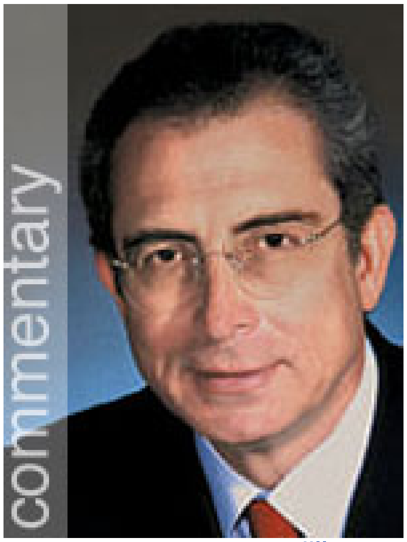
Making Business Work for the Poor

Ernesto Zedillo, 03.29.04



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Historically this lesson is clear: economic growth reduces poverty more than anything else, and the private sector is the key contributor to sustained economic growth. Why then, considering the urgent need to lift billions of people out of poverty, has private entrepreneurship not been unleashed to its full potential in many parts of the developing world?

The answer, of course, is not that there are no entrepreneurs in poor countries. In fact, the release of entrepreneurial activity previously repressed or dormant is an important part of the recent success stories of rapid growth and poverty alleviation. Furthermore, even in countries where growth has stagnated and poverty has risen in the last two decades, millions of men and women keep their families from starving to death only through the entrepreneurial activities they undertake--albeit very precariously--every day.

Go to any shantytown or village in a developing country and you'll find small entrepreneurs working hard to provide for their families' subsistence. As useful as this version of the private sector--usually known as the informal economy--is in providing some employment and income to large masses of people, it isn't enough to defeat their poverty. As Hernando de Soto, the Peruvian economist, has lucidly and frequently explained, informal businesses are constrained to operate in very small markets, usually the local community; consequently they are unable to reap the rewards of productivity and competitiveness that stem from economic specialization in the wider marketplace. Typically, the poorer a country is, the bigger the proportion of its overall economy will be held by its informal economy.

Chief Impediments to Entrepreneurship

In many developing countries the private sector fails to rise to its potential in creating wealth because property rights aren't well protected and government regulation of businesses is excessive. As a rule, to legally incorporate a business in a poor country, a person must complete a labyrinthine series of steps, which consumes a great deal of time and money. The red tape is usually even worse if the aim is to receive legal title to a piece of land. Inability to register a business or property is what most commonly keeps people in the informal sector of the economy.

Lack of legal status and title to property keep entrepreneurs marginalized from, among other things, credit institutions and protection by the justice system. Contrary to popular belief, poor people do accumulate assets. But because the rights to these assets are not legally defined, they cannot be used as collateral for bank loans or as any form of capital useful in establishing and expanding a formal business. As De Soto has said, one of the biggest political challenges facing developing countries is to bring the assets of the extralegal sector into a more inclusive legal property system in which they can become more productive and generate capital for their owners.

Even when the difficulty of registering businesses and land is overcome, entrepreneurs face other hurdles that make their productive activity riskier and less likely to succeed. And, not surprisingly, the more hurdles there are, the more corruption there is. A major hurdle is the weak or faulty application of the rule of law, most notably the legal system's lack of expediency in enforcing contracts and resolving commercial disputes. This compels entrepreneurs to do business in very small environments where people know and trust one another, losing the economies of scale offered by bigger markets. Add to these things unreliable or nonexistent credit bureaus, and it's easy to see why obtaining credit from banks in many developing countries is nearly impossible for a small entrepreneur--even one already possessing legal identity and property.

Matters are further complicated by other sets of government rules that must be followed by those wishing to operate in the formal economy. For example, well-intentioned but poorly conceived labor regulations are excessively complex and rigid; they not only impair a business' capacity to compete but also end up discriminating against the most vulnerable participants in the labor market. Taxation--indispensable to the functioning of government--becomes an inhibiting factor in private sector activity in developing countries when applied through cumbersome rules and administration, as is usually the case.

Progress Impossible Without Entrepreneurs

Needless to say, effectively addressing the above issues is not all that a country must do to overcome underdevelopment. Other key elements, such as good governance, macroeconomic discipline, open markets and sufficient investment in infrastructure and education, must be put into play. However, if entrepreneurship is not allowed to blossom, progress is well-nigh impossible, even if the other ingredients are in place.

The message is precise and compelling: Poverty will remain intractable in countries lacking a vigorous private sector; therefore, the impediments to a vigorous private sector must be removed.1

1The impediments and recommendations to remove them are discussed in a report produced by an independent commission appointed by the UN Secretary-General, cochaired by Paul Martin, prime minister of Canada, and me. The report, "Unleashing Entrepreneurship: Making Business Work for the Poor," released Mar. 1, can be found at http://www.undp.org/cpsd.

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