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## **Entrepreneurship and Political Stability in the Middle East and Northern Africa**

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Frank R. Gunter PhD  
Professor of Economics, Lehigh University  
Senior Fellow, Foreign Policy Research Institute  
[frg2@lehigh.edu](mailto:frg2@lehigh.edu)

### **Abstract<sup>1</sup>**

Over the last half century, almost a third of all countries have undergone conflicts that involve more than a 1,000 violent deaths in a single year. Among the countries currently experiencing conflict in the Middle East and North Africa (MENA) region are Egypt, Iraq, Israel, Sudan, Syria, West Bank and Gaza, and Yemen. What are the salient characteristics of the demand and supply for entrepreneurship in these countries? What is the impact of increased entrepreneurship on political instability? And what can be done to encourage entrepreneurship in politically unstable states? Despite the social, political, and economic diversity of this set of nations; it is found that their political instability/conflict has produced similar barriers to entrepreneurship. And these barriers - political instability/conflict, poor governance, regulatory hostility to private business, and widespread corruption - are tightly interwoven and therefore tend to resist a piecemeal approach.

### **Introduction**

Much of the research on accelerating economic development in politically unstable/conflict countries has focused on stabilizing the country's macroeconomy and

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ensuring that the government is reasonably efficient at rebuilding infrastructure. (Brauer and Dunne 2012; Cramer 2009, p. 129; and Stevenson 2010, p. 171.) While there have been some partial successes with this “top-down” approach, it is generally viewed as an expensive failure. (Schramm 2010, pp. 90-91; Patterson 2010, p. 226) According to del Castillo: “...good macroeconomic management is necessary but not sufficient for the reactivation of investment, trade, and employment.” (2008, p. 290) Not only do most of these macro-oriented economic programs fail to deliver accelerated development and the accompanying improvement in living standards; they appear to do little to reduce political instability. There appear to be at least two reasons for the failure to deliver either economic development or increased political stability. Such programs generally do not lead to the creation of productive jobs and they tend to worsen corruption.

Encouraging entrepreneurship in a politically unstable/conflict country – sometimes referred to as expeditionary economics - is a “bottom-up” approach to increasing political stability by encouraging private sector job creation through productive entrepreneurship while reducing the incentives for corruption. The seminal works on entrepreneurship in conflict states are Naudé 2009 (pp. 251-263), Schramm 2010 (pp. 89-99) and the “Entrepreneurship and Conflict” issue of the *Journal of Conflict and Resolution* (edited by Brück, Naudé, and Verwimp, 2012).

Aside from these efforts, research on the relationship between entrepreneurship and political instability/conflict is in its infancy. (Brück et al 2012, p. 9) Two examples are that Casson et al’s 2006 *Oxford Handbook of Entrepreneurship* has no chapters or even index entries for conflict, political instability, or war while Coyne and Mathers 2011 *Handbook on the Political Economy of War* is silent on the subject of entrepreneurship.

This paper attempts to extend existing research in several directions. After a discussion of the characteristics of MENA politically unstable/conflict states, it integrates entrepreneurship into a specific model of political stability. It then distinguishes between innovative and arbitrage/speculative entrepreneurship and discusses their different effects in low-income politically unstable countries. Next, it argues that public sector jobs and private sector jobs have different effects on political stability. This is followed by a discussion of the relationships among political instability/conflict, corruption, and entrepreneurship. The paper ends with a discussion of pro-entrepreneurship policies appropriate for the MENA region.

### **Characteristics of Politically Unstable States**

Over the last three decades, there has been extensive research on the characteristics of conflict states. But among the MENA states, there are countries that share some of these characteristics and yet have not collapsed into conflict. So rather than limit this study to those MENA countries currently engaged in conflict (Iraq, Israel, Sudan, Syria, West Bank and Gaza, and Yemen), it will examine countries that suffer such severe political instability that conflict is considered likely. (Themnér and Wallenstein 2012, Appendix 1, p. 573) In other words, this paper will examine the characteristics of not only conflict MENA states but also what might be considered “pre-conflict” or “potentially conflict” states.

Table 1 is a list of twenty MENA countries listed in the order of their likelihood of achieving and maintaining peace according to the Global Peace Index (Institute for Economics and Peace, 2014). The countries listed as “Very Low” – Iraq, Sudan, and

Syria – are currently suffering from high levels of internal or cross border conflict deaths while those ranked “Low” are either suffering from lower levels of conflict deaths or are perceived to have the potential for an outbreak of violence.

Table 1: Characteristics of MENA States

Country	Global Peace Index (2014) (Higher is better)	Population (2012) (millions)	Pop Young (<15 years)	Youth Unemployed M/F	GDP (2012) (PPP) (percap)	Gini Index (0 = income equality)
Qatar	Very High	2.1	13%	1%/10%	\$88,400	41
Jordan	High	6.3	34%	26%/51%	\$6,000	35
Kuwait	High	3.3	25%	11%/6%	\$47,800	NA
Morocco	High	32.5	28%	18%/16%	\$5,100	41
Oman	High	3.3	24%	18%/31%	\$25,300	NA
Tunisia	High	10.8	23%	30%/27%	\$9,200	36
UAE	High	9.2	14%	8%/22%	\$41,400	NA
Saudi Arabia	High	28.3	30%	21%/56%	\$30,200	NA
Algeria	Medium	38.5	27%	19%/36%	\$8,400	35
Bahrain	Medium	1.3	20%	25%/32%	\$22,300	NA
Libya	Medium	6.2	29%	19%/34%	\$16,800	NA
Iran	Medium	76.4	24%	26%/41%	\$11,400	38
Egypt	Low	80.7	31%	24%/65%	\$6,500	31
Israel	Low	7.9	28%	12%/13%	\$30,400	39
Lebanon	Low	4.4	22%	23%/22%	\$14,200	NA
Yemen	Low	23.9	41%	28%/52%	\$2,300	38
Iraq	Very Low	32.6	41%	29%/54%	\$7,500	31
Sudan	Very Low	37.2	41%	22%/27%	\$2,100	35
Syria	Very Low	22.4	35%	15%/41%	\$5,100	36
West Bank & Gaza	NA*	4.0	41%	34%/40%	\$2,900	36

\* While the Institute of Economics and Peace doesn't evaluate the West Bank and Gaza, these territories will be considered as having a Low or Very Low likelihood of peace.

Sources: Global Peace Index from Institute for Economics and Peace, 2014; Population, percentage of young, youth unemployment, per capita GDP, and Gini from World Bank, World Development Indicators, 2014b.

The eight countries with a low or very low probability of peace – high probability of conflict – have relatively few economic characteristics in common. One of the

strongest empirical relationships in the literature of the economics of conflict is the high correlation between low per-capita incomes and the propensity for conflict. (Blattman and Miguel 2010, p. 4) And this pattern appears to roughly hold among the countries in Table 1. However, among the MENA ranked “low” or “very low”, there is a wide range of per-capita incomes. Yemen, the Sudan, and the West Bank and Gaza are low-income countries where the average person struggles to survive on less than \$8 per day. At the other extreme, Lebanon and Israel have average per capita incomes more than five times greater. Countries also differ in the variance of their per capita income with the countries that experience the greatest year-to-year income changes tending to have economies dependent on the production and export of a single product such as oil. There is also wide variance in the percentage of each country’s population that is experiencing severe absolute poverty, defined by the World Bank as less than \$1.25 per day. Syria reports extremely low levels of absolute poverty – 2% or less - while in the Sudan and Yemen, almost 20% of the population lives in such severe absolute poverty.

