase. This results in a U-shaped relationship between rates of entrepreneurship and development (Acs 2006).

Although the small size of firms is not *per se* a disadvantage—and may even be an advantage in the right circumstances—it may in fact not be in existing firms that the future growth of fragile states and post-conflict states lie but in the creation of new firms, i.e. start-ups. Research suggests that start-up firms are the ones most likely to grow (Lingelbach et al. 2005; Johnson et al. 2000) and to create new jobs (Audretsch et al. 2006: 25; McMillan and Woodruff 2002: 166). In many transition countries with no significant private sector to start with, new firms often strengthened reforms by improving economic conditions, as for instance in China (McMillan and Woodruff 2002: 153). New firms can be important in a transition context in a post-conflict society since they are less encumbered with the historic influences of such a society as opposed to existing firms which may themselves be undergoing reform, and that some form of private sector development could be a condition for successful privatization of inefficient state-owned firms (Estrin et al. 2006: 693).

Thus, focusing on start-ups that can result in pro-growth, entrepreneurial ventures should be an important objective when promoting entrepreneurship in fragile and post-conflict states. In the next section, I discuss the ways in which such type of entrepreneurship can contribute towards peace and prosperity and ask how likely a resurgence in pro-growth entrepreneurship is in post-conflict states.

### **3 How can entrepreneurship contribute towards peace and prosperity?**

Not all kinds of entrepreneurial activities necessarily promote growth, and not all kinds should be expected to contribute towards peace and prosperity. Apart from destructive and unproductive entrepreneurship, there may however be an important role for productive (both necessity and opportunity driven entrepreneurship) as well as high-growth potential entrepreneurship. What are the contributions that such entrepreneurship can make towards development and peace in a post-conflict environment?

Consider first high-growth potential entrepreneurship. When allocated to what have been termed pro-growth entrepreneurial ventures, entrepreneurship can contribute towards peace, security, and transition in fragile and conflict states through a number of ways. The first is through the contribution to economic growth and development. Entrepreneurs are essential in the reallocation of resources from low productivity uses towards higher productivity uses (Estrin et al. 2006: 693). As noted by Collier (2006: 9) development is the best strategy for peace. Entrepreneurs create jobs, provide diversity, assume risk, provide goods and services, including even public goods, as well as

provide an environment for learning, experimentation, innovation and competition (Sternberg and Wennekers 2005). Moreover, entrepreneurs fulfil a ‘cost discovery’ function (Hausmann and Rodrik 2003) in making sunk costs in a new activity which *ex ante* may or may not be profitable, but which will provide information *ex post* on such profitability to other entrepreneurs. In doing so, entrepreneurs provide information on what an economy can be good at producing, which in the context of fragile and post-conflict states is information that may be fundamentally lacking. Furthermore, entrepreneurs generate change from inside the country and its economic system, rather than from the outside (Metcalf 2006: 60). Entrepreneurship, through new business creation, can also be important for conflict reduction by providing vehicles for individual social mobility (Keister 2000).

There are many potential opportunities for entrepreneurs in post-conflict and fragile states, such as the restructuring of the business sector by filling in niches, the provision of infrastructure,<sup>8</sup> the addressing of supply-demand imbalance, e.g. due to pent-up demand, financial sector development and the possible return of flight capital and new foreign investment. Where state capacity may be weak or unwilling, post-conflict reconstruction could be facilitated by private sector support to governments. An example is that of South Africa’s transition where the private sector co-ordinated efforts to support the first post-apartheid government. One such initiative was the National Business Initiative (NBI) which brought together more than 150 private firms to provide public goods such as education, health, crime prevention and strengthening of local government capacity.

Though networks, entrepreneurs can provide the functions of missing formal institutions, such as contract enforcement and credit (McMillan and Woodruff 2002: 143; Estrin et al. 2006: 716), and even public goods such as roads, water, energy, and education (Uzor 2004).

An important contribution could be through making these economies more diversified. Diversification is important for peace and growth (Collier 2006: 12; Iyigun and Rodrik 2004). Diversity could result in less risk overall, and greater opportunities for knowledge externalities (Nelson 1991: 72). The latter could benefit from population heterogeneity that characterize many fragile states. Audretsch and Thurik (2004: 9) are of the opinion that ‘new ideas are more likely to emerge from communication in a heterogeneous than a homogenous world’. In this regard, the heterogeneity in many fragile states, which is often seen as a potential disadvantage, can indeed be a source of entrepreneurial innovation and growth.

Another contribution of productive entrepreneurship is that it could provide a source for what has been termed ‘radical innovation’ as against ‘incremental innovation’ to use the terms of Teece et al. (1994). Incremental innovations are based on existing competences

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<sup>8</sup> In sub-Saharan Africa alone, more than US\$18 billion per annum in infrastructure spending is needed to raise economic growth to a high enough rate (7 per cent) to achieve the MDGs by 2014 (Ndulu et al. 2007: 143). The rates of return on infrastructure projects have been found to be high in Africa—on average 35 per cent between 1999 and 2003 (Briceno et al. 2004). Although public funding is required, opportunities for entrepreneurial firms in the construction and related industries are thus likely to be significant in post-conflict fragile states. Furthermore, infrastructural investment will benefit entrepreneurship through creation of off-farm employment in rural areas, and improving linkages between urban and rural areas, which will boost retail trade.

of existing firms and are more in the form of the diffusion of knowledge. The latter is important for fragile states as a catch up mechanism and is most often obtained from FDI and trade—which is often the motivation for trade liberalization in these countries, and for policies that attract FDI. Keller (2004: 752) points out that for most countries, foreign sources of technology account for 90 per cent or more of local productivity growth. Imitation and incremental innovation remain important. However, what is ultimately needed in fragile states, particularly those in Africa, is radical innovation. Such entrepreneurship which is ‘innately destructive of the status quo’ (Fogel et al. 2006: 541) can serve precisely to undermine vested interests and even ‘crowd out’ rents by providing new and substitute opportunities (Baland and Francois 2000: 528). This is however also an important reason why new entrepreneurial ventures are often repressed in fragile states.

Although high-potential, pro-growth entrepreneurship has been stressed in this section, careful policy attention should still be given to forms of entrepreneurship that has less of a growth impact, but can still be productive. Many informal, lifestyle and survivalist entrepreneurs resort in this category. Although they do not make a significant impact on economic growth, it has been pointed out that this sector is often targeted for social and anti-poverty reasons. A significant number of entrepreneurs are active in these forms of businesses in developing and fragile states. For instance in Peru about 69 per cent of poor households in urban areas own a business, and in India, Pakistan, and Nicaragua between 47 per cent and 52 per cent of households own a business (Banerjee and Duflo 2007: 151). In rural areas, survey data from 13 poor countries reflects that between 25 and 98 per cent of rural households are self-employed in some form of agricultural activity (Banerjee and Duflo 2007: 151). Thus, where economies are failing, entrepreneurship is often a source of survival as well as autonomy where states are underperforming—a fact that is sometimes under-appreciated when governments harass informal traders or tolerate practices that discriminates against women, who often make up a disproportionate number of these survivalist entrepreneurs.

