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The Plight of Underdeveloped Countries; Institutions and the Direction of Entrepreneurial Activity with Evidence from Romania

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Abstract

Conventional wisdom holds that a lack of entrepreneurial activity in languishing economies is responsible for their poor growth. This paper points out that the cause of poverty in these countries is not the absence of entrepreneurial activity, but rather the way in which entrepreneurial activities are channeled. Entrepreneurial activities may be devoted to productive ends that create wealth, or unproductive/evasive ends that do not. We argue that institutional context determines not whether an economy will have entrepreneurial activity, but rather down which of these avenues omnipresent entrepreneurial activity is directed. The plight of Romania us used to illustrate this argument. (JEL O17, M13).
Key words: Entrepreneurship, Development, Institutions, Romania

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1 Introduction

The question of the wealth of nations has been at the center of economics for over two centuries. There is now little debate – both in academic and policy realms – that the entrepreneur is the driver of economic growth (Kirzner 1973, 1985; Leff 1979; Baumol 1990, 2000). For policy makers, the focus on entrepreneurship has been a recent phenomenon. In 1998, the OECD launched a program, *Fostering Entrepreneurship*, to better understand the role of entrepreneurs in the economy at large.[1] Governments throughout the world have launched various initiatives designed to promote entrepreneurship and economic growth (Reynolds et al. 1999). The importance of the entrepreneur in economic development has also been realized by the key international aid organizations. The World Bank, the United States Agency for International Development (USAID) and the International Monetary Fund (IMF) have all commissioned studies and undertaken initiatives to understand and promote entrepreneurship.

Although many in the academic literature realize the importance of the entrepreneur, this topic has not received the widespread recognition that it deserves. This lack of focus results primarily from the fact that it is difficult to formally model entrepreneurial behavior. The entrepreneur has been characterized as an innovator (Schumpeter 1950, 1961), an arbitrageur (Kirzner 1973), one who bets on ideas (Brenner 1985, Mokyr 1990) and as a forecaster and capitalist (Rothbard 1963). Each of these interconnected elements undoubtedly plays an important role in the notion of entrepreneurship. However, for the purpose of our analysis, we are most interested in understanding entrepreneurship as alertness to and seizing profit opportunities.

[1] An overview of the Fostering Entrepreneurship program is available at: http://www1.oecd.org/publications/Pol_brief/1998/9809-eng.htm

It is typically assumed that a lack of economic growth means that there is a shortage of entrepreneurs and, more generally, 'entrepreneurial spirit.' This view, however, overlooks the essence of entrepreneurial alertness. Understanding alertness to profit opportunities as the central tenet of entrepreneurship makes clear that a lack of progress results from a lack of profit opportunities tied to activities that yield economic growth—not from a lack of entrepreneurial activity. Although it is usual to think that the existence of profit opportunities necessarily leads to economic growth, this may not be the case. Different institutional contexts create higher payoffs to differing sets of activities which may possibly lead to economic growth but which may also lead to economic stagnation or even retrogression. In short, profitability is not synonymous with positive economic growth. What is important is the type of activity that yields profit opportunities to alert entrepreneurs.

Our core thesis is as follows: Institutionally dependent payoffs determine the direction of entrepreneurial alertness and efforts. In order to understand the plight of developing countries, it is critical to understand that it is not a lack of entrepreneurship that is the problem, but rather the institutional context directing entrepreneurial activities toward perverse ends. Specifically, some institutional regimes channel entrepreneurial activity into economically destructive avenues, while other frameworks direct this activity in a way that creates wealth.

We distinguish between productive, unproductive and evasive entrepreneurship. After exploring this distinction, we present a general framework for considering the key institutions that constitute the social order. Original evidence from fieldwork in Romania

is provided to support our claims.[2] We conclude with some general policy guidelines regarding entrepreneurship, institutional regimes and economic growth.

2 Entrepreneurship: Productive, Unproductive and Evasive

Entrepreneurs are present in every country and every cultural setting. We observe different outcomes from entrepreneurial activities because activities yielding the highest payoffs vary across societies. In countries with low growth, it is not that entrepreneurs are not acting, but rather they are stymied by either a lack of profit opportunities or the existence of profit opportunities yielding outcomes counter to economic progress.

