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Entrepreneurship in MENA Conflict and Post-Conflict States

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Abstract¹

Over the last half century, almost a third of all countries have undergone conflicts that involve more than a 1,000 violent deaths in a single year. Among the countries currently suffering from severe conflict in the Middle East and North Africa (MENA) region are Egypt, Iraq, Libya, Sudan, and Syria. What are the salient characteristics of the demand and supply for entrepreneurship in these countries? What is the impact of increased entrepreneurship on political instability/conflict? And what can be done to encourage entrepreneurship in conflict states? Despite the social, political, and economic diversity of this set of nations; it is found that their conflicts have produced similar barriers to entrepreneurship. And these barriers - political instability/conflict, poor governance, regulatory hostility to private business, and widespread corruption - are tightly interwoven and therefore tend to resist a piecemeal approach. Study ends with policy recommendations intended to encourage Kirznerian entrepreneurship in corrupt, conflict states.

Introduction

Much of the research on accelerating economic development in conflict or post-conflict countries (hereafter “conflict and/or post-conflict” countries will be referred to simply as “conflict” countries) has primarily focused on stabilizing the country’s macroeconomy and ensuring that the government of the conflict state is reasonably efficient at rebuilding

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infrastructure. (Brauer and Dunne 2012; Cramer 2009, p. 129; and del Castillo 2008.) If the three components of the “Washington Consensus” are macroeconomic stabilization, trade and investment liberalization, and emphasizing the coordinating role of the market in the domestic economy; then most economic policies in conflict and post-conflict states have focused on the first two components while the third – replacing administrative dictates with market activities – is much discussed but rarely executed. While there have been some partial successes with this “top-down” approach in conflict countries, it is generally viewed as an expensive failure. (Patterson 2010, p. 226) According to del Castillo: “...good macroeconomic management is necessary but not sufficient for the reactivation of investment, trade, and employment.” (2008, p. 290) Not only do most of these macro-oriented economic programs fail to deliver accelerated development and the accompanying improvement in living standards; they appear to do little to reduce political instability. There appear to be at least two reasons for the failure to deliver either economic development or increased political stability. Such programs generally do not lead to the creation of productive jobs and they tend to worsen corruption.

Encouraging entrepreneurship in a conflict country – sometimes referred to as expeditionary economics - is a “bottom-up” approach to increasing political stability by encouraging private sector job creation through productive entrepreneurship while reducing the incentives for corruption. The seminal works on entrepreneurship in conflict states are Naude 2007 and Schramm 2010.

Research on the relationship between entrepreneurship and political instability/conflict is in its infancy. Two examples are that Casson et al’s 2006 *Oxford Handbook of Entrepreneurship* that has no chapters or even index entries for conflict,

political instability, or war while Coyne and Mathers 2011 *Handbook on the Political Economy of War* is silent on the subject of entrepreneurship.

This paper attempts to extend the work of Naude and Schramm in several directions. After a discussion of the characteristics of MENA conflict states, it integrates entrepreneurship into a specific model of political stability. It then distinguishes between innovative and arbitrage/speculative entrepreneurship and discusses their different effects in low-income conflict countries. Next, it argues that public sector jobs and private sector jobs have different effects on political stability. This is followed by a detailed discussion of the relationships among conflict, corruption, and entrepreneurship. The paper ends with a discussion of pro-entrepreneurship policies appropriate for low-income, corrupt, conflict states in the MENA region. In this final section, it is argued that it is often a wasted effort to use targeted policies to encourage entrepreneurship.

Characteristics of Conflict States

Table 1 is a list of twenty MENA countries listed in the order of their likelihood of achieving and maintaining peace according to the Global Peace Index (Institute for Economics and Peace, 2013). The countries listed as “Very Low” – Iraq, Sudan, and Syria – are currently suffering from high levels of conflict deaths while those ranked “Low” are either suffering from lower levels of conflict deaths or are perceived to have the potential for an outbreak of violence.

The types of conflict differ among the that ranked poorly in the Global Peace Index. In Iran, Libya, the Sudan, Syria, and Yemen, the government was directly engaged as a party in conflict. However, in Iraq much of the killing was between two or more

parties that were somewhat independent from the government. At the time when the Global Peace Index was estimated, Egypt was ranked as “medium” but the severe violence associated with the removal of Morsi as Prime Minister would probably currently earn Egypt a “low” or “very low” ranking. Therefore Egypt will be categorized as “low” for the remainder of this study.

Table 1: Characteristics of MENA States

Country	Global Peace Index (2012) (Higher is better)	Population (millions)	Pop Young (<15 years)	Youth Unemployed M/F	GDP (percap)	Gini Index (0 = income equality)
Qatar	Very High	1.9	13%	0%/9%	\$86,440	41
Jordan	High	6.2	35%	26%/47%	\$5,930	35
Kuwait	High	2.8	25%	Adult 2%	\$53,720	NA
Morocco	High	32.3	28%	18%/17%	\$4,880	41
Oman	High	2.8	26%	Adult 15%	\$25,720	NA
Tunisia	High	10.7	23%	Adult 17%	\$8,990	36
UAE	High	7.9	14%	8%/22%	\$47,890	NA
Algeria	Medium	36.0	27%	19%/38%	\$8,310	35
Bahrain	Medium	1.3	20%	Adult 15%	\$21,200	NA
Egypt	Medium*	82.5	31%	15%/54%	\$6,120	31
Saudi Arabia	Medium	28.1	30%	24%/46%	\$24,700	NA
Iran	Low	74.8	24%	20%/34%	\$11,420	38
Israel	Low	7.8	27%	12%/11%	\$27,110	39
Lebanon	Low	4.3	23%	NA	\$14,470	NA
Libya	Low	6.4	29%	Adult 30%	\$16,800	NA
Yemen	Low	24.8	41%	Adult 35%	\$2,170	38
Iraq	Very Low	33.0	41%	Adult 16%	\$3,750	31
Sudan	Very Low	34.3	42%	Adult 20%	\$2,120	35
Syria	Very Low	20.8	35%	15%/40%	\$5,080	36
West Bank & Gaza	NA	3.9	41%	37%/40%	\$2,900	36

* Following the violence associated with the removal of Morsi as Prime Minister, Egypt would probably be currently ranked as “Low” and maybe as “Very Low”.

Sources: Population, percentage of young, per capita GDP, real growth, and poverty data from World Bank, World Development Indicators, 2013.

