

The Relationship between Governance Effectiveness and Entrepreneurship

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Abstract

Entrepreneurship is an essential element for job creation and economic growth. It is therefore important to better understand the conditions under which entrepreneurship flourish. This research tests the relationship between perceptions of government's effectiveness, attitudes towards entrepreneurship, and the extent that entrepreneurship exists on a national level. The data for this study were collected internationally by the World Bank (World Governance Indicators) and the Global Entrepreneurship Monitor project via extensive interviews and surveys to citizens and national experts, respectively. Contrary to expectations, perceived government effectiveness was significantly negatively related to entrepreneurship on a national level. Study implications are presented with suggestions for future research.

Key words: entrepreneurship, world governance, World Bank, Global Entrepreneurship Monitor

1. Introduction

Driven by foreign investment in developing countries and the decision by the World Bank to provide aid to countries with effective governments, there is currently much emphasis placed on nations' ability to increase wealth and increase government effectiveness (Friedman, Cox and Tribunella, 2010; Arndt and Oman, 2006). Entrepreneurship is an important element for job creation and economic growth (Acs, 1992; Minniti and Levesque, 2008). Entrepreneurship is considered a tool for economic growth and innovation across countries regardless of economic development (Acs, Desai and Klapper, 2008), and is critical to the development and well being of society (Kelly, Bosma and Amorós, 2011). In order to increase entrepreneurship, it is therefore important that the variables related to entrepreneurship are better understood.

1.1. Literature Review

Between country variance is large with respect to extant entrepreneurship and the degree to which citizens believe that entrepreneurial opportunities exist. National differences in entrepreneurship activity are important to understand and are fertile ground for research (Troilo, 2011). Conventional wisdom suggests that good governance fosters entrepreneurship. Trust in government effectiveness, political stability, rule of law, and voice in government affairs should be related to citizens' willingness to take risks associated with investing, starting and managing new businesses. The logic is that the economic, social and self actualization benefits of starting up and managing new businesses must outweigh the risks and burdens in order for entrepreneurship to occur. Acs et al. (2008) found that entrepreneurs in developed countries have "greater ease and incentives to incorporate, both for the benefits of greater access to formal financing and labor contracts, as well as for tax and other purposes not directly related to business activities" (Acs et al., 2008, p. 265). Troilo (2011) studied the relationship between property rights institutions, market expansion, rule of law, and job growth. Rule of law was defined as an institution that imposes constraints on doing business such as the number of regulations (Djankov, 2002) and rules that govern investment (LaPorta et al., 1998). Troilo (2011) found that "the number of procedures to enforce contracts, the number of procedures to start a business, and the number of days to start a business is negatively correlated with entrepreneurship, and that a common law legal system is negatively related to entrepreneurship" (Troilo, 2011, p. 158). Contrary to Acs et al. (2008), Troilo (2011) found that well established laws that exist in developed countries may be a barrier to increased entrepreneurship.

Research that relates governance and entrepreneurship is limited and conflicting, and more research is needed in this area. The purpose of this research is to explore the relationship between governance effectiveness, entrepreneurship attitudes and the amount of entrepreneurship in a country level. Established measures of governance and entrepreneurship are reviewed below.

1.2 World Governance Indicators

Kaufmann, Kraay and Mastruzzi (2008) define governance as traditions and institutions by which authority in a country is exercised, the ability of government to formulate and administer policy, and the respect government receives from its citizens. Effective governance has been shown to be related with economic growth (Huynh and Jacho-Chávez, 2009; Malik, 2002) and per capita income (Kaufmann and Kraay, 2002). The World Bank has collected data regarding government effectiveness and governance annually since 2006. The World Bank data collection combines the views of a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. The individual data sources underlying the aggregate indicators are drawn from a diverse variety of survey institutes, non-governmental organizations, and international organizations (World Governance Indicators, 2011; Kelly, Bosma and Amorós, 2011). The World Bank Project identified the following six World Governance Indicators (Kaufmann et al., 2008):

1. Voice and Accountability: perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association and a free media.
2. Political Stability and Absence of Violence: perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically motivated violence or terrorism.
3. Government Effectiveness: perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, and the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
4. Regulatory Quality: perceptions of the ability of the government to formulate and implement sound policies and regulations that permits and promotes private sector development.
5. Rule of Law: perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular, the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
6. Control of Corruption: perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

1.3. Entrepreneurship Measures

The Global Entrepreneurship Monitor (GEM) is a not-for-profit academic research consortium that collects high quality information on global entrepreneurial activity and makes that information readily available to as wide an audience as possible. GEM conducts the largest study of entrepreneurial activity in the world (GEM, 2011). The present study used the National Expert Survey (NES) conducted in 2007 (the most recent data available to the public). The NES provides standardized scales of national entrepreneurship. GEM defines a national expert as "someone who is directly involved in delivering or assessing a major aspect of entrepreneurial condition in his/her country. National Experts could be politicians, academics, entrepreneurs, government officials, or other professionals in the field of entrepreneurship. Thus, National Experts are individuals with knowledge of entrepreneurship that can result from various experience and perspectives. A semi-standardized selection procedure has been developed for selecting National Experts" (GEM, 2011). A more comprehensive description of the National Expert Survey and methodology is available (Kelly, Bosma and Amorós, 2011; GEM, 2011). The GEM variables considered in this study are described below.