This indicates that a complete theory of entrepreneurship must provide some understanding of factors which direct the alertness of individual entrepreneurs. In other words, entrepreneurs can engage in *productive* activities resulting in economic growth or they can engage in *unproductive* and *evasive* activities resulting in economic stagnation or retrogression. Baumol was the first to make the distinction between productive and unproductive entrepreneurship (1990, 2002: 59-61).

Productive activities – arbitrage and innovation – constitute the very essence of economic growth and progress. When engaging in productive activities, the entrepreneur has a dual role. The first involves discovering previously unexploited profit opportunities. This pushes the economy from an economically (and technologically) inefficient point toward the economically (and technologically) efficient production point. The second role takes place via innovation. Innovation results in a more efficient use of resources shifting the entire production possibility frontier (PPF) outward (Kirzner

[2] This fieldwork was conducted by the authors under the auspices of a project considering barriers to entrepreneurship for the United States Agency for International Development (USAID).

1985). This shift represents the essence of economic growth – an increase in real output due to increases in real productivity. In short, productive entrepreneurship encompasses those activities that benefit both the entrepreneur and society at large. The entrepreneur benefits himself by benefiting others.

In contrast, unproductive activities include those that benefit the entrepreneur but harm society in general. Examples of this include crime, rent-seeking and other behaviors that destroy existing resources. In the case of unproductive entrepreneurship, it is possible that innovation is taking place, but these activities don't shift the PPF outward. As an example, consider new techniques for engaging in rent-seeking. While such techniques lead to increased profit for the entrepreneur undertaking the activity, they result in a loss for society as a whole.

To productive and unproductive activities we can add a third category – evasive entrepreneurship. Evasive activities include the expenditure of resources and efforts in evading the legal system or in avoiding the unproductive activities of other agents. Tax evasion is one readily apparent example of evasive activities, as are bribes paid to regulators or inspectors used to evade onerous regulations. Both productive and unproductive entrepreneurship involve the creation of deadweight losses—in both cases resources are expended solely to affect the distribution of existing wealth.

One of the central claims of this paper is that institutionally dependent payoffs determine the direction of entrepreneurial alertness. Before moving on, we must provide a general framework of institutions. In order to gain analytical traction, we consider three general formal institutional categories – economic, political and legal – underlying any social order. Each main category has several subcategories as illustrated below:

Social Order

Economic Institutions	Political Institutions	Legal Institutions

• Private Property
  ○ Well-defined
  ○ Enforceable
  ○ Freedom to Contract
• Capital Markets
• Open Trade
• Low Barriers to Entry and Exit
	• Checks and Balances
	• Federalism
	  ○ Fiscal
	  ○ Monetary
	• Accountability
	• Transparency
		• Rule of Law
		  ○ Generality
		  ○ Stability
		  ○ Predictability
		  ○ Independent Judiciary
		• Functional & Assessable Courts

Figure 1: A Social Order Conducive to Productive Entrepreneurship

The subcategories listed above are those conducive to productive entrepreneurship and sustainable economic growth.[3]

Admittedly, there is some overlap between these categories. For instance, enforceable property rights are a function of an accessible court system. Property rights will also be influenced by the stability of political institutions and the ability to place the appropriate checks on political agents. While recognizing this, these categories provide a framework for understanding the importance of institutions in achieving sustainable growth. In cases where payoffs to the unproductive or evasive activities are higher, we would expect the subcategories outlined above to be either non-existent or distorted.

In the analysis that follows, we attempt to weave together general information regarding the institutional payoffs in Romania with original data gathered from our fieldwork in a way that illuminates the claims made above. This work has a similar approach to previous efforts by De Soto (1989, 2000) to understand the plight of Peru. We conducted approximately 30 in-depth, guided, face-to-face interviews with Romanian

[3] For more on the institutions necessary for a stable social order and economic growth, see Barro (1999), Gwartney et al. (1999) and Scully (1988, 1992).

entrepreneurs and political agents in three major geographic regions of the country—Bucharest, Arad and Olt—representing both urban and rural perspectives in roughly equal proportions.[4] Political subjects were selected on the basis of relevance and availability. Thus those available political agents who seemed most likely to have insights related to the government's role in shaping Romania's climate of entrepreneurship received priority. Interviews with entrepreneurs were selected primarily by reference from other subjects, though some were selected at random.[5] All interviews were conducted over a two month period from May 2003 through July 2003.