What economic characteristics do the ten countries with a low probability of peace – high probability of conflict – have in common? Based on Table 1, relatively few. One of the strongest empirical relationships in the literature of the economics of conflict is the high correlation between low per-capita incomes and the propensity for conflict. (Blattman and Miguel 2010, p. 4) And this pattern appears to roughly hold among the countries in Table 1. However, among the MENA ranked “low” or “very low”, there is a wide range of per-capita incomes. Yemen, the Sudan, and the West Bank and Gaza (hereafter referred to as the West Bank) are low-income countries where the average person struggles to survive on less than \$8 per day. At the other extreme, Lebanon and Libya have average per capita incomes almost five times greater. These countries also differ greatly in the variance of their per capita income. The country that experiences the greatest year-to-year change is Iraq since its income is dependent on the export of a single product, oil. Since oil exports account for two-thirds of the country’s GDP, a sharp drop in oil prices, such as occurred in 2009, results in an immediate drop in per-capita incomes. There is also wide variance in the percentage of each country’s population that is experiencing severe absolute poverty, defined by the World Bank as less than \$1.25 per day. Syria and Iran report extremely low levels of absolute poverty – 2% or less - while in the Sudan and Yemen, almost 20% of the population lives in such severe absolute poverty.

One characteristic that these ten countries have in common is that a large proportion of their populations are young. With the exceptions of Lebanon and Iran, each country has a greater percentage of young persons than the average for countries of similar levels of income. (World Bank 2011, p. 345) And, although unemployment and

underemployment data are notoriously unreliable, these countries are also thought to have very high unemployment and underemployment rates especially among the youngest workers. For example, in Iraq, an estimated 51% of the labor force is either unemployed or underemployed but, for those between the ages of 15 and 19, the combined unemployment and underemployment rate rises to 82%! (Gunter 2013, Table 2.2, p. 15) A large number of young people with little hope of obtaining employment would seem to be a contributing factor to political instability or conflict since the willingness to become a rebel rises as the opportunity cost of this choice falls. (Blattman and Miguel 2010, p. 10) But the relationship between employment, economic development, and political stability is probably more complex than this simple correlation implies.

Economic Development and Political Instability

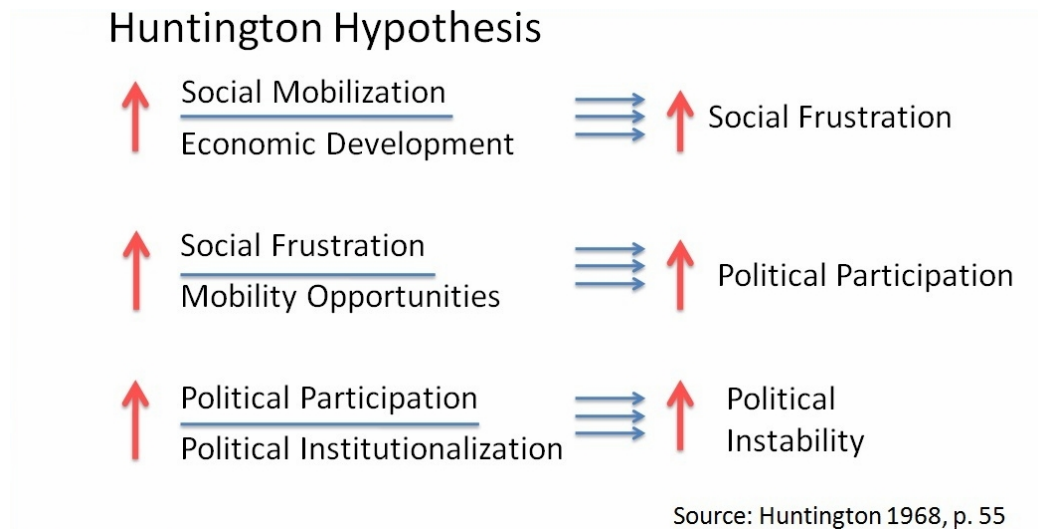
That economic deprivation tends to lead to political instability is one of the most widely accepted hypotheses concerning conflict. (Dumas 2011, pp. 598-600) In fact, in an extensive cross sectional analysis of the origin of civil wars, “rapid economic decline” was the only variable that was a statistically significant cause of civil conflict. (Collier 2000, p. 97) But it is important to understand the exact mechanism(s) connecting economic growth and political stability if policies are to be developed to reduce the probability of political instability or conflict.

Samuel Huntington’s 1968 hypothesis (p. 41) of the relationships among modernization, economic development, and political stability has been described as the last great attempt to integrate the social, economic, and political causes of instability. (Fukuyama 2011, p. IX) There are more elaborate recent models of the relationships

between economic and political change but Huntington's hypothesis provides a solid framework for examining the challenges facing low-income conflict countries.²

Huntington attempted to explain an oft-observed phenomenon that: "Modernity breeds stability but modernization breeds instability." In other words, high-income countries generally experience less political instability or conflict. However, low-income countries that experience an acceleration of economic growth tend to experience *more* political instability or conflict. Huntington sought to explain this counter-intuitive result by looking at the rates of change of modernization, economic development, opportunities for mobility, and political institutions. His hypothesis is illustrated in Figure 1.

Figure 1



Urbanization, increases in literacy and education, and increased exposure to media lead to social mobilization. People in low-income countries begin to realize that there are more satisfying ways of living. For example, on the village TV residents see

² For an example of an alternative model, see Acemoglu and Robinson, 2006. For a extensive literature on the economics of civil wars, see Blattman and Miguel 2010.

shows where people don't have to walk to work, aren't limited to farming with hand tools, and where sick children have access to medical care. This social mobilization leads to expanded aspirations. People begin to believe that progress is possible and they want a better life for themselves and their children.

Economic development increases a society's capacity to satisfy those aspirations. It doesn't have to be immediate or complete e.g. farmers may be aware that others have trucks but if they are able to buy motorbikes then this may partially satisfy their new-borne aspirations - at least for a while. However, if economic development lags too far behind in fulfilling the growing aspirations created by social mobilization then social frustration – a growing dissatisfaction with current circumstances – will increase.

Social frustration can be dissipated if a society allows opportunities for mobility. This mobility can be geographic (people moving from one province to another or from rural areas to urban), occupational (moving to a higher-paying/higher-status job/profession), or international (migrating to another country – “brain drain”). However, if social frustration grows faster than can be dissipated by mobility then people will want increased political participation in order to demand that the government either accelerate economic development or increase mobility. People will seek to either join existing political organizations or create new ones in order to give voice to their demands.

Demands for expanded political participation often collide with closed or inflexible political institutions that are intended to protect the interests of those currently in positions of power. Such institutions will limit the meaningful incorporation of new political participants. This exclusion will provide fertile ground for political instability or armed conflict. What determines the degree of flexibility of political institutions?