One characteristic that these eight countries have in common is a young population. With the exception of Lebanon, each country has a greater percentage of young persons than the average for countries of similar levels of income. (World Bank 2014b) And, while MENA unemployment and underemployment data are notoriously unreliable, unemployment falls disproportionately on the young. Youth unemployment accounts for an average of 53% of total unemployment. And except for Israel, Jordan, and Lebanon; mostly young first time job seekers account for 50% or more of total unemployment. The most extreme case is Egypt where first time job seekers account for over 90% of total unemployment and where a college graduate is ten times more likely to

be unemployed as someone with just an elementary education. (World Bank 2004, p. 90; Acs et al 2013, p. vii)

Combined with underemployment, the situation among young persons appears especially dire. For example, in Iraq, an estimated 51% of the labor force is either unemployed or underemployed but, for those between the ages of 15 and 19, the combined unemployment and underemployment rate rises to 82%! (Gunter 2013, Table 2.2, p. 15) A large number of young people with little hope of obtaining employment would seem to be a contributing factor to political instability or conflict since the willingness to become a rebel rises as the opportunity cost of this choice falls. (Blattman and Miguel 2010, p. 10) But the relationship between employment, economic development, and political stability is probably more complex than a correlation implies.

### **Economic Development and Political Instability**

That economic deprivation tends to lead to political instability is one of the most widely accepted hypotheses concerning conflict. (Dumas 2011, pp. 598-600) In fact, in an extensive cross sectional analysis of the origin of civil wars, “rapid economic decline” was the only variable that was a statistically significant cause of civil conflict. (Collier 2000, p. 97) But it is important to understand the mechanism(s) connecting economic growth and political stability if policies are to be developed to reduce the probability of political instability or conflict.

Samuel Huntington’s 1968 hypothesis of the relationships among modernization, economic development, and political stability has been described as the last great attempt to integrate the social, economic, and political causes of instability. (Fukuyama 2011, p.

IX) There are more elaborate recent models of the relationships between economic and political change but Huntington's hypothesis provides a solid framework for examining the challenges facing low-income conflict countries.<sup>2</sup>

Huntington attempted to explain an oft-observed phenomenon that: "Modernity breeds stability but modernization breeds instability." (1968, p. 41) In other words, high-income countries generally experience less political instability or conflict. However, low-income countries that experience an acceleration of economic growth tend to experience *more* political instability or conflict. Huntington explains this counter-intuitive result by looking at the rates of change of modernization, economic development, opportunities for mobility, and political institutions. His hypothesis is illustrated in Figure 1.

Urbanization, increases in literacy and education, and increased exposure to media lead to social mobilization. People in low-income countries begin to realize that there are more satisfying ways of living. For example, on the village TV residents see shows where people don't have to walk to work, aren't limited to farming with hand tools, and where sick children have access to medical care. This social mobilization leads to expanded aspirations. People begin to believe that progress is possible and they want a better life for themselves and their children.

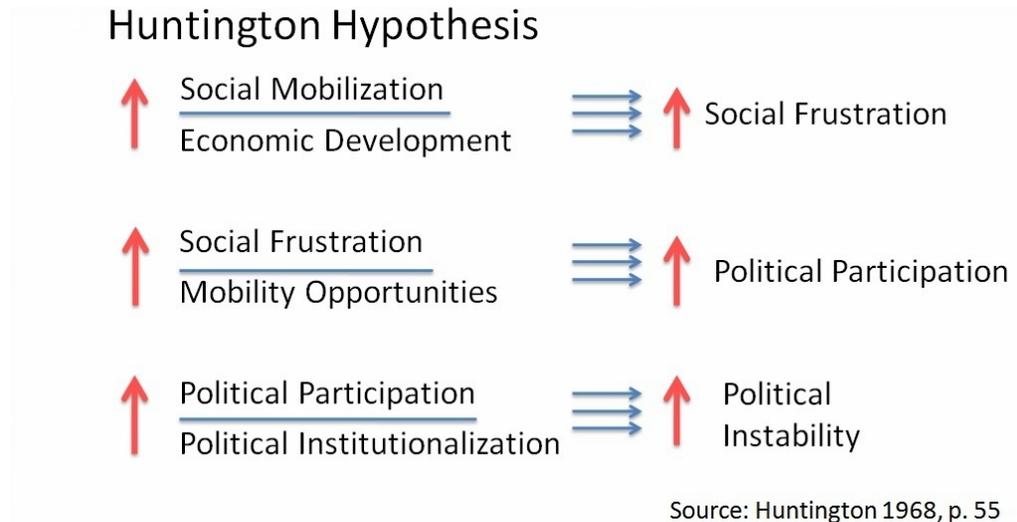
Economic development increases a society's capacity to satisfy those aspirations. It doesn't have to be immediate or complete e.g. farmers may be aware that others have trucks but if they are able to buy motorbikes then this may partially satisfy their new-borne aspirations - at least for a while. However, if economic development lags too far

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<sup>2</sup> For an example of an alternative model, see Acemoglu and Robinson, 2006.

behind in fulfilling the growing aspirations created by social mobilization then social frustration – a growing dissatisfaction with current circumstances – will increase.

**Figure 1**



Social frustration can be dissipated if a society allows opportunities for mobility. This mobility can be geographic (people moving from one province to another or from rural areas to urban), occupational (moving to a higher-paying/higher-status job/profession), or international (migrating to another country – “brain drain”). However, if social frustration grows faster than can be dissipated by mobility then people will want increased political participation in order to demand that the government either accelerate economic development or increase mobility. People will seek to either join existing political organizations or create new ones in order to give voice to their demands.

Demands for expanded political participation often collide with closed or inflexible political institutions that are intended to protect the interests of those currently in positions of power. Such institutions will limit the meaningful incorporation of new political participants. This exclusion will provide fertile ground for political instability or

armed conflict. Huntington argued that one determinate of political flexibility is age; the longer a political institution survives, the more flexible it becomes – the more open to new participants. (1965, pp. 394-395) Newly created political institutions especially those still controlled by their founders tend to be more inflexible since during the early years of such institutions, political influence is limited to trusted insiders. Opening political institutions to outsiders is seen as a sign of weakness or disloyalty to the founders. This collision between demands for expanded political participation and closed political institutions is perceived as one of the causes of the political instability that began in Egypt early in 2011 and has now spread throughout the Middle East and North Africa.

Entrepreneurship can impact the Huntington model in at least three ways. First, entrepreneurship can accelerate economic development and increase productive employment. This will reduce social frustration, as faster economic development and meaningful employment allows more peoples' aspirations to be met. Second, entrepreneurship can provide opportunities for increased mobility to large numbers of people. (Naudé 2009, pp. 253-254) They have the opportunity of moving from being a wageworker to being self-employed. This mobility as a result of entrepreneurship will, at least partially, offset any increases in social frustration that do occur. Finally, organizations of entrepreneurs can seek the adoption of policies more favorable to economic development through organized lobbying. But what type of entrepreneurship is most needed in low-income countries?

## **Entrepreneurship and Economic Development**

There is still no consensus on the definition of entrepreneur or entrepreneurship. (For a summary of eight widely used definitions, see Kayed and Hassan 2011, Table 2.1, p. 28) Some analysts prefer a definition that entrepreneurship specifically involves those who make “judgmental decisions”, decisions where there is no obviously correct answer *and* information is costly. (Schumpeter 1934/2008, p. 85; Casson 1987, pp. 151-153).