The policy objectives of governments, donors, NGOs and development agencies towards entrepreneurship in fragile states should be to recognize the importance of survivalist small entrepreneurs. Supporting these entrepreneurs can have a positive impact on poverty, or at least prevent poverty from progressively getting worse in certain circumstances (Sandy 2004). However, as Banerjee and Duflo (2007: 162) have pointed out ‘it is important not to romanticize these penniless entrepreneurs’. Indeed as economic prospects and opportunities deteriorate, and unemployment in the formal economy increases, this sector tends to expand. If policies to create the incentives for more high-growth impact ventures are successful, one should expect to see this survivalist sector shrink,<sup>9</sup> and not expand, following the U-shape relationship between development and self-employment rates (Acs 2006).

Given the potential of the right kind of entrepreneurship to contribute to development in post-conflict states, the question that could be asked is: how likely is entrepreneurship to be resurgent in these countries, conditional on the fact that the right structures and incentives can be put in place, and that the risk of falling back into conflict can be

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<sup>9</sup> One should therefore not see a rise in self-employment in developing countries necessarily as positive improvement in entrepreneurship.

minimized?<sup>10</sup> The answer is that the prognosis is good. Of about 214 stagnation episodes in 146 countries, sustained growth followed in 54 per cent of cases (Aizenman and Spiegel 2007).<sup>11</sup> More particularly, for countries ending war, subsequent growth is often high. The average rate of growth in a cross-country sample of post-conflict states for the five years following was 5.9 per cent (Przeworski et al. 2000). In many transition economies in East Europe, the former Soviet Union, and even China, the resurgence of the private sector has been underestimated (McMillan and Woodruff 2002: 153). Estrin et al. (2006: 694-95) documents the resurgence of the private sector in the EE-FSU, noting that the private sector share of GDP increased in most countries from around 0 per cent in 1989 to over 65 per cent by 2001. In China, one of the fastest growing countries in the world, the growth in entrepreneurship, as measured by self-employment, was explosive, not only in the richer coastal provinces but also in the rural areas where the number of self-employed increased by more than 30 million during 1988-95 (Mohapatra et al. 2007: 163). In Africa, there are many promising signs indicating that the private sector response to better incentives could be substantial. For example, in the mobile phone sector, where government regulation has been limited and private entrepreneurs the major initiators, the number of mobile phone users have increased from about 2 million in 1998 to over 100 million by 2006 (Ndulu et al. 2007: 154). This has important implications for future African growth, given that communication technology is an important determinant of imitative entrepreneurship (Schmitz 1989: 722).<sup>12</sup>

The likelihood of resurgent private sectors in these countries is further raised by the diverse (even by developed country comparisons) breeding grounds for entrepreneurs in many post-conflict countries. For instance, the circumstances and challenges that various communities and groups have faced during war, conflict, instability can be argued to have honed many entrepreneurial talents, and entrepreneurs can fruitfully emerge from a number of sectors, including households (in particular female-headed households), former state-run enterprises, traders (including smugglers, migrant entrepreneurs), immigrants, minority entrepreneurs, the emigrant community, young cadres/demobilized soldiers, university staff, as well as existing firms. Each of these groups has their own unique features, which together provides a rich tapestry of entrepreneurial talents which could be harnessed for post-conflict reconstruction and development.

In light of the contribution that productive entrepreneurship can make to peace and prosperity, and that the resurgence of the private sector can indeed be rapid under the right circumstances given the scope and sources of entrepreneurship, the question can be raised how to create the right circumstances for productive, pro-growth entrepreneurship? In the next section, I argue that a minimum of six dimensions need to be taken into account when designing entrepreneurial support strategies in post-conflict states.

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<sup>10</sup> The risk of falling back into conflict is a significant risk facing the development of entrepreneurship in post-conflict societies. In Section 4.1 below this risk is discussed in more depth.

<sup>11</sup> To underscore the point about new firm creation as a means to diversify economies, recent research finds that sustained growth after years of stagnation is more likely the more diversified an economy is (Aizenman and Spiegel 2007).

<sup>12</sup> Schmitz (1989) shows that imitation by entrepreneurs account for a significant amount of growth.

## 4 Promoting pro-growth entrepreneurship

As pointed out in the introduction, entrepreneurship in fragile states, and in particular states emerging from conflict, is an under-researched topic. The lack of data on entrepreneurship in these countries is therefore a constraint on policy design.<sup>13</sup> This does not mean that policymakers are without direction in terms of understanding and responding to the need to foster productive, pro-growth entrepreneurship in these countries. There is fortunately a rich literature on the conditions facing poor households and firms in fragile states and post-conflict situations, as well as a valuable literature on private sector development from the literature on the transition economies of Eastern Europe and the former Soviet Union (EE-FSU) (e.g. Smallbone and Welter 2001; McMillan and Woodruff 2002). It is also useful to examine the extensive literature on Africa's economic growth performance (see e.g. Fosu and O'Connell 2006; Ndulu et al. 2007)<sup>14</sup> through the lens of the literature on small business development and entrepreneurship. Within the latter there has been in recent years a significant growth in the literature on African firms (e.g. Bigsten and Söderbom 2005) which is, however, distinct from the literature that deals explicitly with African entrepreneurs. Indeed the literature on African entrepreneurs is unfortunately relatively small (see Naudé and Havenga 2007 for an overview of African entrepreneurship research) and mostly focuses on constraints facing informal entrepreneurs or their attributes.<sup>15</sup> However, from the various strands of literature noted there are important potential lessons for supporting entrepreneurial ventures, as well as useful suggestions for a future research agenda. In this section I draw out some of these lessons, and also identify avenues for further research.

### 4.1 Poverty, conflict, and entrepreneurship

A prerequisite for understanding how to support pro-growth entrepreneurship in fragile and post-conflict states is to understand the context of war, conflict, and poverty which characterizes these states, and how these determine the supply and allocation of entrepreneurial talent. A number of factors distinguish such states from others. The most important is probably the context and consequences of civil war/conflict. The economic consequences of war and civil conflict have been studied in detail, and most recent estimates suggest that the impacts of civil war, especially the indirect impacts, are substantial and tend to last long (Chen et al. 2007). This includes the direct costs in terms of destruction of infrastructure, diverted (military) expenditure as well as the much higher indirect costs of disruption of markets and increase in risk and uncertainty. Milanovic (2005) provides estimates that show that the poorest countries have lost almost 40 per cent of their GDP compared to the global average, and Collier (1999) finds that civil conflict depresses growth rates by about 2.2 per cent per annum on average. Lopez and Wodon (2005) calculate that Rwanda's GDP could have been 25 per cent higher in 2001 if it had avoided the genocide of 1994. Civil conflict also has spillover effects reducing growth in neighbouring countries (Murdoch and Sandler

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<sup>13</sup> It would be useful to have a longitudinal study of entrepreneurship in fragile states, similar in purpose to the Panel Study of Entrepreneurial Dynamics (PSED) in the USA (see Gartner et al. 2004).