Huntington argued that flexibility was directly related to age; the longer a political institution survives, the more flexible it becomes – the more open to new participants. (1965, pp. 394-395) Newly created political institutions especially those still controlled by their founders tend to be more inflexible. During the early years of such institutions, political influence is limited to trusted insiders – opening political institutions to outsiders is seen as a sign of weakness or disloyalty to the founders. This collision between demands for expanded political participation and closed political institutions is perceived as one of the major causes of the political instability that began in Egypt early in 2011 and has now spread to many nations in the Middle East and North Africa.

As Figure 1 illustrates, according to the Huntington hypothesis, there are three ways that a nation can forestall political instability or conflict: by accelerating economic development; by increasing opportunities for geographic, occupational or international mobility; or by increasing the flexibility of political institutions when confronted with new demands for political participation.

Entrepreneurship critically impacts the Huntington model in several ways. First, entrepreneurship can lead to an acceleration of economic development and increase productive employment. This will reduce social frustration, as faster economic development and meaningful employment will allow more of the people's aspirations to be met in a timely manner. Second, entrepreneurship can provide opportunities for increased mobility to large numbers of people. (Naude 2007, p. 8) They have the opportunity of moving from being a waged worker to being self-employed. This mobility as a result of entrepreneurship will, at least partially, offset any increases in social frustration that do occur. Finally, organizations of entrepreneurs can sometimes influence

existing political institutions to adopt policies more favorable to economic development through organized lobbying. But what type of entrepreneurship is most needed in low-income countries?

Entrepreneurship and Economic Development

Despite the growing realization of the importance of entrepreneurship for economic development in both developing and developed countries, there is still no consensus among researchers on the best definition of entrepreneur or entrepreneurship. However, most definitions echo that of Mark Casson (1987, pp. 151-153) who emphasized that the entrepreneur specializes in “judgmental decisions”, decisions where there is no obviously correct answer *and* information is costly. Consistent with this view, this paper uses the following definition: “Entrepreneurs are individuals who, in an uncertain environment, recognize opportunities that most fail to see and create ventures to profit by exploiting these opportunities.” (Gunter 2012, p. 387)³

In addition to a diversity of opinion concerning the best definition for entrepreneurship, there is also disagreement on the most useful subcategories. One common distinction is between necessity (survivalist) entrepreneurship and opportunity entrepreneurship. The former type results from an inability to obtain any form of employment while the latter is a true choice of self-employment in order to gain a better life. (Naude 2007, p. 2) In low-income countries, most small businesses are created from necessity. (Noland and Pack 2007, pp. 243-244)

Another valuable distinction is among productive, unproductive, and destructive

³ For alternative definitions, see Kuratko and Hodges (2007), Naude (2007) p. 20, and Parker (2009).

entrepreneurship. Productive entrepreneurship results in increased economic value. Unproductive entrepreneurship redistributes economic value while destructive entrepreneurship actually destroys economic value. (See Baumol 1990; Naude 2007, pp. 3-5; and Desai et al 2010.) Corruption would be a case of destructive entrepreneurship. Beyond these two categories, there is a third possible distinction that has received little attention and yet I think is critical to understanding the impact of entrepreneurship in low-income conflict countries.

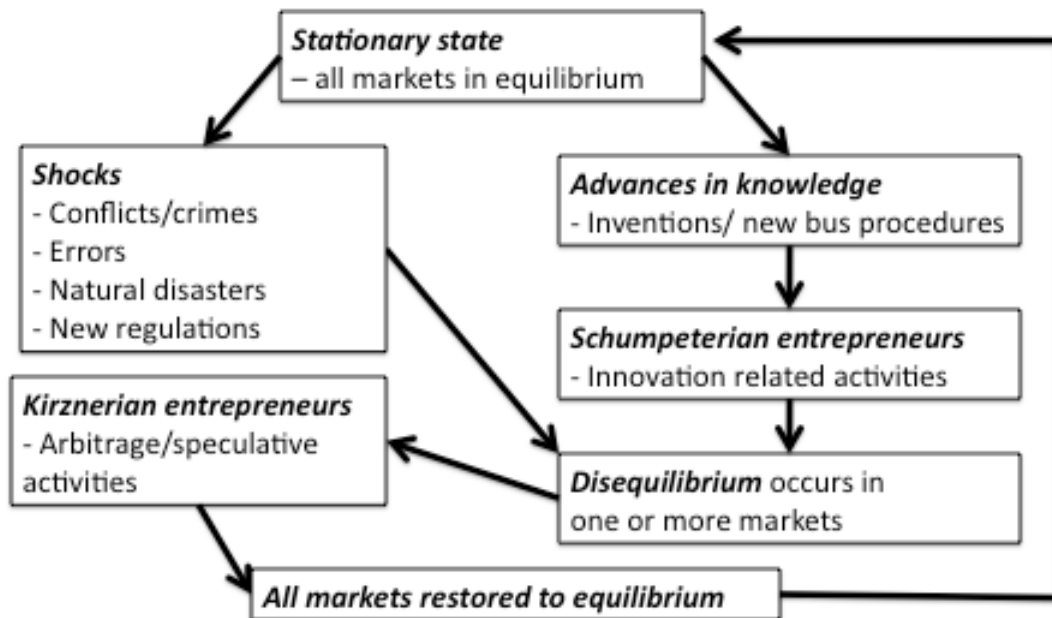
Both arbitrage/speculative (also known as Kirznerian) entrepreneurship and innovative (or Schumpeterian) entrepreneurship occur in most countries. They are difficult to distinguish both in theory and in practice. (Baumol 2010, pp. 13-16) Kirznerian entrepreneurs seek to earn a profit by arbitraging or speculating within existing markets, products, and processes while Schumpeterian entrepreneurs create new markets, processes, or products. For example, an innovative (Schumpeterian) entrepreneur might develop and market a new type of tomato. However, an arbitrage/speculative (Kirznerian) entrepreneur might observe that a shortage of trucks has led to a tomato shortage in a city. She might then bribe a school official to allow the entrepreneur to borrow school busses, load them with baskets of tomatoes, and transport them to the city. The effect of each type of entrepreneurship is very different in low-income countries and they have different complementary inputs.

Most research on entrepreneurship occurs in high-income countries and focuses on the challenges facing innovative entrepreneurship – entrepreneurship that creates new products, processes, or markets. However, the less-studied arbitrage/speculative entrepreneurship may be more relevant when attempting to increase productive

employment in low-income countries especially during conflict. The somewhat complex relationship between the two types of entrepreneurship is illustrated in Figure 2.