3 The Plight of Romania

Romania's plight effectively illustrates the problems that befall reforming nations when the payoffs for unproductive and evasive activities are relatively higher than those for productive activities. Widespread corruption and legal uncertainty, for example, continue to plague Romania. The average monthly income of citizens remains at less than $125 (World Bank 2003). As of 2002, the per capita income was $7,600 and as of 2000, 44.5% of the population were below the poverty line (CIA World Factbook). Since 1995, Romania's total Heritage Foundation/Wall Street Journal Economic Freedom Index Score has varied slightly, but each year has fallen into the category of "Mostly Unfree."[6] It is our contention that these perverse outcomes are due not to a shortage of entrepreneurs, but rather to the fact that Romanian entrepreneurs are alert to opportunities

[4] Bucharest is the capital city of Romania and provides a sample of entrepreneurs in the urban environment. Our interviews of rural entrepreneurs took place in the village of Busteni, in Arad County in the Western Carpathians and Visina Noua in Olt County in the Danube plain.
[5] Subjects ranged in age from 29 to approximately 65 and included both males and females.
[6] For more on the Heritage Foundation/Wall Street Journal, *Index of Economic Freedom*, see: http://www.heritage.org/; For the report on Romania see: http://cf.heritage.org/index2004test/country2.cfm?id=Romania

that do not yield economic growth. As an economic advisor to the Romanian President we spoke with summarized the problem, in Romania "it is easier to take money from others then by producing."[7]

The failure of the Romanian economy is directly linked to its current institutional structure. There are higher payoffs for unproductive and evasive activities relative to productive ones. As a result, entrepreneurs driven by the profit motive undertake activities that fail to remedy the general stagnation of the Romanian economy.

While studies often focus on the entrepreneurs in a specific country as a general category, in the case of Romania it is important to consider both urban and rural entrepreneurs.[8] Our fieldwork indicated that entrepreneurs in both the rural and urban setting face the same administrative and bureaucratic barriers. However, in addition to these common barriers, rural entrepreneurs face additional challenges as well. Many of the unproductive and evasive activities that occur in Romania stem from its unstable legal and judicial institutions and the resulting rampant corruption in political institutions. We first consider unproductive activities in Romania and then turn to evasive activities.

3.1 Unproductive Entrepreneurship

The current legal environment in Romania can be seen as the cause of the rampant corruption throughout the country. The presence of excessive and uncertain regulations raises barriers to productive entrepreneurial activities. This problem is compounded by the random and ineffective enforcement of the regulations. Administrative incapacity of

[7] Interview with Vladimir Pasti, Bucharest, 5/26/03.

[8] Almost half (47.3%) of the Romanian population lives in rural areas. As of 2001, agriculture in rural areas employed 40% of the total employed populace with 33% in services, 23% in industry and 4% in construction. During the same year, agricultural output accounted for only 15% of the GDP (CIA Worldbook).

both the central and local governments presents a continuous problem. Appropriate resources – both financial and human – do not support the high velocity of regulatory changes, the end result being an incoherent legal framework. A 2000 study by the World Bank of corruption in Romania provides insight into the extent of the general legal environment in the country.[9] Of the results reported, 86% of respondents claimed that "constant changes in laws and regulations" was a main obstacle to doing business (11). Constantly changing laws are largely the product of so-called "Emergency Ordinances" – immediately active executive decrees issued by the Romanian President on a frequent basis.[10] Indeed, between 1997 and 2000 alone, 684 Emergency Ordinances were issued– nearly 43% of all laws created during this period. In 2000, Emergency Ordinances actually accounted for the majority – over 56% – of all laws created in Romania that year.[11] As a result, it is nearly impossible to comply with the law even when one desires to do so. Recognizing this, individuals find it cheaper to ignore the law entirely. Thus the *2002 Corruption Perception Report* prepared by Transparency International found that 53% of Romania's surveyed responded that they would "break the law to get things done." [12] In that same report, 54% of the respondents said they had "trust in other people" but only 23% said they had "trust in institutions" that compromise society (280).