However, it is difficult to empirically test hypotheses using this definition since such “judgmental decisions” cannot be readily observed. As a result, many researchers adopt a definition of entrepreneurship that lends itself to empirical study. For example, Brück et al define entrepreneurs as: “...people who create and manage a firm and who are classified as either being self-employed or earning income from a small-business source.” (2012, p. 6) This definition includes the arbitrage/speculative entrepreneurship associated with Kirzner, the innovative Schumpeterian entrepreneurship, as well as firm owners who are not entrepreneurs. But does the wide inclusiveness of this definition limit its usefulness?

While most entrepreneurs operate small businesses, most small business operators are rarely - if ever - entrepreneurial. (Bozzoli 2012, p. 119) Therefore, the use of small business owners as a proxy for entrepreneurship in empirical studies may give ambiguous or counter-intuitive results. For example, since the proportion of self-employed tends to decrease as an economy develops, a few researchers have argued that there are an excessive number of entrepreneurs in low-income poor countries. And yet anecdotal evidence often points to great waste in these same countries as a result of the lack of the lack of arbitrage by local entrepreneurs. Different characteristics of small businesses and

entrepreneurs also lead to substantially different policy recommendations. (Kayed and Hassan 2011, Table 2.2, p. 46)

Another approach to defining entrepreneurship is to restrict analysis to certain sectors such as information technology that tend to be associated with innovative entrepreneurship in high-income countries. As discussed below, these studies run the risk of ignoring most of the entrepreneurial activity in a low-income country.

A final approach to a definition is to rely on self-identification. Small owner-operators are surveyed in an attempt to determine whether they see themselves as primarily motivated by necessity or opportunity. Only the latter are considered entrepreneurs. These survey results must be interpreted with care because the cultural connotations of entrepreneurship differ substantially among countries. In some countries entrepreneurs are envied while in others they are derided as a type of thief.

This paper rejects the empirical definition of Brück et al (2012 p. 6) and others. Instead, a definition consistent with the early theory of entrepreneurship is utilized: “Entrepreneurs are individuals who, in an uncertain environment, recognize opportunities that most fail to see and create ventures to profit by exploiting these opportunities.” (Gunter 2012, p. 387) Admittedly, this definition makes empirical work difficult but helps in the identification of the critical issues involving entrepreneurship in politically unstable MENA states.

In addition to a diversity of opinion concerning the best definition for entrepreneurship, there is also disagreement on the most useful subcategories. One common distinction is between necessity (survivalist) entrepreneurship and opportunity entrepreneurship. The former type results from an inability to obtain any other form of

employment while the latter is a true choice of self-employment in order to gain a better life. (Naudé 2007, p. 2) In low-income MENA countries, most small businesses are created from necessity. (Noland and Pack 2007, pp. 243-244)

Another valuable distinction is among productive, unproductive, and destructive entrepreneurship. Productive entrepreneurship results in increased economic value. Unproductive entrepreneurship redistributes economic value while destructive entrepreneurship actually destroys economic value. (See Baumol 1990; Naudé 2007, pp. 3-5; and Desai et al 2012.) Corruption would be a case of destructive entrepreneurship. There is a third possible distinction that has less attention and yet is critical to understanding the impact of entrepreneurship in low-income conflict countries.

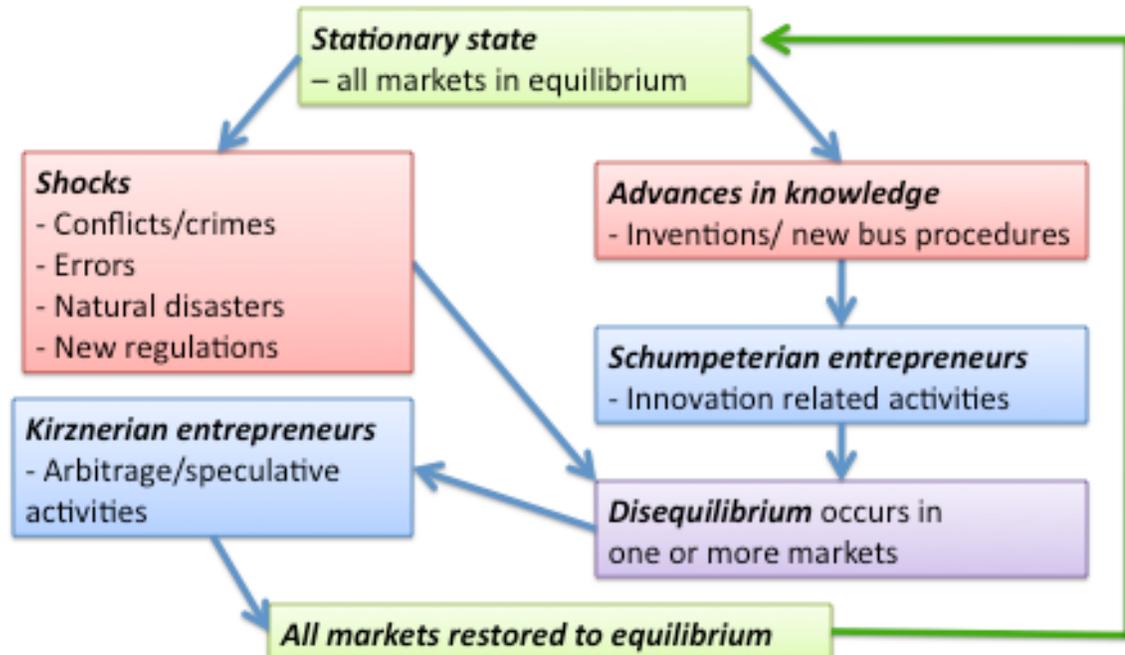
Both arbitrage/speculative (also known as Kirznerian) entrepreneurship and innovative (or Schumpeterian) entrepreneurship occur in most countries. They are difficult to distinguish both in theory and in practice. (Baumol 2010, pp. 13-16) One distinction is that Kirznerian entrepreneurs seek to earn a profit by arbitraging or speculating within existing markets, products, and processes while Schumpeterian entrepreneurs create new markets, processes, or products.

Many researchers on entrepreneurship in low-income countries conflate Kirznerian and Schumpeterian entrepreneurship into a general category of “entrepreneurship”. (For example, see Naudé 2009 pp. 251-254) However, arbitrage/speculative and innovative entrepreneurship not only have different complimentary inputs but also have different effects on the economies of low-income countries.

Since most research on entrepreneurship occurs in high-income countries, it tends

to focus on the challenges facing innovative (Schumpeterian) entrepreneurship – entrepreneurship that creates new products, processes, or markets. However, the less-studied arbitrage/speculative entrepreneurship may be more relevant to increasing productive employment in low-income countries especially during periods of political instability. The complex relationship between the two types of entrepreneurship is illustrated in Figure 2.

**Figure 2: Stationary State and Entrepreneurship**



Source: Gunter 2012, p. 389

A country that never experiences any changes in products, processes, or markets – a stationary state – has no need for entrepreneurs. Of course, in the real world, unexpected change is a given and the nature of a change determines the type of

entrepreneur demanded. Shocks create demand for Kirznerian arbitrage/speculative entrepreneurs while advances in knowledge create demand for Schumpeterian innovative entrepreneurs. Shocks can take a variety of forms. An act of war could destroy an electrical generation plant, a hurricane could devastate a crop just before harvest, human error could wreck a train in a tunnel, or an unexpected new government regulation could require the abandonment of a widely used fertilizer. These shocks lead to market shortages or overages, waste, or inefficiency - market disequilibria – and economic growth slows. A country experiencing these shocks will produce less than its potential.

