



## **ENTREPRENEURSHIP AND INNOVATION AS ENGINES OF GROWTH**

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### **Entrepreneurship and innovation**

Next we're going to talk about entrepreneurship and innovation as engines of economic growth. I'm going to try to show why entrepreneurship and innovation are believed to be the modern capitalism's growth engines. First we're going to talk briefly about the issue of entrepreneurs, how entrepreneurs come to be, whether we can grow them, what the right environments are for entrepreneurship to flourish, and what the prerequisites are for entrepreneurs to emerge and to develop. Then we're going to speak briefly about barriers to entrepreneurship. What the main obstacles are for entrepreneurs to develop their ideas. Then we're going to outline the currently widely popular buzzword: innovation. What does innovation mean, and how does innovation relate to entrepreneurship? And we are going to end with a few examples of what entrepreneurship and innovation mean in Eastern Europe.

### **What is entrepreneurship?**

Entrepreneurship, or entrepreneurial culture, is in essence the capacity of individuals and companies to undertake risk and accept failure. Now, if we look at the history of capitalism, we'll see that it is entrepreneurship, the individual efforts of entrepreneurs that have been the driving force in the change of the capitalist system and the change of the modern market economy. And entrepreneurship has been in the core of all programs in Eastern Europe and the modern world that want to bring in market economy and democracy. So entrepreneurial culture and developing entrepreneurial culture, developing a capacity to take risk, to start a new venture and accept failure and start over again, are the core of the modern Western society.

### **Developing entrepreneurship**

How does entrepreneurship develop? Are there inherent entrepreneurs? Are entrepreneurs born that way? Are they taught? Are they developed? Do they come in different shapes? Does culture shape entrepreneurship? In the modern economy, we've come to realize that there are certain institutions that support entrepreneurship, such as freedom of choice, freedom to establish a business and to grow a business, freedom to employ people, freedom to teach people, freedom to educate people that create entrepreneurs.



Of course, entrepreneurship is a vast theme of utmost importance, and there are many different factors that bring about entrepreneurship. There are different types of entrepreneurship and different cultures of entrepreneurship. Some [entrepreneurs] rely on savings; others rely on credit. Some start early on in their lives; some start later on. Some prefer to stay small; some prefer to grow big. But whatever the different issues, entrepreneurship and free markets are inherently connected. Entrepreneurship can only flourish wherever there is free market, wherever your rewards from undertaking a business depend on the returns that you actually receive. And, of course, these returns have to be secured. So there has to be a system of rules that protect your returns from being squandered by somebody else.

### **Entrepreneurship and free market**

Now, in any development theory, entrepreneurship is of central importance because it's the entrepreneurs, the private sector that are bringing the new ideas, bringing the new markets, bringing the new developments, bringing new wealth, and of course, answering the needs of the market. There are different paths to harnessing a nation's creative power, notwithstanding all these differences between different types of entrepreneurship and different types of countries. There are three basic prerequisites for entrepreneurship to develop, which must be present in any cultural environment so that entrepreneurship can develop. And these include free market, meaning that people can freely exchange goods at prices that they choose, and on contracts that they do with each other.

### **Protection of property rights**

Then it's property rights. Property rights have to be protected, and that is the core role of the state: protecting property rights and upholding the rule of law. This means that whenever you do an exchange, whenever there is a mutual benefit from the exchange between two persons, this is business put in a contract. The state has to see that property rights are enforced, that money that flows from these contracts and property that ensues from these contracts is given to the person who has actually added value, and that this property is protected from somebody else coming in and squandering that value. That is why in development it is of utmost importance that property rights are protected. Because no one would, for instance, try to make music and sell that music so that people can have a good time, or no one will produce anything if they're not sure that their rights to sell this or to own this property are secure. That is why in many African nations today, it's very difficult to have entrepreneurs, because of the lack of any protection of property rights and no rule of law.

### **The rule of law**

There is a certain degree of certainty of rules that apply to everyone so that the law applies to everyone, which is required for the development of entrepreneurship. And rule



of law is much more than putting criminals behind bars. It is enforcing the same rules to everybody. It means that everybody has to face the same constraints provided by the common environment. This means that (especially in Eastern Europe, which has been very common) if someone has to abide by certain laws, and others do not abide, of course that creates an unfair advantage.