[9] Diagnostic Surveys of Corruption in Romania, available at: http://www.worldbank.org.ro/ECA/Romania.nsf/ECADocByUnid/85256B6E005A94B285256B13007CB509?Opendocument

[10] The problem of "Emergency Ordinances" was discussed with Cristian Boureanu, former Advisor to the Minister of Finance, Bucharest, 5/28/03 and Entrepreneur 13, Visina Noua, 6/1/03.

[11] Romanian Ministry of Justice Legislative Database available at: http://www.guv.ro See also, Stan (2002).

[12] Report available at: http://www.globalcorruptionreport.org/download/gcr2003/24_Data_and_research.pdf

When asked about their perception of corruption in specific occupations, 50% of respondents perceived judges and lawyers to be corrupt (287).[13]

The unstable legal institutions in Romania create an environment of arbitrary enforcement and widespread corruption. The World Bank study cited above paints an accurate picture of the current situation. Approximately two-thirds of those surveyed believed that "all" or "most" public officials are corrupt (2000: vi). Of those surveyed, 42% of households and 28% of established enterprises experienced corruption in a twelve-month period (viii, 7). Further, 50% of households and 44% of enterprises "think that bribery is part of every day life" (4). The types of corruption identified by the report include: permits for building repair, construction and real estate, driving licenses and loan applications. In 2002, Romania was listed the third most corrupt country in Europe after Russia and Albania (Transparency International 2003).

Our fieldwork in both the urban and rural areas confirms the story told by the data cited above. The number of authorizations, approvals and licenses varies depending on the region of the country and line of business.[14] The common thread is that in all cases investigated, the entrepreneurs indicated that regulations were both plentiful and rapidly changing. As one entrepreneur stated, "changes are so fast that no one, including public functionaries, know what the law requires on any given day."[15] This situation is strongly reinforced by the lack of an efficient court system. As one entrepreneur reported, you

[13] Percentage of people responding "almost all of them are involved" or "most of them are involved."
[14] In the 2004 Index of Economic Freedom, The Heritage Foundation quotes The Financial Times in saying: "it takes anything from 49 to 102 days to register a new company: 83 pages of forms have to be completed, weighing half a kilo…. Small to medium-sized enterprises have between 11 and 23 inspections a year…. A business start-up needs between 23 and 29 authorisations and approvals."
Report available at: http://cf.heritage.org/index2004test/country2.cfm?id=Romania
[15] Interview with Entrepreneur 7, Bucharest 5/27/03

"cannot use the state courts; they do not exist for me."[16] Another entrepreneur in Visinia Noua told us that he has never used state courts for dispute settlement because "whether you are guilty or not, you have to pay."[17]

The widespread ineffectiveness of state courts also hampers productive entrepreneurship. Specifically, the lack of an effective court system limits the expansion of one's network of clients, lenders and suppliers. The absence of an effective court system makes it extremely difficult for entrepreneurs to extend their network beyond a few close friends and neighbors who they know well. The fear of being cheated with little or no recourse places a strong constraint on the extent of the entrepreneur's business network. Furthermore, anyone who wants to interact with informal entrepreneurs must invest time and effort in gathering information on their credibility and trustworthiness. This increases the transaction costs of expanding one's network. The effects of this constrained network on starting, maintaining and developing a business are apparent by the lack of economic growth in Romania.[18]

The uncertainty created by legal instability, excessive regulation and corruption impacts entrepreneurs in a number of ways. For those who are alert to a potential business opportunity, bribes must be paid at each level of government to obtain the appropriate permits, licenses and authorizations. Therefore, corruption is extremely damaging to economic progress on two fronts. In addition to impacting current enterprises, it also raises the cost of acting on potential business opportunities in the first