A country that is experiencing no changes – a stationary state⁴ – has no need of any kind of entrepreneur. Of course, in the real world, change is continuous - although episodic - and the exact nature of a change determines what type of entrepreneur will be demanded. Shocks create demand for Kirznerian arbitrage/speculative entrepreneurs while advances in knowledge create demand for Schumpeterian innovative entrepreneurs. Shocks can take a variety of forms. An act of war could destroy an electrical generation plant, a hurricane could devastate a crop just before harvest, human error could wreck a train in a tunnel, or an unexpected new government regulation could require the abandonment of a widely used fertilizer. These shocks lead to market shortages or overages, waste, and inefficiency - market disequilibria – and economic growth slows. A country experiencing these shocks will produce less than its potential.

⁴ The stationary state is still widely accepted as an appropriate model for studying economics although such use was criticized by Schumpeter (1911/1983), Knight (1921/1971), and Weber (1930/2002).

Figure 2: Stationary State and Entrepreneurship

However, these shocks also create opportunities for profitable arbitrage by buying low and selling high. (Kirzner 1979, Chap. 7) For example – in response to the first shock listed above – an entrepreneur might import portable generators in order to sell black market electricity. In other words, arbitrage/speculative entrepreneurs - motivated by profit – reallocate existing resources using existing methods in existing markets. To the extent that these entrepreneurs are successful, shortages or overages will dissipate, waste will be reduced, and efficiency will increase resulting in accelerated economic growth and job creation. The country will return to its potential level of production.

In high-income countries, the process of arbitrage/speculative entrepreneurship is so fast and so efficient as to be almost invisible. There is widespread availability of

information on various options. Also, transportation and commercial systems generally support rapid responses to changes in demand or supply. It is only during a natural disaster such as a blizzard or flood that failures of arbitrage/speculative entrepreneurship become evident. But in low-income conflict countries, the arbitrage/speculative entrepreneurship necessary for resolving market disequilibria is often lacking. Perverse regulations, ignorance, inability to access complementary inputs, and security concerns may result in disequilibria lasting for extended periods of time accompanied by abnormally high unemployment and underemployment. An example from 2006 Iraq illustrates the failure of Kirznerian entrepreneurship in a conflict state. Tons of tomatoes lay by the side of a road because those who had workers couldn't get a loan to rent trucks, those who had trucks couldn't get black market fuel, those who had access to black market fuel couldn't get a license to transport tomatoes to another province, etc. In the absence of Kirznerian (arbitrage/speculative) entrepreneurs; the tomatoes rotted while workers and trucks sat idle.

As a matter of empirics, it is difficult to identify Kirznerian entrepreneurs in a developing country. While most Kirznerian entrepreneurs operate small businesses, most small business operators are rarely - if ever - entrepreneurial. Therefore, the use of the number or proportion of small business operators as a proxy for entrepreneurship in empirical studies is likely to give incorrect results. For example, since the proportion of self-employed tends to decrease as an economy develops, a few researchers have argued that there are an excessive number of entrepreneurs in low-income poor countries.

Advances in knowledge can also disrupt a stationary state. These advances provide profitable opportunities for Schumpeterian innovative entrepreneurs to engage in

creative destruction when they create new products, processes, or markets while disrupting the old ways of doing things. In other words, as a result of Schumpeterian creative-destruction, a country simultaneously experiences an increase in its economic potential as well as the creation of disequilibria in existing markets, which puts the country inside its newly expanded PPF. (Schumpeter 1911/1983) Of course, these disequilibria create new opportunities for Kirznerian arbitrage or speculation. And such Kirznerian entrepreneurship by reducing market disequilibria also reduces unemployment and underemployment. In conflict countries, much unemployment is not cyclical – insufficient macroeconomic demand – but frictional and structural in nature. Frictional and structural unemployment represent profit opportunities for Kirznerian entrepreneurs.

Since knowledge is non-rival and only partially excludable, it tends to spill over from the knowledge creators even if they are in another country. (Arrow 1962 and Romer 1990) Thus it is possible for a low-income country to obtain innovations through foreign investment – a country can survive and possibly thrive without domestic Schumpeterian entrepreneurs. But without domestic Kirznerian entrepreneurs, economic development and private sector job creation will stall. *Low-income conflict countries have a great need for Kirznerian entrepreneurs; Schumpeterian entrepreneurs – not so much.* (Gunter 2013, pp. 184-185) But are jobs created in the private sector by Kirznerian entrepreneurs superior to those provided by a government?

Not every job is a real job

In many low-income conflict countries, officials attempt to reduce unemployment by expanding government employment. (World Bank 2011, pp. 161-162) This policy is

based on an opportunity-cost theory "...that gainfully employed young men are less likely to participate in insurgent violence." (Berman et al 2011, p. 496) Increasing government employment is generally a popular policy since working for the government often provides better pay, more benefits, stronger job security, and reduced work intensity compared to private sector jobs. Also, international advisors often support the rapid expansion of government employment since it provides a measurable means of reducing unemployment - especially among difficult to employ uneducated/untrained young men – and puts money in circulation. (del Castillo 2008, pp. 296-297) But does an expansion of government employment actually reduce political instability?

It is often a misnomer to refer to the expansion of government employment as real job creation. A job implies an exchange. The worker provides something of value to his or her employer – his labor and human capital – and, in exchange, the employer provides something of value to the worker - a paycheck. Since this exchange is valuable to both parties, they develop a commonality of interests – a limited form of loyalty - since if the firm goes out of business then both the owner and the workers are worse off.

Contrast this to workers in government employment in low-income conflict countries. The loyalty of these workers is rarely to the government or to the public at large but rather to the particular political, religious, tribal, militia, or family member who arranged for their government paycheck. This is especially true if the government job requires little labor or even attendance. In Iraq, it is estimated that in some government Ministries, as many as 25% workers are "ghosts". These ghost workers receive a regular paycheck without having to show up for work. The combination of a government paycheck, little or no work, and an intense loyalty to whoever arranged this bounty can

be a recipe for instability. Political, religious, tribal, or militia leaders in the MENA countries often have loyal forces of supporters placed in government jobs and paid by the government they oppose.

The failure of government employment to reduce political violence or instability might be part of the explanation for the failure of empirical studies to establish a strong relationship between unemployment and violence. For example, in an important study of violence in Afghanistan, Iraq, and the Philippines; Berman et al (2011) found no positive correlation between unemployment and violence – directly contradicting the opportunity cost theory. Possibly the adverse effect of public employment on instability is disguising a positive correlation between political stability and private sector employment.

In addition to providing paid employment, a focus on creating private sector jobs tends to improve political stability for at least two reasons. First, with a few exceptions such as providing security services, private firms strongly support efforts to achieve political stability. Riots are bad for most businesses. While government employees generally continue to receive their paychecks even if their offices are looted, private sector employees know that if a mob wrecks their shop or factory then they are most likely out of a job. As a result, it is not uncommon for private sector employees in conflict states to risk their lives to protect their place of employment during periods of disorder.