### **Democracy and entrepreneurship**

And making democracy work, in the end of the day, in Eastern Europe has proven difficult and has proven that the public attitudes towards entrepreneurs and towards entrepreneurship actually show whether democracy in a certain state works or not. For example, in many states in Eastern Europe or in the former Soviet Union, entrepreneurs or businessmen are associated with oligarchs, with people that have come to riches through bogus privatization, through racketeering, through not upholding the rule of law but breaking the rule of law. It means that in a country where entrepreneurs or business [people] are understood as people unlawfully enriching themselves, it has long-term negative consequences on the development of democracy and capitalism in this country.

### **Cultivating entrepreneurship with access to formal markets**

Entrepreneurship is a very delicate form of life. While entrepreneurship takes a lot of time to develop, it can be very easily broken. And entrepreneurs – especially in today's mobile world where you have not only physical ability but also virtual ability through the Internet – can move between different countries, and they can move through the virtual world or they could go underground.

The first and most important prerequisite for entrepreneurs to stay in your official economy to do business is to have free market access. Free access to the market is a very important stimulus for entrepreneurs to start doing something. If this is protected by the rule of law and if private property is respected, then entrepreneurs have incentives to develop their product and provide it to the market. But of course for starting and growing a business it's not enough if you have access to the market. You have to have the rules that make it possible for you to start a formal business and to grow a business; rules that make it easy for you to hire workers, to pay your taxes, to get raw materials, to get to other suppliers and all the zillions of other ingredients of success in that entrepreneurial endeavor. So if starting a business is difficult, then entrepreneurs will choose to stay underground, choose to go to another country, or choose to employ their efforts in different opportunities.

### **The issue of tax burden**

Then, of course, comes the tax burden, which is a very delicate balance. There is a true debate about how much tax burden influences entrepreneurship, and, other things being



equal, the harder the tax burden – that is, the more taxes are taken by the state from an entrepreneur – the less incentives an entrepreneur has to start a business. Of course, this is not always true, and this is only true for the really high taxes, because there are examples like the Nordic countries where they have very high tax burdens and at the same time flourishing entrepreneurship. This is because the level of taxes is associated with the level of public goods. If you're paying high taxes, but you deem these high taxes as fair because of the public good that you're getting in return for these taxes in terms of rule of law, in terms of protection of private property, in terms of creating new opportunities, then this might seem to the entrepreneur as fair.

And of course, this tax burden has to be understood as much more than the tax rates, because tax burdens is the way you collect taxes, the way the inspections are done on the entrepreneurs. If you're only inspecting, like in many cases in Eastern Europe, the very visible entrepreneurs, but, at the same time, leave aside violent entrepreneurs, racketeers, or people that work in the underground economy, then of course there are more and more businesses that will be incentivized to go to the underground economy.

### **Administrative burdens create underground economy**

This has to do with the administrative burden. All the inspections, all the different ways that the state has decided to uphold the rule of law and the way these requirements by the state on the products, on the businesses, on the labor market are enforced are of utmost importance. It's very important for entrepreneurs, and [it determines] whether they will stay in the official economy or go underground.

So the size of the underground economy is a clear sign of the way the formal institutions work. If you have a big underground economy like in most of Eastern Europe, this means that a) the level of public service delivery is not very high, and b) businesses perceive the tax and administrative burdens as excessively high and that's why they prefer to stay underground. That is the advantage that you get from saving taxes, and the profit margins that you get from saving taxes are higher than the level of public services that you get if you go to the official economy and pay the taxes and the administrative burdens.

### **Entrepreneurial environment in Eastern Europe**

There are other different levels of easiness of doing business, and of course the World Bank has one of the most comprehensive databases of which countries are making it really easy to start and do business, and in which the countries it's much more difficult to do business. And as you can see in the display, most of the countries in Eastern Europe, the EU's new member states, and countries like Georgia, have created a much better environment for doing business than countries in Central Asia. Of course, this means that many more people in Eastern Europe would be happy to do business, or start the endeavor of doing business than people in [Central Asia].



