



WITTENBERG-ZENTRUM FÜR GLOBALE ETHIK
WITTENBERG CENTER FOR GLOBAL ETHICS

DISKUSSIONSPAPIER NR. 2006-11
DISCUSSION PAPER NR. 2006-11

Prof. Dr. Dr. Karl Homann

***Changing Paradigm:
Fostering Entrepreneurial Spirit***

Herausgegeben vom
Edited by



Wittenberg-Zentrum für Globale Ethik e.V.

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ISSN 1862-6289

ISBN 978-3-86010-892-5

Autorenanschrift

Prof. Dr. Dr. Karl Homann

Lehrstuhl für Philosophie und Ökonomik
Philosophie-Department
Ludwig-Maximilians-Universität München
Ludwigstr. 31/1. Stock
D-80539 München
Tel.: +49 (0) 89-2180-5747
Fax: +49 (0) 89-2180-5679
Email: karl.homann@lrz.uni-muenchen.de

Korrespondenzanschrift

Wittenberg-Zentrum für Globale Ethik e.V.

Collegienstraße 62
D-06886 Lutherstadt Wittenberg
Tel.: +49 (0) 3491-466-257
Fax: +49 (0) 3491-466-258
Email: info@wcge.org
Internet: www.wittenberg-center.org

Changing Paradigm: Fostering Entrepreneurial Spirit

by Prof. Dr. Dr. Karl Homann,
Ludwig-Maximilians-Universität München

The West has raised 2,300 billion US\$ as development aid in the last 50 years, but more than 3 billion people still live on less than 2 US\$ per day. This is a sobering record indeed.

William Easterly believes that the reason for the futility of Western aid is the fact that politicians and aid agencies alike organize development according to the pattern of a socialist planned economy and by means of a “Big Push”, thus losing touch with small entrepreneurs and their special local needs.

Development must not be imposed; it must follow a bottom-up strategy and initiate a self-feeding process of growth, if it is to be sustainable. Success is based on three basic requirements:

- Entrepreneurs and free markets
- Good governance
- Social capital (trust)

Especially in the initial phase, the process can be promoted by Western aid that corresponds to the issues at hand.

Entrepreneurs and markets

The dispute of whether the role of the entrepreneur is tied to certain cultural, ethnic or religious prerequisites can today be regarded as a matter that is over and done with: an entrepreneur is hidden in every human being – especially in the poor, who could not support themselves and their families if they did not have entrepreneurial skills. It is necessary to develop this human potential or create conditions for its development.

Before this can happen, obstacles have to be overcome: bureaucracy, monopolies, usurers and rackets. Free markets will develop after that, starting at the local level and growing into national and international networks. Especially in poor countries, there is always a need that people with entrepreneurial spirit can meet. H. de Soto showed as early as the 1990s that people working in the informal sector are characterized by a high degree of creativity in offering goods and services and in organizing transactions without the assistance of the state. In some countries, as much as 50 percent of the GNP is produced in the informal sector.

W. Easterly attributes the futility of Western development aid to the fact that the poor do not have a say in the “Grand Plan“ of Western aid and are therefore offered solutions that ignore their problems. That is why he demands that free markets be set up. Markets have different advantages, three of which I want to discuss briefly:

1. A systematic feedback mechanism is incorporated in markets. Buyers determine what is suitable for them by their purchasing patterns. This results in offers adapted to local needs.
2. The responsibility is clearly settled: If the product is not accepted, the producer has to adapt to the needs of the consumers. Markets process local knowledge in an efficient manner.
3. Markets give rise to competition. Competition ensures that good, inexpensive, innovative goods and services are offered, good solutions to problems are rapidly disseminated and positions of power, which are continuously created in markets, are eroded.

It's only natural that problems exist with regard to markets, but they are not insurmountable. For instance, considerable informational asymmetries are not to be expected as regards to everyday necessities, and the seed money required by small entrepreneurs is often just a few dollars, which can be provided by western aid agencies or banks such as the Grameen Bank.

Good Governance

Development by means of free markets requires a predictable, solid political basis. Another essential requirement – which I do not wish to elaborate on - is internal and external peace.

An institutional system that creates incentives for investment is indispensable. Investment is the backbone of development. Let me explain this central prerequisite by three examples.

1. Private property rights are typical Western instruments for creating incentives. They prevent the exploitation of investors by third parties. That is an essential requirement, as no one will sow seeds if others steal their crop.

H. de Soto highlights another function of state-guaranteed property rights: titles of ownership such as property can be used to collateralize loans. Besides their direct benefit, they yield a return that is generated by the company, which is financed by loans: “property“ is turned into “capital“, to use H. de Soto's terminology. That is why he recommends introducing land registers. Obviously, he is thinking of Latin American *favelas*, where people have squatted plots at the periphery of metropolises to build their homes and companies. He recommends that the state legalize the claims for possession, which are definitely recognized at the local level, so that they are freed from the fetters of unlawfulness. And he insists on pointing out a great historic example: the squatters in the American West were originally illegal landowners who were later legalized, which gave rise to a tremendous process of growth – and the

myth of pioneers who developed the western stretches of the United States of America.