Second, motivated by profit, private firms tend to be more willing to ignore political, ethnic, religious, or tribal differences when they do business. For example, to an outsider studying Iraq; Sunnis and Shi'a, or Arabs and Kurds appeared to be separated by hundreds of years of hostility. In reality, complex business relationships among these

groups have long existed. For generations, a Sunni farmer has sold his crop to a Shi'a grain dealer; the Kurdish merchant in Mosul periodically arranged with his Arab counterpart in Basra for large shipments by river and rail. These profit-motivated transactions create a degree of common interests and, sometimes, sympathy that can offset attempts by some leaders to benefit by inflaming political instability. (Coyne and Mathers 2011, pp. 592-596)

In contrast, government ministries in the capital city of a conflict country controlled by one political, ethnic or religious group can, with relative impunity, make it extremely difficult for members of other groups to obtain what they legally deserve.⁵ This leads to frustration and anger on the part of the excluded group. Political stability is better ensured with private sector jobs. But there is a continuing debate on the best means of encouraging private sector job growth in a low-income, corrupt, conflict state.

Conflict, Corruption, Entrepreneurship, and Economic Development

In an attempt to understand the relationship of conflict, corruption, entrepreneurship and economic development, it might be valuable to examine three pairs of relationships: conflict and corruption, conflict and entrepreneurship, corruption and entrepreneurship. Figure 3 is intended to provide a simple illustration of the interrelationships among political instability/conflict, corruption, economic stabilization, entrepreneurship, and economic development. And, to the extent that acceleration in economic development

⁵ For example, in Afghanistan and Lebanon, individuals obtained enough power and wealth during periods of conflict to successfully defy the central government. (Cramer 2009, pp. 134-135)

can be achieved, it should – as illustrated in Figure 1 - reduce the likelihood of a future political instability.

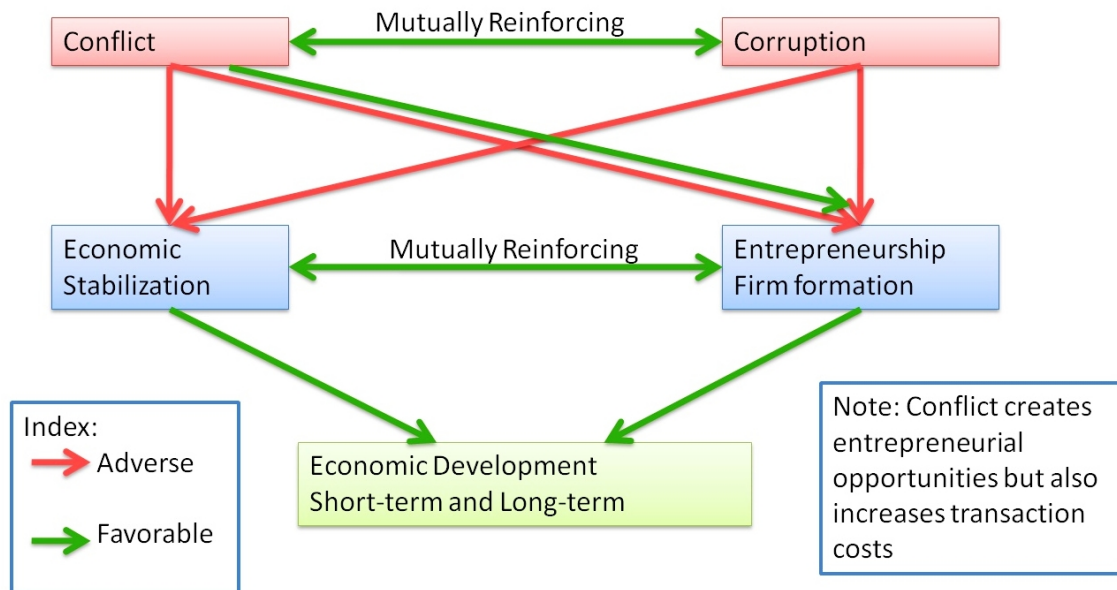
Corruption and conflict

Corruption is abuse of public power for private benefit. (Gunter 2008, p. 173) Bribery gets the most attention, but corruption can also include nepotism, official theft, fraud, certain patron-client relationships or extortion. Discussions of corruption usually do *not* include abuses of private power such as insider trading. Corruption is related to but not synonymous with the existence of a black or underground market. A black market – illegal trade in a good or service – may not require corruption on the part of a public official. It is possible that the officials may be entirely ignorant of the illegal transactions.

One of the challenges of studying corruption in the MENA countries is that the word “corruption” is both descriptive and pejorative. Many societies in the Middle East and North Africa have long cultural traditions of patron-client relationships, nepotism, or “gift giving” to officials. And members of these societies are loath to describe such behavior as corruption. It is often argued that calling such cultural traditions corruption is a distortion - an attempt to apply Western standards to non-Western societies.

Figure 3: Conflict, Corruption, Entrepreneurship, and Economic Development

Conflict, Corruption, Entrepreneurship, and Economic Development



However, whether some forms of corruption are culturally accepted is a separate question from whether corruption has an adverse impact on economic development. While there has been extensive research on this issue, the results can be illustrated in a crude fashion by looking at the relationship between countries' relative per-capita income (adjusted for cost of living) and measures of relative corruption. The relationship is negative. Regardless of culture or geographic location, *there are no (very) corrupt rich countries and few honest poor ones*. Whether it is culturally accepted or not, corruption adversely affects economic development both at the microeconomic level – by

discouraging entrepreneurship – and at the macroeconomic level – by making economic stabilization⁶ more difficult.

Of course, measures of corruption are always somewhat arbitrary. And it is especially challenging to estimate corruption or other key characteristics such as literacy, the ease of doing business, or other political/social/economic variables in a low income, corrupt, conflict states. (Guglielmetti 2011, pp. 124-143; Gunter 2013, pp. 6-24) That said, according to the 2013 Corruption Perception Index (CPI) of Transparency International, all of the countries in the sample, with the exception of Israel, are extremely corrupt. In fact, as shown in Table 2, Iraq and the Sudan are among the ten worst countries. Among the MENA countries ranked “low” or “very low” in the Global Peace Index, only Israel ranks in the top – relatively honest - half of corruption rankings.