<sup>14</sup> It is particularly important to focus on African countries in this current context, given the large number of conflicts on the continent. Cooper (2006: 22) state that 40 per cent of all current armed conflicts in world is taking place in Africa.

<sup>15</sup> See, for instance, the collection published as Volume 9 of the *African Perspectives Yearbook*.

2002), and has a negative impact precisely on those groups from which entrepreneurs typically emerge, namely young males, through raising their mortality and lowering their educational achievements.

In a post-conflict environment, the ‘overhang’ effects from the war create a number of possible threats to the emergence of productive, pro-growth entrepreneurship. The first is the possibility of a relapse into conflict, which is high—there is a 50 per cent risk of conflict renewal during the first five post-conflict years (Collier 2006: 19).

Second, war and conflict cements the stratification between various ethnic groups and communities which requires significant post-conflict reconstruction, and fair allocation of budgetary resources to various group, to sufficiently improve social capital (Addison 2001: 3).

Third, opportunities for rent-seeking are likely to abound. In post-conflict societies, whilst some of the original incentives for rent-seeking might seem to have been lessened, other opportunities often arise through the fact that aid and foreign investment levels often rise quite substantially, and the reconstruction of infrastructure and the creation of trade and tourism opportunities are often the target of entrepreneurs seeking preferential access to these. Aguilar (2004: 87) describes how preferential business licensing has resulted in the formation of powerful oligopolies in Angola, which have subsequently formed strong lobbies in favour of protectionism and the general stifling of reform. A related danger is that privatization—in itself potentially important to stimulate private sector development—may be hijacked as has happened in Angola, Mozambique, and in some of the EE-FSU countries (Addison 2001: 8).<sup>16</sup>

Fourth, possibilities for regulatory capture can encourage inappropriate forms of entrepreneurship. Many wartime entrepreneurs obtain substantial resources during (and because of) war and civil conflict. Post-conflict this poses the danger that, as has happened in the former Soviet Union, that entrepreneurs can finance post-conflict political parties and create a ‘compliant private media’ (Addison 2001: 13). In many African countries, the blurring of borders between the state and the party has also caused regulatory capture in many instances, with party officials’ business interest being advanced through their links with, and hold over, government officials (Aguilar 2004: 79).

Fifth, rent-seeking and regulatory capture, together with the differential impact of the war on various communities, will exacerbate income inequalities, which is in itself often a cause for further conflict, particularly in a socially stratified society. The higher the likelihood of a relapse, the stronger will be the incentive for entrepreneurs to engage in short-term behaviour that might be unproductive or destructive such as shifting assets. Evidence seems to suggest that the shorter the period of preceding conflict, the more likely such shifting of assets may be, unless entrepreneurs have high confidence in the credibility of various parties’ commitment to peace (Collier 1999: 168).

Six, the war overhang can have negative effects on pro-growth entrepreneurship through continued high spending on the military (Collier 2006). Conflict necessitated high

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<sup>16</sup> Lack of adequately defined property rights and transparency in privatization in the former Soviet Union lead to large amounts of assets being appropriated by entrepreneurs (Addison 2001).

military expenditure which created vested interests. This makes a reduction in military spending after the war difficult—and thus reduces the ‘peace dividend’ as well as creates pressures for fiscal deficit spending. The latter in turn gives rise to a high tax liability environment. As a result of shrinking tax bases as tax rates rise (e.g. through capital flight and a resort to ‘informal’ or parallel markets) governments typically resort to heavy taxes on international trade (Azam 2007). This creates strong incentives for smuggling, bribery, corruption, which are documented in virtually every case where trade taxes have become seriously distortive. High trade taxes and unsustainable fiscal deficit spending inevitably results in a high inflation environment, which contributes significantly to capital flight from post-conflict states (Davies 2007).

From the aforementioned discussion it is clear that war and conflict itself, being driven by ‘conflict entrepreneurs’, discourages the supply and allocation of entrepreneurship to productive, pro-growth activities. The signing of peace agreements unfortunately does not signal the automatic resurgence of pro-growth entrepreneurship; various characteristics of the conflict environment may create an overhang which, unless addressed, will maintain and create incentives for unproductive and destructive entrepreneurship to continue.

Therefore, post-conflict reconstruction should aim to raise the costs of conflict and make the benefits of co-operation as large as possible, as a general approach towards preventing a return to violence (Stiglitz 2006). Ways of doing this include the strengthening of networks (when likelihood of repeated future interaction is high the benefits of co-operation rises), breaking down of stratification (hence the necessity of ‘truth and reconciliation’ initiatives, nation building and governments of national unity) and strengthening social capital (reuniting communities, providing information, education, and peaceful outlets for political differences). It also includes political patronage. The latter may be the most frequently used approach in human history to limit violence. North et al. (2006) describes this in a historical context as a ‘limited access order’, which entails the placing of limits of access to economic and political opportunities by powerful individuals and groups in order to create rents, which are used to placate potential sources of conflict. Although the relative peace that this ensures is beneficial, and may leave substantial scope for productive entrepreneurship depending on the precise forms which limits to access takes, North et al. (2006: 72) sees the scope for economic development in such a limited access order as fundamentally limited, as against institutional arrangements which results in an ‘open access order’. The latter is most conducive to high-growth entrepreneurship, but is in the words of North et al. (2006: 72) ‘very difficult to engineer’. This may suggest that the imperatives and shorter term benefits of establishing peace in many conflict-ridden fragile states will tend to result in different types of limited access orders which may very be not conducive for productive, pro-growth entrepreneurship. Wolff (2007) recently postulated that Russia’s transition has ended up with its elites using the political system in such a way as to create rents which are then used to stabilize the political system. The consequence is an absence of civil war and conflict, but also a relative absence of pro-growth entrepreneurship.

Changes in the incentives of the structure of society that raise the costs of conflict and the benefits of co-operation are indeed very difficult to achieve, and requires an understanding of the institutional dynamics of policy reform and its relation to entrepreneurship.



## 4.2 Institutional reform and entrepreneurship

Frye and Shleifer (1997) classify governments as either providing an ‘invisible hand’, a ‘helping hand’, or a ‘grabbing hand’ as far as the private sector development is concerned. For fragile and post-conflict states the fundamental long-term challenge is to change governments from being invisible or grabbing hands towards being helping hands. Collier (2007) mentions in this regard that development requires opportunities and the ability to seize these—with governments preventing the seizure of opportunities. The latter happens through various deliberate and unintended barriers, including high costs of forming a business. A precondition for pro-growth entrepreneurship in post-conflict societies is therefore that governance and transactional trust be restored. This will entail, *inter alia*, the establishment of rules, regulations, property rights, contract enforcement, limiting the role of the state as an economic player, and lowering the costs of business formation (Fogel et al. 2006: 541), in other words, the creation of ‘good institutions’ (Estrin et al. 2006: 693). The stability and credibility of these reforms are important, and it is accepted that policy reform requires mechanisms to ‘lock in’ the reform, which in effect make reversals of reform measures more costly (Collier and Pattillo 2000).