However, these shocks also create opportunities for profitable arbitrage by buying low and selling high. (Kirzner 1979, Chap. 7) For example – in response to the first shock listed above – an entrepreneur might import portable generators in order to sell black market electricity. In other words, arbitrage/speculative entrepreneurs - motivated by profit – reallocate existing resources using existing methods in existing markets. To the extent that these entrepreneurs are successful, shortages or overages will dissipate, waste will be reduced, and efficiency will increase resulting in accelerated economic growth and job creation. The country will return to its potential level of production.

In high-income countries, the process of arbitrage/speculative entrepreneurship tends to be so efficient as to be almost invisible. There is widespread availability of information on various options. Also, transportation and commercial systems generally support rapid responses to changes in demand or supply. It is only during a natural disaster such as a blizzard or flood that failures of arbitrage/speculative entrepreneurship become evident. But in low-income politically unstable/conflict countries, the arbitrage/speculative entrepreneurship necessary for resolving market disequilibria is

often lacking. Perverse regulations, ignorance, inability to access complementary inputs, and security concerns may result in disequilibria lasting for extended periods of time accompanied by abnormally high unemployment and underemployment. An example from 2006 Iraq illustrates the failure of Kirznerian entrepreneurship in a conflict state. Tons of tomatoes lay by the side of a road because those who had workers couldn't get a loan to rent trucks, those who had trucks couldn't get black market fuel, those who had access to black market fuel couldn't get a license to transport tomatoes to another province, etc. In the absence of Kirznerian (arbitrage/speculative) entrepreneurs; the tomatoes rotted while workers and trucks sat idle.

Advances in knowledge can also disrupt a stationary state. These advances provide profitable opportunities for Schumpeterian innovative entrepreneurs to engage in creative destruction when they create new products, processes, or markets while disrupting the old ways of doing things. In other words, as a result of Schumpeterian creative-destruction, a country simultaneously experiences an increase in its economic potential as well as the creation of disequilibria in existing markets, which puts the country inside its newly expanded production possibility frontier. (Schumpeter 1911/1983) Of course, these disequilibria create new opportunities for Kirznerian arbitrage or speculation.

Because of the low levels of physical and human capital in low-income states, the social costs of Schumpeterian innovative are high and generally exceed the social benefits. Fortunately, unlike arbitrage/speculative entrepreneurship, innovations can be imported. Since knowledge is non-rival and only partially excludable, it tends to spill over from knowledge creators even if they are in another country. (Arrow 1962 and

Romer 1990) Thus it is possible for a low-income conflict country to obtain innovations through foreign investment. A country can survive and possibly thrive without domestic Schumpeterian entrepreneurs. But without domestic Kirznerian entrepreneurs, economic development and private sector job creation will stall. Naudé proposes a more realistic view that the need for different types of entrepreneurship depends on the phase of conflict. The initial emphasis in development should be on encouraging arbitrage/speculative (Kirznerian) entrepreneurship while efforts to encourage innovative (Schumpeterian) entrepreneurship should wait until there is evidence of substantial private sector long-term investment. (2009, p. 253 and 257) *Low-income conflict countries have a great need for Kirznerian entrepreneurs; Schumpeterian entrepreneurs – not so much.* (Gunter 2013, pp. 184-185) But are jobs created in the private sector by entrepreneurs superior to those provided by a government?

*Not every job is a real job*

In most MENA countries, the government has acted as an employer of “first resort” since the end of Colonialism. Socialist or corporatist development strategies led to a government-labor social contract that combined nationalization of industrial property with a constitutional right to work. (Abraham et al 2002, pp. 22-25; World Bank 2004, Table 2.2, p. 32) In low-income politically unstable countries, officials have an even stronger motivation to attempt to reduce unemployment by expanding government employment. (World Bank 2011, pp. 161-162) This policy is based on an opportunity-cost theory “...that gainfully employed young men are less likely to participate in insurgent violence.” (Berman et al 2011, p. 496) Increasing government employment is

generally a popular policy since working for the government often provides better pay, more benefits, stronger job security, and reduced work intensity compared to private sector jobs. (Stevenson 2010, p. 185; World Bank 2004, p. 95) Also, international advisors often support the rapid expansion of government employment since it provides a measurable means of reducing unemployment - especially among difficult to employ uneducated/untrained young men – and puts money in circulation. (del Castillo 2008, pp. 296-297)

Government employment in MENA countries averages almost 21%. And if government employment is combined with employment in state owned enterprises, the proportion is still greater. For example, combined direct and indirect government employment accounts for about 60% of the labor force in Algeria, over 50% in Iraq and Jordan, and an estimated 35% in Egypt. (Abrahart et al 2002, Table 2.1 p. 23 and p. 24; Gunter 2013, p. 16) But does an expansion of government employment actually reduce political instability?

Years of almost guaranteed government employment for educated youth in the MENA countries has contributed to politically destabilizing high youth unemployment rates in at least three ways. First, the non-salary benefits of government employment are so great compared to the private sector that many young people would rather devote their efforts to striving for a government job rather than accept one in the private sector. Second, accompanying MENA government dominance of labor markets has been the proliferation of labor regulations that severely distort the labor market in the private sector. Finally, the high returns to education in MENA government employment has led

young people to seek degrees such as administration and law that are not of great value in the private sector of a low income country. (World Bank 2004, p. 126)

In addition, it is often a misnomer to refer to the expansion of government employment as real job creation. A job implies an exchange. The worker provides something of value to his or her employer – labor and human capital – and, in exchange, the employer provides something of value to the worker - a paycheck. Since this exchange is valuable to both parties, they develop a commonality of interests – a limited form of loyalty - since if the firm goes out of business then both the owner and the workers are worse off.

Contrast this to workers in government employment in low-income politically unstable MENA countries. The loyalty of these workers is rarely to the government or to the public at large but rather to the particular political, religious, tribal, militia, or family member who arranged for their government paycheck. This is especially true if the government job requires little labor or even attendance. In Iraq, it is estimated that in some government Ministries, as many as 25% workers are “ghosts”. These ghost workers receive a regular paycheck without having to show up for work. In Egypt, it is a common complaint that bureaucrats operate private businesses using their government offices. The combination of a government paycheck, little or no work, and an intense loyalty to whoever arranged this bounty is a recipe for political instability. Political, religious, tribal, or militia leaders in MENA countries who actively oppose the government, often have large numbers of loyal supporters placed in government jobs.

The failure of large-scale government employment to reduce political violence or instability might be part of the explanation for the failure of empirical studies to establish

a strong relationship between unemployment and violence. For example, in an important study of violence in Afghanistan, Iraq, and the Philippines; Berman et al (2011) found no positive correlation between unemployment and violence – directly contradicting the opportunity cost theory. The adverse effect of public employment on instability may disguise the expected positive correlation between private sector employment and political stability.

In addition to providing paid employment, a focus on creating private sector jobs tends to improve political stability for at least two reasons. First, with a few exceptions such as providing security services, private firms strongly support efforts to achieve political stability. Riots are bad for business. While government employees generally continue to receive their paychecks even if their offices are looted, private sector employees know that if a mob wrecks their shop or factory then they are most likely out of a job. As a result, it is not uncommon for private sector employees to risk their lives to protect their places of employment during periods of disorder.