Table 2: Corruption and Business Regulation

Country	Global Peace Index (Higher is better)	Corruption (Lower is better)	Literacy (Male/Female)	Ease of Doing Business (Lower is better)
Qatar	Very High	27	96%	40
Jordan	High	58	93%	106
Kuwait	High	66	94%	82
Morocco	High	88	57%	97
Oman	High	61	86%	47
Tunisia	High	75	79%	50
UAE	High	27	90%	26
Algeria	Medium	105	73%	152
Bahrain	Medium	53	92%	42
Egypt	Medium*	118	72%	109
Saudi Arabia	Medium	66	86%	22
Iran	Low	133	85%	145

⁶ Economic stabilization generally refers to reducing fluctuations in a nation’s macro economy. An economy with fairly constant real output growth combined with low and stable inflation would be considered economically stable.

Israel	Low	39	99%	38
Lebanon	Low	128	90%	115
Libya	Low	160	90%	NA
Yemen	Low	156	64%	118
Iraq	Very Low	169	79%	165
Sudan	Very Low	173	71%	143
Syria	Very Low	144	84%	144
West Bank & Gaza	NA	NA	95%	135

There is a symbiotic relationship between corruption and conflict especially when government is one of the parties to the conflict. (Gunter 2013, pp. 49-50; Gunter 2007, p. 5) Corruption is good for the anti-government forces in an insurgency. Corrupt activities, including black market sales of stolen goods, official theft, extortion and “ghost workers,” can provide funding for the insurgency. (Bahney et al 2010, p. 36) Also, organizations and ratlines that handle smuggled or stolen goods provide routes and safe houses for insurgents, their munitions, and other parts of the insurgents’ logistical tail. Corruption also undermines the public’s confidence in both its government and allies. Finally, corruption can result in diversion of government resources - from food to weapons - into the black market.

And conflict is good for corruption. As the government absorbs an increased proportion of a nation’s resources to fight the conflict, there will be widespread shortages and it is likely that price and wage controls will be imposed to prevent inflation. Both of these events provide strong incentives for the population to trade in the black market. The reality of insurgent attacks justifies bypassing procedures and provides a ready excuse for corruption related losses. Finally, fighting an insurgency increases the urgency of getting

things done regardless of cost, which facilitates bribes and extortion. (Naude 2007, p. 12)

Since they are mutually reinforcing, corruption makes it more difficult to resolve a conflict while, the longer a conflict lasts, the more embedded corruption becomes in a society. Further complicating the relationship between conflict and corruption is that the former is sometimes favorable to entrepreneurship.

Conflict and Entrepreneurship

The relationship between conflict and entrepreneurship is complex. Conflict increases the transaction costs of entrepreneurship. Reductions in security make it more difficult for entrepreneurs to operate. Their suppliers or customers may be less willing to travel any distance to sell to or buy from the entrepreneur. It becomes more difficult to gather accurate market information concerning prices and product shortages. It may become almost impossible to gain necessary licenses or approvals as government officials are either distracted, in hiding, or isolated by their security forces. Conflict tends to make people less trusting of others especially strangers. And low levels of trust make it more difficult for entrepreneurs to establish new ventures. To the extent that formal and informal institutions are substitutes rather than complements, the periodic conflict related isolation of government officials can lead to unpredictable changes in the business environment. (Tonoyan et al 2010, p. 806) Banks and other formal financial institutions hesitate to lend while informal financial sources charge higher interest rates for shorter maturities in an effort to compensate for increased risk. Governments may view any entrepreneurial profits during a period of violent political turmoil as being immoral and seek to confiscate them. (Naude 2007, p. 15; Balabkins 1982, Chapter VII, pp. 191-216)

All of the above are in addition to the possible direct impact on the entrepreneur. He or

she may be drafted by the government or the insurgency, may experience theft or destruction of inventory or capital equipment.

However, conflict might also provide profit opportunities for Kirznerian arbitrage/speculative entrepreneurship. Even low levels of political instability can disrupt existing markets. For example, security issues might require diverting civilian shipments from traditional routes. The businesses of providing bodyguards and home/office security will expand rapidly. Both the government and any insurgency will possibly try to rapidly expand their operations requiring increased purchases of supplies. Arbitrage entrepreneurs may thrive by meeting these demands. Periods of instability may also lead to a substantial reduction of government oversight over business – a regulatory holiday. Finally, trades that were traditionally dominated by a particular group may be opened to entrepreneurs from other ethnic, religious, political, gender, or cultural backgrounds. (Naude 2007, pp. 3-4) A prime historical example of the favorable impact of conflict on entrepreneurship would be the American Civil War that resulted in the founding of some great entrepreneurial fortunes. A more recent study found a similar result in Mozambique. (Cramer 2009, p. 130)

Corruption and Entrepreneurship

While the net impact of conflict on entrepreneurship is ambiguous, that of corruption is not. Corruption tends to weaken entrepreneurship in multiple ways. First, it increases the cost of being a business owner. He faces the choice of either continuously paying bribes to an unending queue of rapacious officials or structuring his enterprise so as to reduce its vulnerability to the actions of corrupt officials. The former option can be expensive. A survey of over 1,600 private businesses in Iraq revealed that one in five thought that

bribes and other forms of corruption added 40% or more to their total costs of doing business! (CIPE 2007, Table 27, p. 11) The alternative is for a business to operate in the underground or black market. In order to avoid coming to the attention of officials seeking bribes: businesses will stay small, avoid advertising, limit transactions only to family, tribal, or other trusted persons, and often produce their product or service so that equipment and inventory can be quickly hidden or moved. As expected, these avoidance tactics severely limit potential profits from entrepreneurial activities. (Tonoyan et al 2010, pp. 806-811)

The second means by which corruption adversely impacts entrepreneurship reducing the number of entrepreneurs engaged in productive activities. Not all entrepreneurship is beneficial to an economy. Baumol (1990) and Desai et al (2011) discuss the possibility that entrepreneurship can be unproductive, or even destructive. In fact, much corruption can be thought of as a form of unproductive or destructive entrepreneurship e.g. rather than improve customer service to take market share from a competitor, an entrepreneur might instead bribe the police to arrest his competitor. And to the extent that officials can perform profitable corrupt acts with impunity, potential entrepreneurs may decide that they are better off becoming officials themselves and preying on anyone foolish enough to try to run a business.

Third, corruption may allow entrepreneurs who produce lower quality or higher cost products to gain market share at the expense of other entrepreneurs that are producing objectively better products but who failed to bribe the right officials. In this case, the return from investing in the bribing of officials is greater than the return from investing in producing a better product.

Finally, if many entrepreneurs – in order to survive - are operating in the black market and either bribing officials or extracting economic rents themselves, there will be a reputational effect. Over time, the public will begin to associate entrepreneurs with corruption and other forms of law breaking. This justifies government confiscation of entrepreneurial profits and assets. In addition, this reputation for corruption will probably last a long time and discourage otherwise qualified persons from becoming entrepreneurs.