As far as the design of good institutions post-conflict states are concerned, we are still largely in uncharted waters. A number of factors complicate institutional design, suggesting that although there may be certain core universal requirements, a one-size-fits-all approach to institutional design may be inappropriate. For one, institutions are endogenous (Acemoglu et al. 2005) and relatively little is known about the co-evolution of institutions, entrepreneurial behaviour and a country’s stages of development (Fogel et al. 2006: 572).

Second, ‘obvious’ policy reforms to create good institutions such as mentioned above (e.g. property rights, rule of law, etc.) may only be a necessary, but not sufficient condition for development. Iyigun and Rodrik (2004) note that many countries where much progress have been made in adopting these during the 1990s experienced low and disappointing growth, whereas countries with less enthusiasm for the received wisdom (e.g., China and Vietnam) achieved higher growth rates.

Third, institutional reform itself is an ongoing, dynamic process that needs to be managed with care towards its speed and consistency (Estrin et al. 2006). It creates uncertainties which can have unwanted outcomes for productive entrepreneurship to emerge, such as the entrenchment of former elites and a rise in rent-seeking behaviour (see Section 4.1).

Fourth, initial conditions may matter for the dynamics and success of institutional strengthening. These include the distribution of income and wealth before the commencement of institutional reforms and institutional building. High wealth inequalities may be associated with lower start-up rates. It also has to be recognized that during civil war, different households will have different means and opportunities to maintain or dispose of assets so that their post-conflict ability to start-up businesses will differ across the country and between various groups (Addison 2001; Brück 2006). Household structure, which in itself may be influenced by the war, will influence the subsequent start-up rate not only through the assets that may allocate towards new ventures, but also in its attitudes and experiences towards risk-taking, and existing

commitments (Brush and Manolova 2004: 39). Hence also the call for decentralization (see Section 4.6) of entrepreneurial support programmes. This suggests the importance of targeting various groups (also, in particular, women) and places in a country so as to have the best effect on start-ups. It also suggests that the borders between firms and households in fragile states are often blurred and that understanding households better may improve understanding of entrepreneurship in these situations.

Fifth, the wide variety of opportunities being exploited during a war, including survivalist behaviour and actions to profit from war are often criminalized in the post-conflict era before alternative profit opportunities are established. This is important to recognize in countries such as Afghanistan where it is estimated that up to 80 per cent of the economy is involved in drug trade and Angola where only 10 per cent of GNP is produced in the formal economy (Cooper 2006).

Six, one should recognize that post-conflict transition can go through various stages, as it did in the EE-FSU. Estrin et al. (2006: 697) document three phases, each with its own implications and opportunities for entrepreneurship. In the first phase they note that uncertainty will be high, but that many opportunities for arbitrage will exist. Policy should aim to reduce uncertainty (e.g. through macroeconomic and political stability) and encourage entrepreneurs to be active as traders and middlemen. In the second phase, longer-term investment will start to take place, as lower uncertainty and government stability give rise to public sector investment projects and the latter start to crowd in private sector investment. The efficient implementation of public sector investment projects and the attraction of external resources for investment (aid and FDI) are important policy objectives in this phase. The third phase is characterized by the deepening of institutions to promote finance, market exchange, and contract enforcement. Entrepreneurs in this phase will engage in raising levels of competition and the growing maturity of networks and national innovation systems will encourage technological transfers and innovation. Policy objectives during this phase should include the promotion of R&D,<sup>17</sup> university-based research, networking and clustering.

### **4.3 Displaced communities, minorities, and entrepreneurs**

War and conflict displaces communities and entrepreneurs. It also marginalizes and represses immigrants and minorities. Good entrepreneurs in particular are highly mobile. Conflict displaces entrepreneurs, weakening their social networks and family bonds (Addison 2001: 2). For example, during Mozambique's 18-year civil war it is estimated that more than 5 million people have been displaced internally and almost 2 million had emigrated (Ndulu et al. 2007). The 1998-2000 Ethiopia-Eritrean war displaced more than 1.5 million Eritreans (Addison 2001: 2-3). More than a million Afghans are estimated to have fled to Iran. The total number of refugees in the world today exceeds 10 million (Loescher et al. 2007), and the number of émigrés not counted as refugees but leaving due to uncertainties, persecution and the like probably amount to a similar magnitude. Solimano (2002: 17-18) discusses the prominence of

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<sup>17</sup> Should developing countries spend many resources on R&D? The answer would seem to be that it is not as vital, especially during the first stages of institutional development. For one, imitation may have higher returns initially. Two, spending on R&D can crowd out entrepreneurship with the result that there might be new ideas but not enough entrepreneurs to implement these (Michelacci 2003: 256). Three, empirical evidence finds that entrepreneurship is distinct from innovation and will contribute more than knowledge capital to economic growth (Audretsch and Keilbach 2004: 949).

'entrepreneurial migration' in recent years and its potential impact on developing countries. Very often the people who emigrate tend to be relatively skilled individuals. Ndulu et al. (2007: 157) quotes the International Organization for Migration which estimates that there are more African scientists and engineers working in the USA than there are in Africa.

Development of pro-growth entrepreneurship in post-conflict societies needs first of all to be able to limit the migration of skilled individuals, to mobilize the talent in their émigré population,<sup>18</sup> use their diasporas as sources of entrepreneurial finance,<sup>19</sup> to ensure policies for the recruitment of skilled labour and skilled entrepreneurs from elsewhere, and to improve conditions for immigrant and minority groups. These elements are most often neglected in entrepreneurship support during transition. A case in point is South Africa, where more than a million skilled individuals have left the country since 1994, precisely when the country entered its post-conflict transition phase. Two other elements that are also overlooked in theory and practice are that:

- (i) A growing number of individuals appear 'trapped' in protracted refugee situations which mean that they can be refugees for an average of up to 17 years (Loescher et al. 2007: 1); as refugees they face many restrictions which limit their capacity to engage in productive, pro-growth activities.
- (ii) Returning refugees, emigrants and demobilized soldiers often require access to land which, given the rural and agricultural basis of many start-ups ventures, can create substantial conflict, as in Angola, Ethiopia, Guinea-Bissau (Addison 2001) and more recently Zimbabwe.

In many countries where land reform and land distribution schemes are in place, intra-group conflict due to inappropriate or missing management of the land reform and redistribution process may limit the economic performance of such nascent entrepreneurs, and may have a negative impact on the ability of the agricultural sector to recover after conflict. In Angola, the displacement of the rural population during war, the legacy of the war in the form of landmines that remain buried in prime agricultural land, as well as uncertainties and difficulties in terms of land reform, have been recognized to have had a depressing effect on the ability of entrepreneurs to take up the many opportunities that exists in the country's agricultural sector (Aguilar 2004: 89).