Second, motivated by profit, private firms tend to be more willing to ignore political, ethnic, religious, or tribal differences when they do business. For example, to an outsider studying MENA; Muslims and Christians, Sunnis and Shi'a, or Arabs and Kurds appeared to be separated by hundreds of years of hostility. In reality, complex business relationships among these groups have long existed. For generations, a Christian farmer in Egypt has sold his crop to a Muslim grain dealer; a Kurdish merchant in Mosul has periodically arranged with his Arab counter-part in Basra for large shipments by river and rail. These profit-motivated transactions create a degree of common interests and,

sometimes, sympathy that can offset attempts by some leaders to inflame political instability. (Coyne and Mathers 2011, pp. 592-596)

In contrast, government ministries in the capital city of a conflict country controlled by one political, ethnic or religious group can, with relative impunity, make it extremely difficult for members of other groups to obtain what they legally deserve. This leads to frustration and anger on the part of the excluded group. Political stability is better ensured with private sector jobs. But there is a continuing debate on the best means of encouraging private sector job growth in low-income, corrupt, politically unstable states.

### **Political Instability, Corruption, Entrepreneurship, and Economic Development**

In an attempt to understand the relationship of political instability/conflict, corruption, entrepreneurship and economic development, it might be valuable to examine three pairs of relationships: political instability and corruption, political instability and entrepreneurship, and corruption and entrepreneurship. Figure 3 is intended to provide a simple illustration of the interrelationships among political instability/conflict, corruption, economic stabilization, entrepreneurship, and economic development. And, to the extent that acceleration in economic development can be achieved, it should – as illustrated in Figure 1 - reduce the likelihood of future political instability.

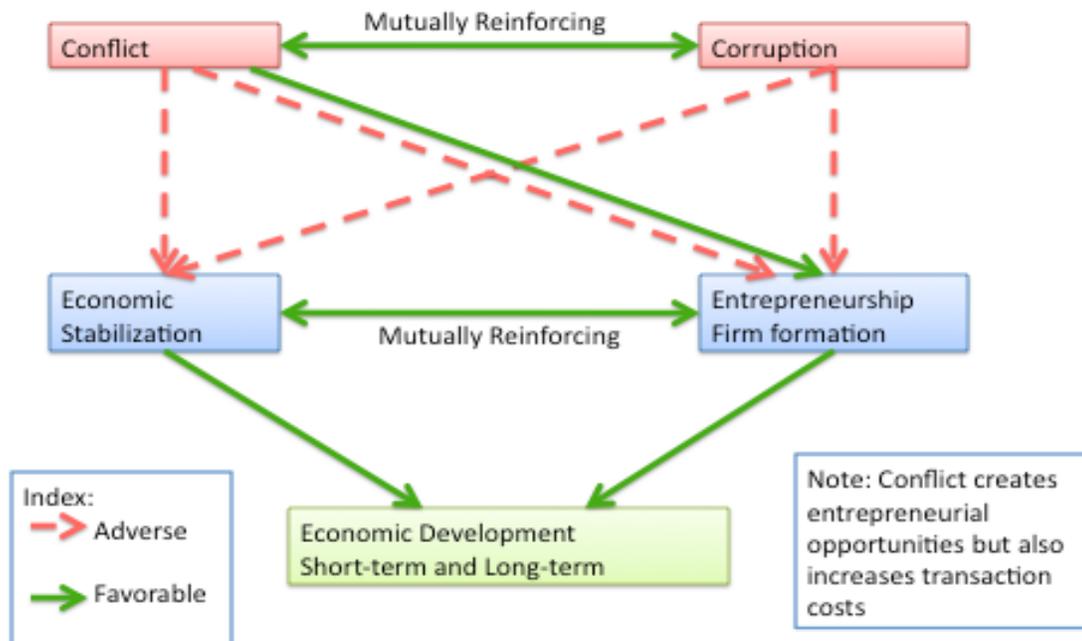
#### *Corruption and political instability/conflict*

Corruption is abuse of public power for private benefit. (Gunter 2008, p. 173) Bribery gets the most attention, but corruption can also include nepotism, official theft, fraud, certain patron-client relationships or extortion. Corruption is related to but not synonymous with the existence of a black or underground market. A black market –

illegal trade in a good or service – may not require corruption on the part of a public official. It is possible that the officials may be entirely ignorant of the illegal transactions.

One of the challenges of studying corruption in the MENA countries is that the word “corruption” is both descriptive and pejorative. Many societies in the Middle East and North Africa have long cultural traditions of patron-client relationships, nepotism, or “gift giving” to officials. And members of these societies are loath to describe such behavior as corruption. It is often argued that calling such cultural traditions corruption is a distortion - an attempt to apply Western standards to non-Western societies.

**Figure 3: Political Instability/Conflict, Corruption, Entrepreneurship, and Economic Development**



However, whether some forms of corruption are culturally accepted is a separate question from whether corruption has an adverse impact on economic development.

While there has been extensive research on this issue, the results can be illustrated in a crude fashion by looking at the relationship between countries' per-capita income (adjusted for cost of living, PPP) and measures of corruption. The relationship is negative. Regardless of culture or geographic location, *there are no (very) corrupt rich countries and few honest poor ones*. Whether it is culturally accepted or not, corruption adversely affects economic development both at the microeconomic level – by discouraging entrepreneurship – and at the macroeconomic level – by making economic stabilization<sup>3</sup> more difficult.

Of course, measures of corruption are always somewhat arbitrary. And it is especially challenging to estimate corruption or other key characteristics such as literacy, the ease of doing business, or other political/social/economic variables in a low income, corrupt, conflict states. (Guglielmetti 2011, pp. 124-143; Gunter 2013, pp. 6-24) However, as can be seen in Table 2, among MENA countries ranked “low” or “very low” in the Global Peace Index, only Israel ranks in the top – relatively honest - half of corruption rankings.

There is a symbiotic relationship between corruption and political instability/conflict. (Gunter 2013, pp. 49-50; Gunter 2007, p. 5) Corruption is good for the anti-government forces in an insurgency. Corrupt activities, including black market sales of stolen goods, official theft, extortion and “ghost workers,” can provide funding for the insurgency. (Bahney et al 2010, p. 36) Also, organizations and ratlines that handle smuggled or stolen goods provide routes and safe houses for insurgents, their munitions,

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<sup>3</sup> Economic stabilization generally refers to reducing fluctuations in a nation's macro economy. An economy with fairly constant real output growth combined with low and stable inflation would be considered economically stable.

and other parts of the insurgents' logistical tail. Corruption also undermines the public's confidence in both its government and allies. Finally, corruption can result in diversion of government resources - from food to weapons - into the black market.