Encouraging Entrepreneurship

In view of the interrelationships among conflict, corruption, and entrepreneurship; what are the best policies to encourage entrepreneurship and the accompanying productive job creation? It is unlikely that strategies that are successful in encouraging entrepreneurship in high-income countries will be as effective in countries in low-income countries. In high-income countries, not only are the government bureaucracies relatively honest and competent but also the emphasis is on encouraging innovative (Schumpeterian) entrepreneurship that results in new processes, products, or markets. However, in low-income MENA countries, governments tend to be both more corrupt and less capable. And, in low-income conflict countries, the greatest need is for arbitrage/speculative (Kirznerian) entrepreneurship that creates productive employment while knitting economies together by buying and selling everything that people want.

These different types of entrepreneurship have somewhat different requirements for success. For example, Schumpeterian entrepreneurs tend to have higher levels of

education⁷ and favor strong intellectual property rights (IPR). In contrast, successful Kirznerian entrepreneurs tend to have less education and often find IPR to be either irrelevant or a burden. As a result, recommendations from researchers on entrepreneurship in high-income countries are often inappropriate or actually damaging to entrepreneurship in low-income countries. For example, at the 2012 Global Entrepreneurial Congress in Liverpool, speakers exhorted governments to develop targeted programs to encourage entrepreneurship. These recommendations might make sense in a country with a reasonably honest, somewhat competent bureaucracy. However, in most low per-capita, high corruption, conflict countries, the last thing that entrepreneurs need is an excuse for a further expansion of their grasping and incompetent government. Only if the characteristics of entrepreneurial activity in a low-income conflict are clearly understood can successful policies to encourage entrepreneurship be developed, coordinated, and executed. Three of these characteristics are particularly important.

First, much entrepreneurial activity in low-income conflict is invisible to an outsider or an official. This invisibility is partly a function of the lack of business information. Few small firms have websites or even a listed phone. In many low-income countries, credit or business registries are either non-existent or limited to relatively few well-established firms. In addition, political instability or conflict may force entrepreneurs to move to different areas where they are less known. But this invisibility is

⁷ This is especially true for very successful innovative – Schumpeterian – entrepreneurs. Petrescu reports that of the 2,458 billionaire entrepreneurs in the world, 88% have at least a college degree while 39% have a graduate degree. (2013, Figure 1, p. 26)

also partly a matter of entrepreneurial strategy to avoid criminal activity or exploitation by bribe-seeking officials.

Second, most owner-operators of small businesses in low-income countries are not Kirznerian – arbitrage/speculative – entrepreneurs. They do not “...create ventures to profit by exploiting these opportunities.” (Gunter 2012, p. 387) Rather they find themselves self-employed as a last resort, their attempts to obtain employment as a salaried worker having failed. And most of these entrepreneurs from necessity will eagerly abandon self-employment as soon as they are able to get what they consider a “real” job, a job with a firm or government agency that pays a regular salary. This raises a difficult challenge in both analyzing arbitrage/speculative entrepreneurship and developing appropriate policies to encourage such activity. The differences between (a) a person who is self-employed in order to exploit an arbitrage/speculative opportunity that most fail to see – a Kirznerian entrepreneur - and (b) a person who is self-employed as a second-best option is a matter of motivation.

Therefore, it is difficult or impossible for someone to look at a group of small business owner/operators and determine whether they are entrepreneurs or not. Empirical studies have generally followed three paths. Some assume that all small owner-operators are entrepreneurs. Since the proportion of the labor force that is self-employed tends to decline during economic development, these analyses lead to the strange conclusion that there is “excess” entrepreneurship in low-income countries. A second approach is to restrict analysis to certain sectors such as information technology that tend to be associated with entrepreneurship (Schumpeterian?) in high-income countries. These studies run the risk of ignoring most of the entrepreneurial activity in a low-income

country. A third approach relies on self-identification. Small owner-operators are surveyed in an attempt to determine whether they see themselves as primarily motivated by necessity or opportunity. Only the latter are considered entrepreneurs.

Low-income conflict countries tend to have a “bed post” distribution of entrepreneurs. A few high-income entrepreneurs engage in high volume activities possibly with many employees. These entrepreneurs tend to be closely associated with local political and military authorities for reasons both of self-protection and in order to use the authorities to suppress competition. At the other extreme, there are a large number of low-income, low-volume entrepreneurs who operate at very low levels of economic activity

Third, the failure rate of new entrepreneurial enterprises is very high – probably over 50%. As a result, especially in an environment marked by insecurity and political instability, entrepreneurs attempt to diversify their activities. A family’s primary business may be to run a butcher shop. However, since they need electricity to operate their freezer, they may own a private generator and either sell some electricity to their neighbors or speculate in black market fuel for their generator. And, since being the neighborhood butcher is a cash business, the butcher’s family may make small loans to other businesses or family members. It is possible that the family may even earn more from selling electricity, trading diesel fuel, and money lending than from its “primary” business of selling meat.

That most Kirznerian entrepreneurs run businesses that are invisible, small, and diversified complicates creating policies to directly encourage entrepreneurship. However, even without being able to identify the exact benefactors, policies can

encourage entrepreneurship either by seeking to increase the availability of complementary inputs to entrepreneurship or by reducing the transaction costs of being an entrepreneur. The most important complementary inputs to entrepreneurship are finance and education while – aside from conflict – the expense of dealing with corruption and regulatory hostility are probably the most serious transaction costs facing entrepreneurs.

Finance

Conflict, by reducing banks and other financial intermediaries confidence that their loans will be repaid on schedule, tends to reduce available finance. But even during periods of peace, limited finance is a serious constraint on the ability of entrepreneurs to provide more goods or services and expand employment. (Petrescu 2013, pp. 4-5; Naude 2007, pp. 20-21) Because they often lack acceptable collateral, small-scale entrepreneurs generally cannot access formal finance sources such as banks. As a result, needed finance comes from retained earnings, family, tribe, traditional moneylenders, suppliers, or from their customers. Finance from these sources tends to be limited and can be extremely expensive. (Gunter 2013, p. 158) Creative use of micro-grant/micro-loan programs can often provide needed finance for job-creating entrepreneurial activity. However, these grants should be accompanied by substantial, somewhat expensive, expertise in order to maximize the favorable results. (Berman 2013, p. 516) And such expertise tends to be in short supply in a low-income corrupt country.