[16] Interview with Entrepreneur 1, Bucharest, 5/19/03.
[17] Interview with Entrepreneur 13, Visina Noua, 6/1/03.
[18] The state of courts and the impact on the entrepreneurial process were discussed in interviews with: Entrepreneur 1, Bucharest, 5/19/03, Entrepreneur 4, Bucharest, 5/22/03, Entrepreneur 7, Bucharest, 5/27/03; Entrepreneur 8, Bucharest, 5/27/03; Cristian Boureanu, Bucharest, 5/28/03; Entrepreneur 13, Visina Noua, 6/1/03; Entrepreneur 16, Visina Noua, 6/2/03 and Entrepreneur 18, Visina Noua, 6/3/03.

place. In terms of our framework, the payoff to productive activities is lowered by the very presence of expensive bribes.

These bribes continue once the business is up and running. As one entrepreneur summed up the situation, "I'm upset about paying bribes but I've adapted to them. I want to make money."[19] Our interviews confirmed the survey results cited above and concluded that entrepreneurs have come to view corruption and the uncertain legal environment as part of their normal, daily lives.

Even after the initial bribes are paid and authorization is secured, the lack of stability and predictability of the legal environment makes it difficult to develop a long-term business plan. Given the high turnover of law, the regulations in place today may very well be drastically different in (near) future periods. This not only makes it extremely difficult for entrepreneurs to decide whether to pursue a potential profit opportunity, but also to forecast the future business environment. As one entrepreneur put it, the "law changes so often, you can't formulate a long-term business plan."[20] In addition to the aforementioned problems, the lack of stability and predictability of the legal environment also makes it difficult to obtain funding. Most formal lending institutions require some forecast of expected profitability over the long term. Generating a future forecast, however, is virtually impossible given that legal factors affecting potential profitability change frequently.

There are two ways to interpret the situation in Romania presented above. The standard interpretation, reflected in reports by development agencies, is that there are high barriers to entrepreneurs and, hence, a shortage of entrepreneurship. Another

[19] Interview with Entrepreneur 1, Bucharest, 5/19/03.
[20] Interview with Entrepreneur 1, Bucharest, 5/19/03.

interpretation is that entrepreneurship in Romania is flourishing. The key is the distinction made in Section 2 between productive, unproductive and evasive entrepreneurship. Productive entrepreneurship is currently stagnant in Romania. Unproductive and evasive entrepreneurship, on the other hand, are alive and well.

Given the ease in changing laws and earning an income via bribes and corruption, we see entrepreneurial activities directed toward these activities instead of productive ones. Returning to the World Bank survey cited above, 42% of enterprises responded that state officials engage in "skewing parliamentary votes in favor of certain private interests" (2002: x). Because changing the law is relatively easy, it makes sense for entrepreneurs to engage in activities which shift the legal environment to their own personal gains. Therefore, a large amount of resources are dedicated to rent-seeking in order to obtain privileges from those in positions of power. One entrepreneur we interviewed in Visina Noua described this problem particularly well: "The sole profitable business in this environment is to have a connection in the government and make money from cheating and stealing."[21]

The situation in Romania can be viewed as a vicious circle that is self-reinforcing a sub-optimal equilibrium. One unproductive activity – e.g., a new law or regulation – creates several more opportunities for other unproductive opportunities – for example, inspectors using the new law to extract bribes. In fact, the constant creation of new laws and regulations often raises the returns from entering civil service above those of entering wealth-creating enterprises like business. As one entrepreneur we spoke with indicated, several of his associates left successful businesses they were running to become regulators and inspectors because they could earn more engaging in unproductive activity

[21] Interview with Entrepreneur 16, Visina Noua, 6/2/03.

than in productive ones.[22] Unproductive activities thus have a negative cumulative affect, reinforcing the current stagnation that characterizes the Romanian economy.

3.2 Evasive Entrepreneurship

Above we considered the reasons why entrepreneurs in Romania would direct their efforts toward unproductive ends. We concluded that the current situation in Romania yields relatively higher payoffs from such activities. However, the widespread existence of unproductive entrepreneurship does not mean that there is a complete absence of productive activity. Our fieldwork indicated that there are many entrepreneurs engaged in productive activities. Unfortunately, many of these efforts are stifled by unproductive activities and channeled into evasive ones.