While war and conflict displace people in a dramatic and visible fashion, poverty and small markets often lead to different forms of migration, namely temporary or cyclical migration, for reasons of trade. In many cases this migration crosses borders and assumes an international dimension. Muzvidziwa (2004) documents the case of thousands of Zimbabwean entrepreneurs, most of them women, who trade across borders on a daily basis despite being prosecuted. In many countries, rural-urban migration assumes such a cyclical nature, and can be seen as a rural household income diversification strategy (Azam 2007).

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<sup>18</sup> Haque and Kahn (1997) argue that international agencies should use national emigrants in technical assistance operations.

<sup>19</sup> Emigrant populations have been recognized as sources of funding for rebel groups during civil war. Currently a sizable fraction of African-owned wealth is held outside the continent—up to 39 per cent according to estimates of Collier and Gunning (1999). The total registered remittances by emigrants to their countries of origin almost exceeded US\$100 billion in 2004, an amount significantly larger than total aid to developing countries (Carling 2005).

Finally, in many fragile states and post-conflict environments it may be important to reconsider the roles of immigrant and/or ethnic (minority) entrepreneurs<sup>20</sup> as these are often important sources of productive entrepreneurship. The networks, business environment and inherited wealth associated with these communities are seen to confer entrepreneurial advantages on members of these communities (Munshi 2007: 1; Richman 2006: 384). In many of the least developed economies ethnic entrepreneurs play a valuable role, see for instance the role of Asian entrepreneurs in Kenya, Mozambique, South Africa, Tanzania and Uganda; Lebanese entrepreneurs in Liberia and Angola; and Chinese entrepreneurs in Cape Verde (see e.g. Egbert 2004; Sandy 2004; PRIO 2007).

However, ethnic (including immigrant and minority entrepreneurs) are often harassed and persecuted in many fragile states, and often find refuge in entrepreneurship due to political restrictions or being denied employment in the formal sector (Godley 2006: 608; Greene and Owen 2004: 27). During and after conflicts, these groups may face particularly difficult circumstances. This is especially true of minority entrepreneurs in Africa. Godley (2006: 605) for instance describes the expulsion of more than 155,000 Asians from Uganda in 1972 stating that these contained a significant number of entrepreneurs who migrated to the UK where they 'have had a disproportionate impact on entrepreneurship and entrepreneurial success'. In Angola, Lebanese entrepreneurs have been so successful that they have been seen as a threat to large state-patronized firms (Aguilar 2004: 88). The phenomenon of successful ethnic entrepreneurs is not limited to developing countries. In the USA start-up rates among blacks and Hispanics tend to be much higher than among whites (Gartner et al. 2004: 18). The Ewing Marion Kauffman Foundation (2007: 15-16) documents that high-skilled foreign-born entrepreneurs make a significant contribution to start-ups and innovation in the USA stating that 25 per cent of all venture capital backed firms in the country since 1990 have been started by immigrants.

#### **4.4 Market size, access, and entrepreneurship**

The capacity of entrepreneurs to find markets and co-ordinate production, distribution and marketing may be more important than technology, which they see as being readily available in many instances (Chandler 1990; Teece 1993). Although it is certainly the case that technology is not that readily available<sup>21</sup> in fragile states, it must be an important objective of entrepreneurial support in fragile states to improve the capacity of entrepreneurs to find markets, and have the means to market and distribute their products and services. First, following the destruction of infrastructure during war, investments in transport and trade infrastructure are vital (Naudé and Matthee 2007). Second, regional trade integration is important, especially to the large number of landlocked countries in Africa (Sachs et al. 2004). Third, efforts are required to get small firms to be able to export more, given the predominance of small firms in these countries. Currently, small firms export little and almost no internationalization of small firms and start-ups seems to take place in developing and fragile states, despite the clear

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20 Waldinger et al. (1990: 3) define ethnic entrepreneurship as entrepreneurship based on 'a set of connections and regular patterns of interaction among people sharing common national background or migration experiences'.

21 Keller (2004: 753) points to the fact that no global pool of technology exists, and that technology tends to be localized. Moreover, the tacit nature of much of technology implies that technological diffusion to fragile and post-conflict states will not be an automatic process.

need to find markets. Unfortunately little is currently known in the research literature on international entrepreneurship in fragile states.<sup>22</sup> For instance, in the recent *Handbook of Research on International Entrepreneurship* (Dana 2004) which has 40 chapters, there is not a single chapter on a fragile state or any of the least developed countries, such as those in Africa. Although it is difficult for small firms to export (see Söderstrom and Teal 2004; Naudé and Krugell 2004) it may be achieved, as shown by examples from a growing number of countries. A number of preconditions exist though over the short-to-medium term for greater exports as well as the eventual internationalization from entrepreneurial ventures in fragile states. One is the importance of networks and clusters (Dana and Wright 2004: 9; Schmitz 1995, 1999). There are different types of networks such as personal networks and organizational networks (Egbert 2004; Uzor 2004). Amongst organizational networks linkages amongst small firms are important sources of externalities, and linkages between small and larger (often more well-established firms) are important in realizing economies of scope, as when small firms can perform specialized functions for large firms (Altenburg and Meyer-Stamer 1999). Small firms can even become important for innovation through their linkages with larger firms, as in the USA where many large firms in effect outsource their R&D to start-ups (Schramm 2004: 109). Van Dijk (2004) describes the advantages provided by clustering of small firms in Burkina Faso, such as cost reductions, greater access to inputs, finance and training, and opportunities for co-entrepreneurship.

Personal networks can act as substitutes for missing institutions in fragile states in a number of ways, such as making reputational incentives stronger where court enforcement is weak; in providing trade credit where bank credit is limited, and in allowing entrepreneurs opportunity for 'portfolio' entrepreneurship to spread risk (Estrin et al. 2006: 716). Networks can also facilitate learning to export, which can help entrepreneurs in fragile states overcome the high fixed cost in exporting (Söderbom and Teal 2004). Despite the clear importance of networks and clusters in the literature, they also have shortcomings and limitations, which will depend on the country context, the type of network and the underlying reason or its existence. Thus, in many cases networks can inhibit, rather than promote innovation (Munshi 2007: 2). This is often the case in family-owned firms and firms in ethnic clusters (Egbert 2004). Wohlmuth (2004: 225) notes that the exclusivity of many networks in Africa may limit their impact on pro-growth entrepreneurship.

Finally, although the scope of markets for entrepreneurs in fragile states and those emerging from conflict needs to be enlarged, the perceived exports/trade from many such states have often been underestimated. Again, it is a case of entrepreneurs being inventive in finding markets and circumventing detection. One particular reflection of this is the low volumes of recorded trade between African countries, which according to Azam (2007: 1) is in all likelihood not the case due to smuggling and the informal economy, since 'any fieldwork, either in warehouses or near the borders, would convince the observer that a lot of trade was going on'. It may be important to find novel ways of support, and not criminalizing, much of the existing productive (but unrecorded) activities of entrepreneurs.