## **Creative businesses**

And of course, entrepreneurship, starting a business, is the first prerequisite for a vibrant, well-functioning, growing market economy. But what is more important is that this business is creative; that not only are there a lot of new businesses, but that these businesses are productive. Sometimes, when the rules are not set in place, businesses tend to look for ways to squander other people's money, to get public contracts, to get privileges from the state, and to monopolize the business. Now, for these businesses to be creative, to bring new ideas to the market, to bring fresh value to the market, we have to talk about innovation. Entrepreneurship and innovation are the two engines of economic growth in modern capitalist systems. And these are not only technological innovations that we're talking about. Not only are there technological breakthroughs like the Internet, or the IT revolution, or the new materials, or biotechnology. There are also market and organizational innovations. These are the Wal-Marts; these are different ways you find to satisfy customer's needs or to work with the customers.

So we can say that entrepreneurship is the first step, but innovation – bringing new and higher value to the customers and bringing fresh value to the market – is the way that the modern economy functions. And of course, entrepreneurship is already a very delicate phenomenon, and innovation is even more difficult to encompass. It requires above all that free entrepreneurship, or productive entrepreneurship, exists. It requires that people have incentives to start new businesses and want to create value.

## **The role of competition**

Competition is the key driver of innovation. Businesses that have fair competition, abiding by the same rules that are being applied to everyone are driving the competitive forces. This can be seen on a personal level as well as on enterprise level. And of course, competition is what many people call the “animal spirit” of market, and competition is something that no one really likes even in their personal lives. Because in its very essence, competition means that you're in a kind of a fight with an adversary, but that is the role of the rules and that is why it's so delicate to create those rules.

If the rules are created so that some competitors start squandering others, then of course, this will not result in innovation. But if rules are that there is fair competition, that there is no violence in competition, and that competition is the same for everyone, then this makes room for new products, new ways to deliver those products to customers, or new ways to supply needed efforts to those customers.



## **Measuring innovation**

Measuring innovation is inherently difficult. There have been several measurement mechanisms that have been put in place by both the World Bank and by the European Union. There have been a lot of different efforts – by the Boston Consulting Group, let's say – on corporate innovation measuring. Because innovation is very much important to the very survival of business, there have been many different efforts to measure this very subtle and complex phenomenon. And, of course, what gets measured gets done, and managers know that very well. That's why recently there has been an increasing push towards measuring and managing innovation.

But of course, this does not preclude us from saying that innovation remains a black box and sometimes we have innovation that has not been measured, innovation that has not come from a well-designed process. It is much more important to the development of the market and new entrepreneurs that disruptive innovations come to the market. The new ideas that come from a garage, are sometimes much more important than the innovations that come from the labs.

## **Challenges to entrepreneurship in Eastern Europe**

Now let us turn briefly to the entrepreneurship and innovation experience in Eastern Europe. It has turned out to be much easier to impose the formal rules of market economy, build up formal institutions, build up commissions for protection of competition, build up all the different institutions of market economy and democracy, like elections, political parties and so on and so forth. What has been difficult, however, is changing informal institutions, changing the mindset, and also ensuring level playing field or enforcement of the rules for everybody. Because there have been oligarchs, there have been violent entrepreneurs, there have been entrepreneurs that have not looked into the productive sphere, but have looked how to steal or to force their way into competitive advantage.

Eventually, however, entrepreneurship and innovation have flourished in Eastern Europe. The more a country is free and the easier it is to start a business in that country, the higher economic growth is realized. And of course, we have to say that the level of market reforms that is required for entrepreneurship and innovation to take hold is very high. Some countries have succeeded, others have not. And we have to say that once Eastern Europe became part of the global economy, it has tried to orient itself on the new global market rules. If there is a country that does not meet the needs for entrepreneurs to realize their new ideas, they sometimes move out of this country or they find alternative ways to realize their ideas, either the virtual space or moving to another country.



## **Knowledge, innovation, and growth**

But what we have to say is that ensuring the vibrant entrepreneurial culture in Eastern Europe, the culture that is targeted towards innovation, means more growth for each country. The countries of the Baltic, the countries of Central Europe, the countries like Slovakia that have been most reformist and have brought about most freedom to do business and for entrepreneurship have seen the highest growth in their level of innovation. It means more new products and more ways to satisfy customer needs. And of course, this has meant that their knowledge economy has grown the highest. And this means that they have been able to gain more from the globalization decade that was seen in the 1990s and the beginning of the 21st century.

As a recapitulation, we have to say that both entrepreneurship and innovation are very delicate life forms, and they need not only culture but also formal and informal institutions and mindset to support them in the long run. Of course, they pay off in growth, better social value, and better economic value.

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