The introduction of property rights is the Western way of dealing with the “tragedy of the commons“. Research conducted by E. Ostrom shows that other cultures have other ways of successfully dealing with this problem. Easterly refers to the fatal impact of the introduction of private property rights in Kenya, where a well-functioning system of cooperation was destroyed, while the imposed Western system was rejected. His conclusion is that local particularities must be thoroughly analyzed for their functional correlation before changes are initiated.

2. Good governance is a prerequisite for the optimum development of free markets. Government action and the machinery of government must follow clear rules; rather than being partial or arbitrary it must be predictable and reliable, if entrepreneurs are to make long-term investments. Foreign investors especially make these demands.

In addition, the government must fight corruption and constrain excessive bureaucracy in a credible manner – especially since the two often are interrelated. As part of an experiment, de Soto tried to lawfully set up a company in Peru: He needed more than 200 permits and had to pay bribes for many of them.

3. To achieve good governance, the African continent has come up with an innovation: In 2001, the presidents of South Africa, Nigeria, Senegal, Algeria and Egypt launched the initiative „New Partnership for Africa’s Development“ (NEPAD). We will hear more about it during this conference. I just want to mention two things that are particularly innovative. First, African states are taking the initiative on their own. They are standing on their own feet, making Africa’s development their own cause and acknowledging their responsibility: This might be the decisive step required to overcome Western patronage. Second, the need of controls is recognized and a new type of information and control mechanism – the “African Peer Review Mechanism“ (APRM) – is set up.

There may be people who have reservations about specific provisions of this initiative. They must not forget, however, that this is a revolutionary first step. This initia-

tive deserves all possible support, for it must not fail. We have met here in order to advance matters. Those of us who live in the West should always be aware of the fact that it took us more than 500 years to develop good governance and achieve prosperity for the majority of the people. We hope that it will not take as long in Africa, but those who believe in the rapid success of a “Grand Plan” have not understood the problems of the local people.

Social capital

For free markets to be able to fully develop their potential, formal institutions like the rule of law and good governance are not sufficient. In addition, an atmosphere of trust, referred to as social capital in jargon, is needed.

Trust facilitates transactions in markets. If service and consideration take place at different points in time or if there are informational asymmetries, many mutually productive interactions materialize only if there is trust that helps parties to overcome uncertainties. Whether or not people conduct transactions with people, who are not part of their personal circles, depends on trust. In a fully developed national economy, personal trust must be complemented by trust in the formal institutions of the state; this means we have to examine how social capital supported by institutions can be developed.

Traditional networks of trust do usually exist in poor countries. They can be based either on family ties and clans or on ethnic or religious communities. It is recommended to take up such traditional networks. However, there is a disadvantage: they are not only inclusive but also exclusive. That is why one must try, depending on the local conditions, to expand the basis for social capital beyond the traditional networks.

Grameen Bank is a good example of the way new networks can be set up. Mohammed Yunus, the founder of the bank, was awarded the Nobel Peace Prize earlier this year. The network is characterized by the fact that all members are borrowers and is based on personal friendships: a woman will be granted a loan only on the recom-

mentation of another woman – 97 percent of the borrowers are women – who will personally guarantee for the “new” one. In addition, women meet regularly in small groups of five women in order to discuss their business. This group acts as an extremely efficient control system: the loan loss ratio is only 1 percent and many loans are paid back before maturity. In the last 25 years, Grameen Bank gave 40 million people the opportunity to become small entrepreneurs.

It is certainly a long road from there to the development of trust in institutions. Whether this aim can be realized depends largely on good governance, but also on transparency, national communication and education.

The core problem may well be how to develop traditional networks without causing abrupt breaks so that trust can develop also in anonymous contexts at the national and international levels.

Western aid?

Sustainable poverty alleviation can only be achieved by poor countries themselves. Should western aid be discontinued on that account? The answer is no, but we need to change the conditions of the aid.

First, the West has to dissociate itself from such ideas as a uniform „Grand Plan“ and a “Big Push“ and tackle, with adjusted actions, the specific problems that vary from place to place. Second, politicians and aid agencies have to transfer control of the process - via the feedback from markets - to the people in poor countries. External assistance must always help people to help themselves. As local conditions are not known to the providers of assistance, they must avoid any “pretence of knowledge“ (F.A. von Hayek).

Before I conclude, let me make some recommendations based on Easterly’s writings.

Aid agencies must give the poor a chance to express their views; they must have the effectiveness of their projects evaluated by third parties.

Foreign governments and international development agencies must offer – not impose - their technical, institutional and organizational know-how. As regards to the allocation of funds, they must increasingly reward good governance and, above all, abide by the principles of free markets – that is to say dismantle rampant protectionism in accordance with the motto “Trade not Aid.”

Lastly, multinational corporations must participate, in their own long-term interest, in the development of conditions that would allow them to invest and get a fair return on their investments. Development will not be possible without the participation of big companies or against their interests.

Concluding remarks

For the very first time in world history, global peace and poverty elimination can be achieved by human action. To work jointly to make it happen is a rewarding aim for everyone. No one is so poor that he cannot enrich others, and no one is so rich that he cannot gain from others. The essential task is not redistribution but the development of entrepreneurial spirit for mutual advantage.

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