1. New Entrepreneur Motivation: number of adults [18-64 years old] per 100 involved in nascent business (young firm start-up), defined as active, expect to be a full or part owner, and no salaries or wages paid for over three months motivated by opportunity.
2. All Entrepreneur Opportunity Motivation: Number of Adults [18-64 years old] per 100 reporting opportunity as major motive.

3. Entrepreneurial Intention: percentage yes on item: You are, alone or with others, expecting to start a new business, including any type of self-employment, within the next three years?
4. New Entrepreneurial Activity: Number of Adults [18-64 years old] per 100 involved in a nascent (new) firm or young firm or both (if doing both, still counted as one active person).
5. All Entrepreneurial Activity: Number of adults [18-64 years old] per 100 involved in entrepreneurial activity, either as a nascent entrepreneur, owner-manager of a baby business or owner-manager of established businesses.

1.4 Hypotheses

It is hypothesized that entrepreneurship flourishes under favorable governance conditions. Starting a business entails such beliefs as trust in government effectiveness, political stability is at a level where entrepreneurs do not feel their businesses are likely to be nationalized, and that rule of law exists. The latter is important to ensure an acceptable level of certainty (e.g., contractual obligations are met). The specific hypotheses are:

HYP 1: World Governance (WG) is positively related to the new entrepreneur motivated by opportunity.

HYP 2: WG is positively related to the percentage of entrepreneurs motivated by opportunity.

HYP 3: WG is positively related to entrepreneurs' intention to start new business.

Hypotheses 1-3 address attitudes towards entrepreneurship, namely national experts' beliefs that their country affords opportunities to start new businesses, the extent that they believe citizens have the intention to actually start new businesses, and that opportunity (rather than necessity) is the prime motivator. Such attitudes are hypothesized to be positively related to perceptions that their government is effective. That is, effective governance is related to positive intent to engage in entrepreneurship. Governance effectiveness is hypothesized to be a prerequisite for citizens of a particular country to take the extraordinary risks associated with starting new businesses.

HYP 4: WG is positively related to new entrepreneurial activity.

HYP 5: WG is positively related to the total amount of entrepreneurial activity in a country.

Hypotheses 4 and 5 address the actual extent that effective governance is related to extant new entrepreneurial activity and entrepreneurial activity overall.

2. Method

2.1 Sample

World Governance Indicator data collected by the World Bank and the GEM entrepreneurship data were collected in GEM, the last year that the National Expert Survey was publically available. Thirty-six ($N=36$) countries had both the World Governance Indicators and the GEM entrepreneurial data. Table 1 contains the 36 countries represented in the study. The countries were located in Western Europe (15), Central Europe (5), South America (6) Asia (5), Caribbean (2), United States, Russia, and Antarctica. The average Gross Domestic Product (PPP) per capita was \$20,047 (USD) and the average population was 79,540,000.

2.2 Data Analysis

Descriptive statistics and Pearson correlations were computed using the Statistical Package for the Social Sciences (version 18). Scale reliability for the World Governance Indicators was determined using Cronbach's Alpha model of internal consistency.

3. Results

The six World Governance Indicators were highly correlated. To increase parsimony, a World Governance Index was therefore developed. The six item World Governance (WG) scale reliability (Cronbach's Alpha) was .92 ($p \leq .001$). This level of reliability is acceptable, and the World Governance overall scale (WG) was used in subsequent analyses. Table 2 contains descriptive statistics and correlations between all variables. On average, 15.17% of adults ages 18-64 were engaged in entrepreneurship across all 36 countries, and 16.44% expected to start a new business with the next three years. The percentage of adults involved in entrepreneurship with opportunity (rather than out of necessity) was lower 6.28%. With respect to attitudes, WG was *negatively* related to entrepreneurs' perception that opportunity was the prime motive to start new businesses and intention to start new businesses. WG was not significantly related to new entrepreneurs' perception that opportunity was the prime motive to start a business.

Hypotheses 2 and 3 were not supported, but were significant in the opposite direction. WG was also negatively related to entrepreneurship activity, both for new (nascent) business and total businesses. Once again, hypotheses 4 and 5 were not supported, and were in the opposite direction than hypothesized.