Those who undertake productive activities must invest a large amount of resources to evade the unproductive activities of others. In many cases, evasion is the only way that productive opportunities can be made profitable. Because engaging in evasive activities involves a large amount of resources, the welfare implications of these efforts constitute a significant deadweight loss for society as a whole. Evasive entrepreneurship in Romania takes place across several margins which we consider below.

The most common form of evasive activity in Romania occurs via tax evasion, which is largely a result of the oblique and rapidly changing Romanian tax code. In the 2003-2004 Global Competitiveness Report, which ranks countries according to business leaders' beliefs about how complex and distortive the tax system is on their business

[22] Interview with Entrepreneur 1, Bucharest, 5/22/03.

decisions, Romania ranks 100th out of 102 countries. In the same report, entrepreneurs cited tax regulations as "the most problematic factor for doing business" in Romania. While the volume of tax evasion is hard to measure, the Executive Opinion Survey, which asked Romanian business leaders about the frequency of bribes paid in connection with annual tax payments, placed Romania among the top 32 nations in this regard (World Economic Forum 2003-2004).

New labor laws (2003 Code) also make it extremely difficult to hire short-term labor and make the process of firing employees arduous. The excessive taxation of labor causes many entrepreneurs to report the minimum wage on the books while paying employees the remainder, and majority, of their salaries off the books.[23] Rapid, erratic changes in tax law make it difficult for entrepreneurs to calculate their tax liability for the purposes of forecast future liabilities. Many understate their revenues in order to avoid paying taxes or being subject to future changes in the tax law. Tax evasion has become engrained in the everyday life of entrepreneurs. As one entrepreneur told us, he doesn't feel guilty about evading taxes because "if you don't steal the money, state officials will."[24] Furthermore, bribes and other side payments made to avoid the unproductive activities of regulators and bureaucrats—although they constitute a major business expense[25]—cannot be formally recorded and tracked by entrepreneurs. In this environment it is extremely difficult to effectively keep accounts about the actual costs and revenues of various business activities. The result is often gross firm inefficiency.

[23] The impact of tax law and tax evasion on the entrepreneurial process was discussed in interviews with: Entrepreneur 1, Bucharest, 5/19/03, Entrepreneur 7, Bucharest, 5/27/03; Entrepreneur 8, Bucharest, 5/27/03; Entrepreneur 12, Visina Noua, 6/1/03; Entrepreneur 13, Visina Noua, 6/1/03; Entrepreneur 16, Visina Noua, 6/2/03; Entrepreneur 18, Visina Noua, 6/3/03 and Entrepreneur 26, Visina Noua, 6/3/03.
[24] Interview with Entrepreneur 1, Bucharest, 5/19/03
[25] According to the Global Competitiveness Report (2003-2004), Romania ranked 70/102 in terms of the commonness of paying bribes connected to annual tax payments.

Regarding the formally required authorizations, approvals and licenses, many entrepreneurs, especially those from rural areas, try to evade the legal process altogether. Thus in addition to facing the same barriers as urban entrepreneurs, rural entrepreneurs face additional barriers. The main barrier is the physical distance that one has to travel to the main cities to obtain the appropriate approvals, licenses and paperwork. As a result, many rural entrepreneurs join the underground economy or look to better connected individuals from urban areas who specialize in obtaining the necessary forms, etc. These middlemen are evasive entrepreneurs engaged solely in assisting productive entrepreneurs in evading the deadweight losses associated with the formal legal structure. As a result, the official and unofficial fees paid by rural entrepreneurs are comparatively higher than those paid by their urban counterparts.

For instance, one entrepreneur we interviewed cited five major licenses/permits he needed to obtain before he could open his business: re-chartering his company statute, environmental protection, sanitary/animal police, fire and worker protection standards.[26] These registrations and approvals could only be obtained by going to the Chamber of Commerce in Arad. It took him seven trips to Arad, approximately fifty miles from his home, and one and half months, to obtain all the paperwork to open his business (he estimated that each permit took about three hours to obtain and indicated that the office in Arad is only open until 11am each day). While it was possible to hire professionals to undertake all of the start-up activities, he noted that doing so was very costly. Without the funds to do this, he undertook the authorization process himself, which cost him about 10 million lei (approximately $300).