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<sup>22</sup> The field of international entrepreneurship studies the field of why, when and how entrepreneurs internationalize their firm. The March 2001 edition of *Small Business Economics* is devoted to the internationalization of small business.

## **4.5 Human and financial capital and entrepreneurship**

There is little doubt, also in entrepreneurial support programmes in developed countries, that human capital development and access to financial capital are significant requirements for the growth and development of entrepreneurs. I first discuss some aspects of the support for human capital and then turn to financial capital.

### *4.5.1 Human capital*

In a developing country context, it is frequently pointed out that it is management capabilities and management capacity that needs to be strengthened. Even the type of skills provided for entrepreneurship have been identified; entrepreneurs require multiple or balanced skills instead of specialization (Lazear 2004: 208). Management skills are particularly important in the present context for reasons of networking; efficient networking depends on appropriate organizational and management skills (Dana and Wright 2004: 9).

Internal differences in firms' management and organization in fragile and post-conflict states could therefore very well be an important source of the lack of growth and dynamism of these firms. There is however a relative lack of research on these 'industrial organization' and management aspects of entrepreneurs in fragile states. Nelson (1991) noted that economists often see differences between firms as a result of different environment, and not due to discretionary differences. Many economists working on firms in developing countries (see for instance the work based on the World Bank's Regional Enterprise Development Programme in Africa) take this position, and ascribe differences in firm behaviour in Africa (e.g. in terms of investment, exports, employment choices) as due to different market and business conditions. Thus, if these are changed according to prescription, then these firms are expected to behave more as other firms without the adverse market and business environment (e.g. Bigsten and Söderbom 2005).

Although it is undoubtedly accurate to infer that the external environment does impact on firm behaviour and the actions of entrepreneurs, it may also be the case that firm differences are discretionary due to, for instance, entrepreneurial strategies and aims (i.e. due to internal aspects of African firms). As put by Nelson (1991: 69) 'to be successful in a world that requires that firms innovate and change, a firm must have a coherent strategy that enables it to decide what new ventures to go into and what to stay out of. And it needs a structure, in the sense of mode of organization and governance that guides and supports the building and sustaining of the core capabilities needed to carry out that strategy effectively'. It may very be that traditional owner-managed firms and family/household firms in fragile states cannot implement new technologies or adopt strategies to broaden their markets because these are beyond their organizational capabilities. Changes in these organizational abilities of firms in fragile states may therefore be an important medium- to long-term strategy to raise growth.

Further research is needed to identify the factors that might be stifling organization change in fragile states and in African countries in particular. One such factor may be the lack of adequate education and training offered to women entrepreneurs (who often predominate during and after conflict) and which is reflected in the fact that profits of female-headed micro-enterprises in African countries tend to be in some case less than

half those of men (Addison 2001: 4).<sup>23</sup> Another such factor may be the lack of adequate 'national innovation systems' to promote change, technological advancement, and institutional deepening (Lundvall 1992). Nelson (1991: 72) notes as important in this regard are open, free and 'entrepreneurial' universities, a culture for scientific discourse, appropriate public infrastructure, legal frameworks, and support for R&D.

Related to the need for organizational changes and national innovation systems, is the fact that entrepreneurs need to perceive opportunities before they can exploit them. Once they have perceived opportunities, they need to create a firm as vehicle to utilize these opportunities (Alvarez et al. 2005: 6). The psychological (individual-level) aspect that influences this ability has not been adequately researched in the context of developing countries. Two issues in particular have however been noted. The first is the apparent lack interest by many poor people to seek opportunities. In a recent review of the behaviour of the extreme poor (those living with less than US\$1 per day) Banerjee and Duflo (2007: 165) are perplexed by the apparent lack of the poor to perceive opportunities, stating 'one senses a reluctance of poor people to commit themselves psychologically to a project of making more money'. This may, however, not only reflect a lack of psychological commitment, but also the fact that entrepreneurs have limited attention, and that in poor countries the environment is such that it attaches a very high opportunity cost for an individual to turn attention away from pressing matters in order to seek or perceive new opportunities (Gifford 1998: 17). It also prevents the absorption of difficult knowledge and therefore adversely impact on skills development support programmes (Lall 2000). This is often why manager-owners and family businesses have difficulty in innovating and adopting new technology, and why separation of management and ownership (entrepreneurship) may often be required for entrepreneurial ventures to emerge.

A second aspect is that the obstacles to create a firm once an opportunity has been perceived sometimes arise out of complexities associated with an ever increasing number of forms of business ownership—many of these perhaps incompatible with traditional institutional frameworks which sees private ownership and private property rights as essential in firm formation. Sun (2003: 17) describes a variety of ownership structures that have emerged in recent years such as employee-owned firms, farmer-owned co-operatives, and joint ownerships. He notes that the nature of the firm is changing and that 'a diverse pattern of enterprise ownership and governance is emerging'. This cautions against being too prescriptive in defining or supporting the formats that entrepreneurial ventures can take, and in being too much focused on the individual as the unit of analysis in entrepreneurship research and policy support (Hwang and Powell 2005: 201).

#### 4.5.2 *Financial capital*

Lack of financial support is often cited as one of the foremost constraints facing entrepreneurs. Evans and Jovanovic (1989) and Banarjee and Newman (1993) illustrated how access to finance is important for start-ups, and that the accumulation of personal assets is often necessary to start a business. Many macroeconomic reform

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<sup>23</sup> Research on women entrepreneurs in post-conflict states (e.g. Ethiopia, Mozambique) show that despite their hugely important role in these societies in general, they tend to be either necessity entrepreneurs, or find it difficult to exploit opportunities due to being marginalized (Stevenson and St. Onge 2005: 11).

strategies in developing countries have attempted to support financial sector stability, and financial ‘deepening’. Similarly, the lack of proper financial institutions in the countries of EE-FSU has been recognized as a factor limiting the adjustment of these economies to market economies. As a consequence, much international effort has gone into the development of so-called micro-credit programmes in developing countries, with notable examples of such programmes to be found in Bangladesh (Grameen Bank), Bolivia (BancoSol) and Indonesia (Bank Rakyat). The usefulness of these programmes as a manner of alleviating poverty in some countries has been noted (Schreiner and Woller 2003: 1567) although the absence of noticeable examples from Africa stands out. In fact Pitamber (2004: 494) is highly critical of micro-finance institutions in Africa stating that evidence is lacking that these programmes have had a noticeable impact on poverty. The implied context sensitivity of micro-credit programmes have also been illustrated by Schreiner and Woller (2003) who finds that micro-credit and micro-enterprise development programmes have been much more difficult in the USA than in developing countries.