Table 2: Corruption and Business Regulation

Country	Global Peace Index (Higher is better)	Corruption (2013) Lower is better	Adult Literacy (Male/Female) (2005-12)	Ease of Doing Business 2013 (Lower is better)
Qatar	Very High	28	97%/95%	48
Jordan	High	66	98%/94%	119
Kuwait	High	69	95%/92%	104
Morocco	High	91	76%/58%	87
Oman	High	61	90%/82%	47
Tunisia	High	77	87%/71%	51
UAE	High	26	89%/91%	23
Saudi Arabia	High	63	91%/82%	26
Algeria	Medium	94	81%/64%	153
Bahrain	Medium	57	96%/92%	46
Libya	Medium	172	96%/83%	187
Iran	Medium	144	89%/81%	152
Egypt	Low	114	82%/66%	128
Israel	Low	36	99%/99%	35
Lebanon	Low	127	93%/86%	111
Yemen	Low	167	72%/52%	133
Iraq	Very Low	171	86%/71%	151
Sudan	Very Low	174	81%/63%	149
Syria	Very Low	168	90%/78%	165
West Bank & Gaza	NA	NA	98%/93%	138

Sources: Corruption – *Transparency International*; Literacy – *World Development Indicators 2014*, Table 2.13; Ease of Doing Business – *World Bank*

And political instability/conflict is good for corruption. As the government absorbs an increasing proportion of a nation's resources to fight the conflict, there will be

widespread shortages and it is likely that price and wage controls will be imposed to prevent inflation. Both of these events provide strong incentives for the population to trade in the black market. The reality of insurgent attacks justifies bypassing procedures and provides a ready excuse for corruption related losses. (Collier 2000, p. 109) Finally, fighting an insurgency increases the urgency of getting things done regardless of cost, which facilitates bribes and extortion. (Naudé 2007, p. 12) Since they are mutually reinforcing, corruption makes it more difficult to stabilize the political situation while, the longer political instability/conflict lasts, the more embedded corruption becomes in a society. Further complicating the relationship between conflict and corruption is that the former is sometimes favorable to entrepreneurship.

*Political instability/conflict and entrepreneurship*

The relationship between political instability/conflict and entrepreneurship is complex. Conflict increases the transaction costs of entrepreneurship. Reductions in security make it more difficult for entrepreneurs to operate. Their suppliers or customers may be less willing to travel any distance to sell to or buy from the entrepreneur. (Brück et al 2012, p. 9) It becomes more difficult to gather accurate market information concerning prices and product shortages. It may become almost impossible to gain necessary licenses or approvals as government officials are either distracted, in hiding, or isolated by their security forces. Firms might be forced to adopt less efficient means of production in order to become less vulnerable to damage or confiscation. (Noland and Pack 2007, p. 250)

Political instability tends to make people less trusting of others especially strangers. And low levels of trust make it more difficult for entrepreneurs to establish

new ventures. To the extent that formal and informal institutions are substitutes rather than complements, the periodic conflict related isolation of government officials and associated cessation of government activities can lead to unpredictable changes in the business environment. (Tonoyan et al 2010, p. 806) And political instability not only affects businesses in violent areas but can also lead to large-scale migration that will impact businesses in other parts of a country or even across international borders. (Bozzoli et al 2012, p. 118)

In addition, banks and other formal financial institutions hesitate to lend while informal financial sources charge higher interest rates for shorter maturities in an effort to compensate for increased risk. Governments may view any entrepreneurial profits earned during a period of political turmoil as being immoral and seek to confiscate them. (Naudé 2007, p. 15; Balabkins 1982, Chapter VII, pp. 191-216) Finally, the risk engendered by political instability may discourage foreign direct investment. (Noland and Pack 2007, pp. 262-264) All of the above are in addition to the possible direct impact on the entrepreneur. The government or the insurgency may draft the entrepreneur or her employees. In addition, there may be theft or destruction of inventory or capital equipment.

In addition, as noted by Naudé, conflict can exacerbate income inequalities resulting in both increased political instability and an increasingly short-term entrepreneurial focus. Also, conflict can lead to the creation or strengthening of institutions that will have an adverse impact on entrepreneurship when the violence ends. (2009, pp. 255-256) Further complicating analysis of entrepreneurship in a politically

unstable/conflict state is that while the number of entrepreneurs may decrease, the number of involuntarily self-employed tends to increase. (Bozzoli et al 2012, p. 126)

However, political instability might also provide profit opportunities for Kirznerian arbitrage/speculative entrepreneurship. Even low levels of political instability can disrupt existing markets. Security issues might require diverting civilian shipments from traditional routes. The businesses of providing bodyguards and home/office security will expand rapidly. Both the government and any insurgency will rapidly expand their operations requiring increased purchases of supplies. Arbitrage entrepreneurs may thrive by meeting these demands. (Brück et al 2012, pp. 9-10) Periods of instability may also lead to a substantial reduction of government oversight over business – a regulatory holiday. This would appear to be a negative but, especially in states suffering from severe political instability, entrepreneurs have survived by relying on ongoing relationships reinforced by repeated game incentives. (McMillan and Woodruff 2003, pp. 110-113)

Finally, trades that were traditionally dominated by a particular group may be opened to entrepreneurs from other ethnic, religious, political, gender, or cultural backgrounds. (Naudé 2007, pp. 3-4) The American Civil War resulted in the founding of some great entrepreneurial fortunes by formally excluded groups and a recent study found a similar result in Mozambique. (Cramer 2009, p. 130) In fact, some “conflict entrepreneurs” may develop substantial businesses and prefer a delay in any return to political stability<sup>4</sup>. (Naudé 2009, p. 252)

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<sup>4</sup> For example, in Afghanistan and Lebanon, individuals obtained enough power and wealth during periods of conflict to successfully defy the central government. (Cramer 2009, pp. 134-135)

*Corruption and Entrepreneurship*

The interrelationship between corruption – a form of unproductive or destructive entrepreneurship – and productive entrepreneurship is complex. One of the more interesting studies is the comparative statics model of Sanders and Weitzel that posits three possible career choices (entrepreneur, raider, and wage earners) in a world where formal and informal institutions are non-existent. (2012 pp. 41-64) This study and the recent experience of the MENA states lead to the belief that - while the net impact of conflict on entrepreneurship is theoretically ambiguous – the effect of corruption is not. Corruption tends to weaken entrepreneurship in at least four ways.

First, it increases the cost of being a business owner. He faces the choice of either continuously paying bribes to an unending queue of rapacious officials or structuring his enterprise so as to reduce its vulnerability to the actions of corrupt officials. The former option can be expensive. A survey of over 1,600 private businesses in Iraq revealed that one in five thought that bribes and other forms of corruption added 40% or more to their total costs of doing business! (CIPE 2007, Table 27, p. 11) The alternative is for a business to operate in the underground or black market. In order to avoid coming to the attention of officials seeking bribes: businesses will stay small, avoid advertising, limit transactions only to family, tribal, or other trusted persons, and often produce their product or service so that equipment and inventory can be quickly hidden or moved. As expected, these avoidance tactics severely limit potential profits from entrepreneurial activities. (Tonoyan et al 2010, pp. 806-811)

The second means by which corruption adversely impacts entrepreneurship is by reducing the number of entrepreneurs engaged in productive activities. Rather than

improve customer service to take market share from a competitor, an entrepreneur might instead bribe the police to arrest his competitor. And to the extent that officials can perform profitable corrupt acts with impunity, potential entrepreneurs may decide that they are better off becoming officials themselves and preying on anyone foolish enough to try to run a business. Of course, the degree to which potential entrepreneurs decide to engage in corruption – unproductive entrepreneurship – as opposed to productive entrepreneurship is a function of institutions and the incentives created by those institutions. (Desai et al 2012, pp. 32-33) And during political instability/conflict, one can expect institutions to either dissolve or evolve unexpectedly.

Third, corruption may allow entrepreneurs who produce lower quality or higher cost products to gain market share at the expense of other entrepreneurs that are producing objectively better products but who failed to bribe the right officials. And the resulting lower quality or higher price of goods and services usually reduce the returns to upstream or downstream entrepreneurs.