[26] Interview with Entrepreneur 24, Buteni, 6/14/03.

Our fieldwork indicated that excessive inspections and the need to bribe were especially high in the rural areas. Due to the relatively smaller number of enterprises and entrepreneurs in each local bureau's jurisdiction as compared to the urban areas, inspections tend to occur in these places more often. This also requires an investment on the part of entrepreneurs in building a relationship with the inspectors in order to minimize the number of bribes that need to be paid.

The rampant evasion of all laws and regulations has created a large informal sector in Romania.[27] According to the Project on Human Development, in 2003 Romania scored a 4.0 out of 5.0 for its extent of black market activity, placing the estimated size of its black market among the 50 largest underground economies in the world.[28] Due to corruption and an unstable legal system, entrepreneurs who are productive must hold many of their assets outside the law. The costs of engaging within the system are simply too high. As a result, they do not have access to the mechanisms that a formal legal system would provide them. This includes, for instance, contractual protection that is necessary to enable entrepreneurs to expand their business networks beyond a few friends and family members, as we noted earlier.

It is important to note that although the informal sector allows productive entrepreneurs to operate, it is far from perfect. In fact, there are substantial costs involved with operating in this fashion. The range of choices available to those in the informal sector, whether they are clients, suppliers, financiers or courts, are severely limited. As already discussed, the costs involved in evading the formal system are

[27] Romania received a score of 4 (with "1" being the best and "5" being the worst) in the *2004 Index of Economic Freedom* in the category of "Informal Market."
Report available at: http://cf.heritage.org/index2004test/country2.cfm?id=Romania

[28] Report available at:
http://humandevelopment.bu.edu/use_exsisting_index/show_aggregate.cfm?index_id=295&data_type=1

significant. Property rights are not as strong as they could be because of a lack of formal recourse in the absence of an effective court system. There is also a limitation on how much informal businesses can expand because they must remain small in order to avoid detection. Utilizing certain credit instruments, physically expanding a business or hiring too many workers makes detection by authorities easier and so must be avoided when productive entrepreneurs operate underground.

4 Conclusion: Changing the Relative Payoffs

This paper has argued that economic growth requires that entrepreneurial alertness be directed toward productive activities. To illustrate this argument, Romania was analyzed as a case where the payoff to unproductive and evasive activities is relatively higher as compared to productive activities. Given this, it is possible to put forth some general guidelines for the achievement of economic progress:

1. Entrepreneurship is omnipresent – Entrepreneurs are present in all settings. Cultural explanations for a lack of entrepreneurship overlook what people have in common – namely alertness for profit and to improve their general situations. Underdeveloped nations do not lack entrepreneurship. Rather, entrepreneurial activities exist, but are not being directed toward productive ends conducive to economic progress.
2. Government cannot create entrepreneurship – Given that entrepreneurs are omnipresent, government policy cannot "create" entrepreneurship. Instead, emphasis should be placed on creating a general institutional framework, making payoffs to productive entrepreneurship relatively high compared to

unproductive and evasive activities. Resources should not be allocated to "encouraging" or "training" entrepreneurs, but in developing the necessary institutional context to allow productive activities to come to the forefront.

3. Transparency and accountability are critical for reform – In many cases, the lack of transparency and accountability allows officials to abuse the law for personal reasons. One key mechanism for creating transparency is a free media industry which serves as a check on those in positions to abuse the political and legal institutions (see Coyne and Leeson 2004). Increased transparency and accountability reduce the payoff to unproductive activities.
4. Reform needs to be decentralized – As discussed previously, entrepreneurs in rural Romania face a special set of challenges. Currently, the national government controls all reform efforts and neglects the unique situation of rural entrepreneurs. Reform efforts should be decentralized to the local level so that those that truly understand these challenges are involved in the reform process.

As economics and history teach us, these guidelines present us with the best opportunity for overcoming the plight of underdeveloped nations.

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