Just as programmes successful in a developing country context do not work in a developed country context, so care has to be taken in attempting to duplicate financial systems from developed countries onto the reality of fragile states. For one, most entrepreneurs make use of own funds (savings) in establishing a business. Or where external funding is used, informal sources are most often used, instead of formal banks. The development of the formal bank system is therefore unlikely in itself to reduce financial constraints on entrepreneurial start-ups in fragile states. Indeed, despite the substantial theoretical literature on the role of finance (e.g. Banarjee and Newman 1993) it remains the case that empirical evidence on finance as a constraint is at best mixed (Munshi 2007; Paulson et al. 2006).<sup>24</sup> Furthermore, Lloyd-Ellis and Bernhardt (2000: 160) point out that frequent complaints by entrepreneurs captured in surveys about lack of access to finance ‘often masks technical and managerial inadequacies’. In fact, some authors doubt whether financial constraints are that binding on start-ups, and see it to be more important in the expansion of existing businesses rather than in the creation of new firms (Estrin et al. 2006: 702). This has to be seen against the observation that start-up requirements are often relatively small in developing countries (Lingelbach et al. 2005: 5). Also, it is unlikely that banks will ever be major financiers of entrepreneurial ventures (start-ups) in high-technology and science based industries, preferring low-risk firms—preferably ones that have been existing for some time so as to have a reputation and/or collateral (Audretsch et al. 2006: 146). The development of funding for high-tech entrepreneurial start-ups in fragile states is therefore an important objective. Such funding should take into consideration the possibility that a motivator for many people in developing countries for starting their own business could be control aversion, i.e. to be independent (autonomous), and that forms of finance which could reduce their control over their enterprise (such as venture capital funds) may not be attractive (Petty and Bygrave 1993).

The implication from this discussion is that a sufficient understanding of the role of finance in fragile states and post-conflict states is still lacking. Issues on which further research are needed, include the clarification of the relationship between entrepreneurial skills and finance, the capital requirements for start-ups in post-conflict and fragile

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<sup>24</sup> The debate about whether financial sector development causes economic growth or is a result of economic growth has also not been settled empirically (Calderon and Liu 2003: 322).



states, the context-specific forms of finance most appropriate in different situations and the need for funding of high-technology enterprises.

#### **4.6 Governments, entrepreneurs, and development of the private sector**

Having discussed how the context of war, the requirements of institutional reform shape the post-conflict environment for entrepreneurs in fragile and post-conflict states, and having pointed out the necessity of focusing on the displacement of people, their access to markets, education and finance is important, it remains to make a few remarks of the appropriate forms of government–private sector interaction that will be most conducive in this.

Clearly, although entrepreneurs in fragile states often provide substitutes for government functions, and co-exist with states with an ‘invisible’ or even ‘grabbing hand’, over the long run government support for private sector development is vital. Moreover, as economic historians and scholars in the field of industrial organization will argue, a ‘developmental state’ is required for long-run development of private enterprise (Lazonick 2007).

Private sector development (and more specific pro-growth entrepreneurship) in fragile states have been hindered not only through the adverse incentive structures which promoted unproductive and destructive forms of entrepreneurship, but also due to reductions in the capacity of governments to support private sector development (Wohlmuth 2004: 211) as well as strategies that were limited to macro-level issues instead of micro-level constraints. The latter have often entailed tied-aid as well as donor and international development agency support for privatization, liberalization and the reduction of the policy space of governments (Schulpen and Gibbon 2002: 1).

Although one should be mindful of the difference between entrepreneurship (entrepreneurial ventures) and small businesses, the latter has a potentially significant role to play in post-conflict states, as was remarked in Section 2. This means that government attitudes and approaches towards small and micro-enterprises should be such as to facilitate the emergence of high-growth entrepreneurial ventures, as well as to allow small and micro firms to be vehicles of autonomy and security. In many fragile and post-conflict states small businesses have been neglected. As pointed out by Wohlmuth (2004: 5) this is particularly the case in Africa. He notes that agricultural development strategies were biased towards large-scale, mechanized cash-crop type of ventures, manufacturing development was premised on large state-owned firms and multinationals, and information and communication infrastructure were neglected.

Not only should the appropriate vehicles for entrepreneurship development be the object of support, but it should be the right inputs required by entrepreneurial ventures that should be supported, rather than outputs. Governments and donors have in the past often targeted outputs (industries, state-owned firms, multinationals) for support rather than inputs such as knowledge and skills (Audretsch and Thurik 2004: 11). Because this can be difficult in a situation where government is itself constrained in terms of skills and knowledge, it is often more appropriate and effective over the short term to stimulate entrepreneurship through the elimination of barriers than to provide direct forms of intervention (see also Garret and Wall 2006: 525). The problem with this argument is the implicit assumption that entrepreneurship development will take place automatically once obstacles have been removed (Wohlmuth 2004: 4). Although the private sector is

resurgent in many cases as was noted in Section 3, support for inputs may be very necessary. With the availability of resources, support for inputs can take many forms. Schramm (2004) notes for instance the effective use of subsidies in the USA for R&D, small business innovation funds, government procurement from local high-tech firms, etc. Although spending on R&D subsidies is more appropriate during later stages of development (see Section 4.2), in resource-rich fragile states, where the extraction of resources have often been a ‘curse’ in that it resulted in conflict, rent-seeking, and adverse macroeconomic effects, strategies to benefit mineral resources may create opportunities for entrepreneurship—but dependent on government co-ordination of inputs such as technology and knowledge of markets.

Whatever modalities of support for small business may be forthcoming, it may be important to provide these in a decentralized manner. A shortcoming of many programmes is that they tend to be centralized. This reflects a general trend in most fragile states, particularly in Africa, for governments to centralize decision making (the so-called capital city bias). Thus decentralization, local economic development and spatial development initiatives were neglected in Africa (as against for instance Asia, specifically China, where local planning and marketing have been a much more prominent strategy). There are a number of benefits from decentralization of decision-making and small business support initiatives. The first is that entrepreneurs in small businesses in developing countries may be difficult to reach. This is because the number of small and micro firms is numerous, and they have few professional managers who may be members of national networks (Knott 2005: 393). Second, by promoting entrepreneurship from a national level, governments may miss supporting innovative activities which are very often localized (in regional clusters or networks) (see Audretsch and Thurik 2004: 12). Third, after conflict, infrastructural and other support for entrepreneurship is likely to have significant spatial differences. Brück (2006) emphasizes the importance of decentralization in the provision of public goods in post-conflict countries, illustrating the wide regional differences in experience of the war in Mozambique. Finally, decentralization of responsibility for economic development to local government level could improve locality marketing initiatives, the identification of local opportunities for investment, and better ties between local business chambers and local government structures (Jansen van Rensburg and Naudé 2007).

## **5 Summary and conclusions**

Although a number of countries are still engaged in conflict across the world, the total number of conflicts has been declining significantly since the early 1990s. As a consequence, a growing number of people in fragile states are enjoying post-conflict peace. The widely held view is that support for entrepreneurship can help these countries raise their prosperity and consolidate their peace, and that poverty in these countries is partly due to a lack of entrepreneurs. Is this view accurate? The simple answer seems to be that entrepreneurship may not automatically improve the peace and prosperity in post-conflict states.