4. Discussion and Conclusions

This research found that countries high in governance effectiveness as measured by the World Bank World Governance Indicators have less favorable attitudes towards, and lower levels of, entrepreneurship when compared to countries with less effective governance. This finding was statistically significant yet counterintuitive. One possible explanation is that developed countries with higher GDP per capita have fewer entrepreneurial opportunities. That is, the market for new businesses in developed countries is saturated relative to developing countries. This saturation would decrease the motivation for nascent business, and subsequently, entrepreneurship overall.

A second explanation for the results concern specific country policies and leadership direction that either fosters or hinders entrepreneurship. For example, China has managed a transition over the last decade towards a free market economy in some sectors of their economy, and these changes in their specific policies may have increased entrepreneurship.

A third explanation for the unexpected finding is that some countries have higher barriers for entry for new businesses. Barriers for entry may include higher regulation and greater taxes. For example, two countries in the present study with among the highest WG scores are Finland (10.58) and Denmark (11.02). Voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption are among the highest WGI dimension scores in the World Bank dataset, indicating a high level of governance effectiveness. Denmark and Finland are among the heaviest tax burdens, with ranks of 14 and 17 out of 210 countries. The tax burden of Denmark and Finland are 55% and 51% of GDP, respectively. The World Factbook (Central Intelligence Agency, 2011) contains the total tax and revenues as a percentage of a country's GDP for 210 countries. Total tax includes personal and corporate income taxes, value added taxes, and social contributions such as payments for social security and health.

Thailand (-4.81) and China (-3.14) have among the lowest WG scores in this study, and among the lowest scores on all WGI dimensions. Citizens in these countries reported significantly higher levels of entrepreneurship than countries with higher governance effectiveness. The World Factbook (Central Intelligence Agency, 2011) reports that Thailand and China are ranked 170 and 148, respectively, with respect to the tax burden imposed upon its citizens, indicating a low relative tax burden. The tax burden of Thailand and China are 18% and 20%, respectively. The vastly higher tax burdens in Denmark and Finland relative to Thailand and China may have contributed to the present findings. The role of national tax burden in the relationship between governance and entrepreneurship is a subject of further research.

4.1 Study Limitations

Limitations of this research include sample size and representativeness. The GEM 2007 NES database limited the number of countries in the study to 36. While the present study used the most recent data available to the public, more recent data is needed. As mentioned previously, 2008 data will be available sometime in 2012.

4.2 Future research

Longitudinal research is needed to ascertain the relationship between governance and entrepreneurship over time. Future research can also incorporate a more comprehensive array of variables. Control variables for future research include national economic indicators (e.g., GDP per capita, tax burden) and country population. Countries with more resources may be better positioned to foster entrepreneurship.

4.3 Conclusion

Entrepreneurship is important in world markets and national competitiveness. The present study found a negative relationship between countries' governance effectiveness and their level of entrepreneurship, but the intervening variables that underlie that relationship must be identified in order to increase entrepreneurship. The relationship between governance and entrepreneurship is complex and more research is needed to identify the important underlying variables.

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Table 1. Countries represented in the study (N = 36).

Country	Region	Country	Region
Antarctica	Antarctic	Japan	Northeast Asia
Argentina	South America	Kyrgyzstan	Central Asia
Belgium	Western Europe	Latvia	Central Europe
Brazil	South America	Netherlands	Western Europe
Chile	South America	Norway	Western Europe
China	Northeast Asia	Peru	South America
Croatia	Central Europe	Portugal	Western Europe
Denmark	Western Europe	Puerto Rico	Caribbean
Dominican Rep.	Caribbean	Romania	Central Europe
Finland	Western Europe	Russia	Eastern Europe
France	Western Europe	Spain	Western Europe
Greece	Western Europe	Sweden	Western Europe
Hong Kong	Asia	Thailand	South East Asia
Hungary	Central Europe	Turkey	Central Europe
Iceland	Western Europe	United Kingdom	Western Europe
Ireland	Western Europe	United States	North America
Israel	Western Europe	Uruguay	South America
Italy	Western Europe	Venezuela	South America

Table 2. Descriptive statistics and correlations for World Governance Indicators and Entrepreneurship Variable

Variable	Mean	S.D.	Correlations					
			1	2	3	4	5	6
1. Overall World Governance (WG)	40	4	1	-.27	-.39*	-.53**	-.49**	-.44**
2. New Entrepreneur Opportunity Motivation	61	1		1	.92**	.74**	.89**	.80**
3. All Entrepreneur Opportunity Motivation	28	1			1	.79**	.98**	.94**
4. Entrepreneurial Intention	5.44	18				1	.83**	.75**
5. New Entrepreneurial Activity	93	4					1	.95**
6. All Entrepreneurial Activity	5.17	5						1

** $p \leq .001$, * $p \leq .01$