Finally, if many entrepreneurs – in order to survive - are operating in the black market and either bribing officials or extracting economic rents themselves, there will be a reputational effect. Over time, the public will begin to associate entrepreneurs with corruption and other forms of law breaking. This justifies government confiscation of entrepreneurial profits. In addition, even after the conflict “ends”, this reputation for corruption will last for a period of time and discourage otherwise qualified persons from becoming entrepreneurs.

### **Encouraging Entrepreneurship**

In view of the interrelationships among political instability, corruption, and entrepreneurship; what are the best policies to encourage entrepreneurship and the accompanying productive job creation? It is unlikely that strategies that are successful in encouraging entrepreneurship in high-income countries will be as effective in low-income countries. In high-income countries, not only are the government bureaucracies relatively honest and competent but also the emphasis is on encouraging innovative (Schumpeterian) entrepreneurship that results in new processes, products, or markets. However, in low-income MENA countries, governments tend to be both more corrupt and less capable. And, in low-income conflict countries, the greatest need is for arbitrage/speculative (Kirznerian) entrepreneurship that creates productive employment while knitting economies together by buying and selling everything that people want.

The two options for encouraging entrepreneurship are programs intended to improve the overall environment for entrepreneurship and targeted programs that seek to identify and aid particular entrepreneurs. Only if the characteristics of entrepreneurial activity in a low-income conflict are clearly understood can successful policies to encourage entrepreneurship be developed, coordinated, and executed. Three of these characteristics are particularly important.

First, much entrepreneurial activity in low-income politically unstable MENA states is invisible to an outsider or an official. This invisibility is partly a function of the lack of business information. Few small firms have websites or even a listed phone. In many low-income countries, credit or business registries are either non-existent or limited to relatively few well-established firms. In addition, political instability or conflict may force entrepreneurs to move to different areas where they are less known. But this

invisibility is also partly a matter of entrepreneurial strategy to avoid criminal activity or exploitation by bribe-seeking officials. This desire for invisibility on the part of entrepreneurs in a corrupt or conflict state makes it difficult to efficiently reach them with a centralized government pro-entrepreneurship program. (Naudé 2009, p. 261)

Second, most owner-operators of small businesses in low-income countries are not entrepreneurs. They do not "...create ventures to profit by exploiting these opportunities." (Gunter 2012, p. 387; Naudé 2009, p. 261) Rather they find themselves self-employed as a last resort, their attempts to obtain employment as a salaried worker having failed. And most of these entrepreneurs from necessity will eagerly abandon self-employment as soon as they are able to get what they consider a "real" job, a job with a firm or government agency that pays a regular salary. This raises a difficult challenge in both analyzing arbitrage/speculative entrepreneurship and developing appropriate policies to encourage such activity. The differences between (a) a person who is self-employed in order to exploit an arbitrage/speculative opportunity that most fail to see – a Kirznerian entrepreneur - and (b) a person who is self-employed as a second-best option is a matter of motivation.

Third, the failure rate of new entrepreneurial enterprises is very high – probably over 50%. As a result, especially in an environment marked by insecurity and political instability, entrepreneurs attempt to diversify their activities. (Stevenson 2010, p. 174) A family's primary business may be to run a butcher shop. However, since they need electricity to operate their freezer, they may own a private generator and either sell some electricity to their neighbors or speculate in black market fuel for their generator. And, since being the neighborhood butcher is a cash business, the butcher's family may make

small loans to other businesses or family members. It is possible that the family may even earn more from selling electricity, trading diesel fuel, and money lending than from its “primary” business of selling meat.

*Improving the Environment for Entrepreneurship*

That most Kirznerian entrepreneurs run businesses that are invisible, small, and diversified complicates creating policies to directly encourage entrepreneurship. However, even without being able to identify the exact benefactors, policies can encourage entrepreneurship either by seeking to increase the availability of complementary inputs to Kirznerian entrepreneurship or by reducing the transaction costs of being an entrepreneur. The most important complementary inputs to entrepreneurship are finance and education while – aside from political instability – the expense of dealing with corruption and regulatory hostility are probably the most serious transaction costs facing MENA entrepreneurs.

Conflict, by reducing banks and other financial intermediaries confidence that their loans will be repaid on schedule, tends to reduce available finance. But even during periods of peace, limited finance is often considered a serious constraint on the ability of entrepreneurs to provide more goods or services and expand employment. (Petrescu 2013, pp. 4-5; Naudé 2007, pp. 20-21; and Naudé 2009, pp. 260-261)

However, because they tend to operate on a smaller scale, Kirznerian entrepreneurs need less financial support than Schumpeterian entrepreneurs. Therefore their lack of access to traditional debt or equity finance is not as serious a constraint. Needed finance can be obtained from retained earnings, family members, tribal leaders, traditional moneylenders, suppliers, or from their customers. Of course, finance from

these sources tends to be limited. (Gunter 2013, p. 158) Creative use of micro-grant/micro-loan programs can often provide needed finance for small-scale job-creating entrepreneurial activity. However, these grants should be accompanied by substantial, somewhat expensive, expertise in order to maximize the favorable results. (Berman 2011, p. 516) And such expertise tends to be in short supply in a low-income corrupt country.

Improved education can also increase the likelihood of entrepreneurial success. However, the education level of the average successful arbitrage/speculative (Kirznerian) entrepreneur and that of an innovative (Schumpeterian) entrepreneur tend to be very different. Schumpeterian entrepreneurs tend to have high levels of education, many with university degrees. However, lack of education doesn't appear to be a barrier to successful Kirznerian entrepreneurship as long as the owner is literate. For example, studies in Egypt and Nigeria show a wide range of educational levels among successful entrepreneurs including many who were barely literate. (El-Gamal et al 2000, p. 13 and Harris 1970, pp. 352 and 354)

However, lack of basic literacy does appear to reduce the likelihood of success of Kirznerian entrepreneurs. If literacy is defined (for those 15 years or older) as being able to both read and write a straightforward passage then the situation is fairly grim for some of the MENA countries. As shown in Table 2; Morocco, Algeria, Egypt, Yemen and the Sudan each have less than 75% literacy. Of course, advocating universal literacy is even less controversial than advocating motherhood but, for historical and cultural reasons, efforts to achieve 100% literacy in the MENA countries have been slow.

Reducing corruption can be expected to facilitate entrepreneurship and economic development in several ways. Successful anti-corruption efforts will weaken the

insurgency by making it more difficult to obtain financing and logistical support. Reduced corruption will also decrease the costs of running a business thereby increasing the likelihood of business success and therefore increase productive employment. Finally, by increasing the risk and reducing the returns to corrupt acts, anti-corruption efforts should also motivate entrepreneurs to shift from unproductive or destructive activities to those that encourage economic development and associated job creation.

While many countries have instituted anti-corruption strategies, no country has ever succeeded in eradicating corruption. Simply punishing a few corrupt officials and placing anti-corruption banners along major thoroughfares is insufficient. As they say in New York Police Internal Affairs: “If you get rid of the rotten apples without getting rid of the rotten apple barrel then you will have to do it all over again next year.”

The few cities and countries that have actually achieved a substantial extended reduction in corruption have designed, coordinated, and executed a country-specific anti-corruption strategy with four components. (Speville 1997) These are: 1) increasing the likelihood of punishment of corrupt acts, 2) improved governance possibly including a restructuring of official compensation, 3) change the culture of corruption, and 4) reduce the economic incentives to be corrupt. (Gunter 2013, pp. 61-66) The fourth component of a successful anti-corruption strategy is essential but probably the most difficult especially in a conflict situation.