Entrepreneurship is however, a ubiquitous quality in fragile and post-conflict states. It is not lacking as some would claim. Also, unproductive and destructive entrepreneurship implies that the establishment of peace may not automatically result in prosperity, and might even cause a relapse into conflict. To prevent unproductive and destructive entrepreneurship from derailing peace and prosperity, efforts to increase the supply of

entrepreneurship itself may be less important than efforts to change the allocation of entrepreneurial effort into productive entrepreneurship. How can this reallocation of entrepreneurial initiative be achieved?

In this paper I have suggested that there are at least six dimensions which need to be taken into consideration. First, the context of war needs to be taken into account. This environment may not only contain the seeds of its future destruction, but also inform our understanding of the incentives which affects the behaviour of various sources of entrepreneurship. Some of the most significant threats to productive entrepreneurship lie in the possibility of a relapse into war, in the myriad new opportunities for rent-seeking, in the possibility of regulatory capture by elites, and difficulties in controlling fiscal expenditures due to continued high military spending.

Second, the relationship between institutions and entrepreneurship, and the evolution of institutional reform need to be better understood. The design of good institutions for fragile states and post-conflict states are complex for four main reasons: (i) institutions are endogenous and relatively little is known about the co-evolution of institutions, entrepreneurial behaviour and a country's stages of development; (ii) 'obvious' policy reforms such as property rights, rule of law, etc., may only be a necessary but not sufficient condition for development; (iii) institutional reform itself is an ongoing, dynamic process which creates uncertainties which can have unwanted outcomes for productive entrepreneurship to emerge, such as the entrenchment of former elites and a rise in rent-seeking behaviour; (iv) initial conditions may matter for the dynamics and success of institutional strengthening.

Third, particular characteristics of entrepreneurship in poor and conflict countries need to be taken into consideration, in particular the roles played by ethnic/immigrant (minority) and diasporic entrepreneurs. Conflict displaces entrepreneurs, weakening their social networks and family bonds. Development of pro-growth entrepreneurship in post-conflict societies needs first of all to be able to limit the migration of skilled individuals, to mobilize the talent in their émigré population, use their diasporas as sources of entrepreneurial finance, to ensure policies for the recruitment of skilled labour and skilled entrepreneurs from elsewhere, and to improve conditions for immigrant and minority groups. These elements are a side of entrepreneurship support that is most often neglected in transition.

Fourth, attention needs to be given to the scope of the market. It must be an objective of entrepreneurial support in post-conflict states to improve the capacity of entrepreneurs to find markets, and have the means to market and distribute their products and services. Three ways in which this can be accomplished are: (i) to invest in transport and trade infrastructure, (ii) to further regional trade integration; (iii) and to get small firms to be able to export more. Furthermore, many entrepreneurs are already trading significantly across borders, perhaps also in illicit goods. It may be important to find novel ways of support, and where possible not to criminalize, much of the existing productive (but unrecorded) activities of entrepreneurs.

Fifth, human and financial capital requirements are critical inputs into the entrepreneurial process, but the kind and type of requirements cannot easily be transplanted from other contexts or countries. In fragile states human capital formation remains important in general, but on the level of the entrepreneur a twofold emphasis is

need, on strengthening general skills and on developing organization and management expertise. The latter is needed in light of the need for organizational evolution in fragile states. It may very be that traditional owner-managed firms and family/household firms in fragile states cannot implement new technologies or adopt strategies to broaden their markets, because these are beyond their organizational capabilities. Changes in these organizational abilities of firms in fragile states may therefore be an important medium to longer term strategy to raise growth. Finance will play an important part in firm evolution, although currently there are a number of issues on the modalities of financial sector development in post-conflict states that need to be settled. Indeed, a sufficient understanding of the role of finance in fragile states and post-conflict states is still lacking. Issues on which further research is needed include the clarification of the relationship between entrepreneurial skills and finance; the capital requirements for start-ups in post-conflict and fragile states; the context-specific forms of finance most appropriate in different situations; and the need for funding of high-tech enterprises.

Six, the relationship between government and the private sector in fragile post-conflict states need to be put on an appropriate footing, argued to be that of a developmental state, wherein governments remove barriers to business development, provide support on the input side of the entrepreneurial process and decentralize the provision of support measures and economic decision-making as much as possible.

When allocated to pro-growth entrepreneurial ventures, entrepreneurship can contribute towards peace and security, and transitions, in fragile and conflict states through a number of ways. Entrepreneurs create jobs, provide diversity, assume risk, provide goods and services, including even public goods, as well as provide an environment for learning, experimentation, innovation and competition. Moreover, entrepreneurs fulfil a 'cost discovery' function in making sunk costs in a new activity which *ex ante* may or may not be profitable, but which will provide information *ex post* on such profitability to other entrepreneurs. In doing so, entrepreneurs provide information on what an economy can be good at producing, which in the context of fragile and post-conflict states is information that may be fundamentally lacking. Furthermore, entrepreneurs generate change from inside the country and its economic system, rather than from the outside. By providing vehicles for individual social mobility entrepreneurship can also be important for conflict reduction. Entrepreneurship is also a source for what has been termed 'radical innovation' which is 'innately destructive of the status quo' and which can undermine vested interests and even 'crowd out' rents by providing new and substitute opportunities.

Although high-potential, pro-growth entrepreneurship has been stressed, careful attention should still be given to forms of entrepreneurship that has less of a growth impact, but can still be productive such as informal, lifestyle and survivalist entrepreneurs. Although they do not make a significant impact on economic growth this sector is supported for social and anti-poverty reasons, specifically through support to the high proportion of small and micro-enterprises that proliferate in the aftermath of war. Despite certain disadvantages of being small, and having noted that the environment in fragile states often inhibits the growth of firms, the fact that most firms in fragile states and post-conflict societies are small firms, are not in itself problematic. Unshackled from constraints these firms may have the flexibility to utilize opportunities that larger firms, including state-owned enterprises and multinational firms, cannot take on. However, I argued that despite the potential importance of existing small firms, it

may in fact not be in existing firms that the future growth of fragile states and post-conflict states reside but in the creation of new firms, i.e. start-ups. Start-up firms are the ones most likely to grow and to create new jobs. In many transition countries, where there were no significant private sectors to start with, new firms often strengthened reforms by improving economic conditions. New firms can be important in a transition context in a post-conflict society since they are less encumbered with the historic influences of such a society as opposed to existing firms which may themselves be undergoing reform, and that some form of private sector development could be a condition for successful privatization of inefficient state-owned firms.

Finally, despite the useful light that many strands of the existing literature on fragile states and entrepreneurship throw on the design of post-conflict entrepreneurial support strategies, our understanding of entrepreneurship in such circumstances remain limited given that entrepreneurship in fragile states is a significantly under-researched topic. The consequent lack of data on entrepreneurship in these countries remains a constraint on policy design.

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