One source of corruption is a regulatory environment that is hostile to private businesses. As can be seen on Table 2, seven out of the eight countries ranked “Low” or “Very Low” in the Peace Index have a very hostile regulatory environment for private businesses according to the World Bank “Doing Business” report. (World Bank 2014a)

The only exception is Israel. These measures of regulatory hostility are not perfect for our purposes. Guglielmetti argues that the “Doing Business” indicators fail to recognize some of the unique characteristics of entrepreneurship in fragile and post-conflict states and therefore may provide only a rough guide to the environment for entrepreneurship. (2011 pp. 142-143) However, despite their imperfections, the “Doing Business” indicators provides information on MENA countries where regulatory hostility towards the private sector adversely affects entrepreneurs either directly by increasing costs associated with operating a small business or indirectly by encouraging corruption.

The Global Entrepreneurship and Development Index (GEDI) provides a more comprehensive picture of the environment by incorporating estimates of entrepreneurial attitudes, abilities, and aspirations. Only four of the eight countries ranked low or very low on the Peace Index are also ranked among the 118 countries on the 2013 GEDI. Egypt with a GEDI ranking of 83 and Syria with a GEDI of 81 are in the bottom third – the least favorable environment for entrepreneurship. Lebanon is in the middle third with a GEDI of 54. Only Israel is ranked in the top third with a GEDI of 20. (Acs et al 2013, pp. 164-165, 202-203, 222-223, and 302-303)

The complex web of business regulations in MENA generally date from previous socialist regimes (Stevenson 2010, pp. 190-191) but rationalizing these regulations should be easy - in theory. The World Bank and other international organizations are ready to advise on best practices around the world and it is now possible for a government to adopt a complete commercial code that would sharply reduce the perverse incentives of the existing business regulations. However, the existing harsh regulations are not simply unloved artifacts of previous regimes. Rather, each complicated and

ambiguous regulatory clause provides an opportunity for an official to extract a bribe. Each complex required administrative process reduces competition for low quality/high cost state owned enterprises. (Naudé 2007, p. 9; McMillan and Woodruff 2003, p. 107) As a result, any serious attempt to rationalize a country's regulatory systems can be expected to consume a large amount of political capital.

At least one study found that while corruption and a hostile regulatory environment have the expected adverse effect on small and medium firms, they actually have a favorable effect on very small - micro – enterprises. The authors' interpretation is that corruption and regulatory hostility discourage firms from expanding. Possibly firms fear that if they grow then their activities will come to the attention of the authorities resulting in increased costs for conforming to regulations or paying bribes. (Arterido et al 2011, Table 4 on page 628 and p. 631)

#### *Targeted entrepreneurial policies*

How useful are policies specifically targeting specific types of entrepreneurship? Naudé argued that while reducing the obstacles to starting and running a business is necessary to promote entrepreneurship, it might not be sufficient. He states: "More pro-active measures, such as support for venture finance, education and training, particularly for technological entrepreneurship, may be needed in developing countries." (Naudé 2011, pp. 251-252) However, he notes that one of the challenges facing such pro-active measures is the difficulty of identifying and reaching entrepreneurs. (Naudé 2009, p. 261) International organizations also often argue that after good business fundamentals have been established, that governments should institute programs such as new business

incubators and mentoring systems to encourage entrepreneurship.<sup>5</sup> However, there are at least four arguments against such targeted policies in low-income politically unstable countries.

First, such programs tend to focus on the goal of high-income countries to encourage innovative – Schumpeterian – entrepreneurship. However, as argued above, the binding constraint to productive job creation and economic development in politically unstable/conflict states is a shortage of arbitrage/speculative – Kirznerian – entrepreneurs. If this is correct, programs to encourage innovative entrepreneurship are irrelevant and possibly a waste of money.

Second, as shown in Table 2, MENA conflict countries tend to be very corrupt although this aspect is often ignored in designing entrepreneurial programs in MENA states. (Stevenson 2010, pp. 171-202) However, widespread corruption makes it likely that any targeted entrepreneurship program will be hijacked. Program directors will be selected and paid based on their political connections. Business participants will be expected to pay bribes for any “free” benefits they receive. And programs will often ensure the success of their business participants by using political influence to punish the competition. (Naudé 2007, p. 6)

Third, low-income conflict countries may have only a relatively small pool of persons capable of planning, coordinating, and managing a targeted policy to encourage entrepreneurship. (Naudé 2007, p. 22) Is hiring some of these people to manage a targeted entrepreneurial policy the best use of a scarce resource?

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<sup>5</sup> See Schroeder (2013) for an enthusiastic discussion of various Middle East governments and NGOs efforts to encourage innovative entrepreneurship in the technology sector.

Finally, targeted programs are often used to provide political cover for countries unable or unwilling to establish good business fundamentals. For example, the Greek government is proud of its entrepreneur incubator program. (Global Entrepreneurial Congress 2012) These incubators not only helped potential entrepreneurs with business basics, networking, marketing, management, but also provided a variety of business services. However, the success of this program gives a false image of the entrepreneurial environment in Greece. Based on the World Bank's Ease of Doing Business report, Greece ranks 146<sup>th</sup> in ease of starting a new business. In view of the general regulatory hostility towards private business, targeted entrepreneurship programs in low-income conflict states are often, at best, a distraction to severely overburdened government with limited capacity or, at worst, a cynical attempt to disguise lack of progress in productive job creation by encouraging Kirznerian entrepreneurship.

### **Summary**

In view of the failure of top-down macroeconomic policies to accelerate economic development and reduce politically destabilizing mass unemployment and underemployment in low-income conflict countries, there is increased interest in encouraging entrepreneurship, a bottom-up strategy. However, it is important to realize that the binding constraint in low-income conflict MENA countries is not a shortage of the Schumpeterian entrepreneurship that receives most of the research attention in high-income countries. Rather, the binding constraint is a shortage of Kirznerian arbitrage/speculative entrepreneurship.

Increased entrepreneurship tends to increase the probability of political stability by accelerating economic growth and providing more mobility options. And unlike public sector jobs, that may be politically destabilizing because they create loyalty to political, religious, tribal, or criminal groups that oppose the existing government; private sector employment tend to strengthen the sense of community.

Understanding the demand and supply of entrepreneurship in low-income conflict countries requires modeling the interaction of conflict, corruption, and entrepreneurship. There is a symbiotic relationship between conflict and corruption while it is not clear in theory whether the net effect of conflict on entrepreneurship is positive or negative. There is no ambiguity with respect to the effect of corruption on productive entrepreneurship; it is negative.

Since it is very difficult to identify entrepreneurs in low-income conflict countries, pro-entrepreneurship strategies should concentrate on increasing the complementary inputs of entrepreneurship while reducing the transaction costs involved in running a private sector business. The most important inputs are probably finance and education. The most damaging transaction costs arise from corruption and regulatory hostility towards private business. So if governments can find the political will to unleash their entrepreneurs from the corruption and regulatory morass while increasing access to the complimentary inputs then there is the potential for a rapid increase in productive employment. And such an increase in private sector employment by reducing social frustration and improving worker mobility should lead to improved political stability.

However, it is tough to convince most governments in low-income conflict to turn their attention from day-today fights for political and regime survival to efforts to

encourage entrepreneurship that should result in long-term political stability. But without this change in priorities, the likelihood of continued conflict is high. Or in other words: *It is difficult to think about draining the swamp when the alligators are attacking. But if you don't drain the swamp, the alligator attacks will never end.*

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