Another approach is to permit international organizations to establish micro-finance institutions (MFI). While individual loans are generally small – an average of \$360 in the Middle East and North Africa – and the interest rates are high – 27% in one

report, loans from MFI may still offer better terms than small entrepreneurs can receive from other lenders. (Gunter 2013, pp. 149-150; Gunter 2009b) There is a continuing debate over whether MFI should focus on loans intended to smooth consumption or finance small businesses. Due to the severe difficulty in monitoring the use of loans by small, diversified firms operating within or on the fringe of the underground economy, trying to ensure that a loan is used strictly for the contracted purpose may be a fool's errand. Maybe MFI should be satisfied if the loan is paid back on schedule.

Education

One of the differences between successful arbitrage/speculative (Kirznerian) and innovative (Schumpeterian) entrepreneurship is the level of education of the entrepreneurs. Schumpeterian entrepreneurs tend to have high levels of education, many with university degrees. However, lack of education doesn't appear to be a barrier to successful Kirznerian entrepreneurship as long as the owner is literate. For example, studies in Egypt and Nigeria show a wide range of educational levels among successful entrepreneurs including many who were barely literate. (El-Gamal et al 2000, p. 13 and Harris 1970, pp. 352 and 354)

However, lack of basic literacy reduces the likelihood of success of Kirznerian entrepreneurs. If literacy is defined (for those 15 years or older) as being able to both read and write a straightforward passage then the situation is fairly grim for some of the countries in the MENA. As shown in Table 2; Morocco, Algeria, Egypt, Yemen and the Sudan each have less than 75% literacy. Of course, advocating universal literacy is even less controversial than advocating motherhood. As is well known, a related education

goal, universal primary education, is one of the U.N. Millennium Development Goals for 2015. But achieving this goal in low per-capita income, conflict societies is difficult. Conflict tends to reduce literacy in several ways. Increased government conflict-related expenditures often results in reduced education spending. Also, concerns about indiscriminate violence motivate families to cease sending their children to primary school. This is especially true with female children in rural areas. In addition to the adverse impact on entrepreneurial success, reduced literacy among females has an adverse effect on family health and increases corruption – if someone cannot read then they are a ready victim for any official waving a piece of paper.

Reducing corruption

Reducing corruption can be expected to facilitate entrepreneurship and economic development in several ways. Successful anti-corruption efforts will weaken the insurgency by making it more difficult to obtain financing and logistical support. Reduced corruption will decrease the costs of running a business thereby increasing the likelihood of business success and therefore increase productive employment. Finally, by increasing the risk and reducing the returns to corrupt acts, anti-corruption efforts should also motivate entrepreneurs to shift from unproductive or destructive activities to those that encourage economic development and the associated job creation.

While many countries have instituted anti-corruption strategies, no country has ever succeeded in eradicating corruption. Simply punishing a few corrupt officials and placing anti-corruption banners along major thoroughfares is insufficient. As they say in

Police Internal Affairs: “If you get rid of the rotten apples without getting rid of the rotten apple barrel then you will have to do it all over again next year.”

The few cities and countries that have actually achieved a substantial extended reduction in corruption have designed, coordinated, and executed a country-specific anti-corruption strategy with four components. These are: 1) increasing the likelihood of punishment of corrupt acts, 2) improved governance possibly including a restructuring of official compensation, 3) change the culture of corruption, and 4) reduce the economic incentives to be corrupt. (Gunter 2013, pp. 61-66) The fourth component of a successful anti-corruption strategy is essential but probably the most difficult especially in a conflict situation.

Every country has different laws and institutions and, therefore, will have different economic incentives to be corrupt. At an aggregated level, one can examine a country’s regulatory environment for private business. A hostile regulatory environment motivates private citizens to offer bribes to compliant officials in order to avoid harsh regulations. For example, to export a shipping container of rugs from Iraq would require almost 80 days to obtain the necessary documentation required by Iraqi law. Or the exporter could pay a bribe to reduce the process to a week. But if Iraq adopted a less hostile commercial code that reduced the time required to complete required documentation to a week as in the United Arab Emirates then the Iraqi businessman or woman would be unwilling to pay a bribe or would offer a smaller one.

Hostile regulatory environment

As can be seen on Table 2, eight out of the nine countries ranked “low” or “very low” (including Egypt) have a very hostile regulatory environment for private businesses. The World Bank does not rank Yemen but its regulatory environment for private businesses is thought to be very poor. The only exception to this hostility is Israel. A hostile regulatory environment not only increases the cost of doing business but also, as mentioned above, motivates corruption. In other words, difficult regulations adversely affect entrepreneurs directly by increasing costs associated with operating a small business and indirectly by encouraging corruption.

As an example, to get the government’s permission to build a warehouse – not to actually build it – takes about 270 days in the Sudan and 187 days in Iraq. The average period to legally build a warehouse in the MENA countries is 151 days. As a matter of scale, this process only takes 27 days in the USA. (World Bank 2013) With this level of government obstructionism, it is no surprise that most of the private businesses in these countries choose to operate in the underground economy with all of the associated inefficiencies and bribes to officials rather than attempting to operate legally and deal with a rat’s nest of red tape.

Rationalizing the regulation of these businesses is easy in theory. The World Bank and other international organizations are ready to advise on best practices around the world and it is now possible for a government to adopt a complete commercial code that would sharply reduce the perverse incentives of the existing business regulations. However, the existing harsh regulations are not an unloved artifact of some previous regime. Rather, each complicated and ambiguous regulatory clause provides an opportunity for an official to extract a bribe. Each complex required administrative

process reduces competition for low quality/high cost state owned enterprises. (Naude 2007, p. 9) As a result, any serious attempt to rationalize a country's regulatory systems can be expected to consume a large amount of political capital.

Targeted entrepreneurial policies

How useful are policies specifically targeted to encourage specific types of entrepreneurship? Naude argued that while reducing the obstacles to starting and running a business is necessary to promote entrepreneurship, it might not be sufficient. He states: "More pro-active measures, such as support for venture finance, education and training, particularly for technological entrepreneurship, may be needed in developing countries." (Naude 2011, pp. 251-252) International organizations also often argue that after good business fundamentals have been established, that governments should institute programs such as new business incubators and mentoring systems to encourage entrepreneurship. I think that there are at least four arguments against such targeted policies in low-income conflict countries.

First, such programs tend to focus on the First World goal of encouraging innovative – Schumpeterian – entrepreneurship. However, as argued above, the binding constraint to productive job creation and economic development is a shortage of arbitrage/speculative – Kirznerian – entrepreneurs. If this is correct, programs to encourage innovative entrepreneurship are irrelevant and probably a waste of money.

Second, conflict countries tend to be very corrupt. As a result, it is likely that any targeted program to encourage entrepreneurship will be hijacked. Program directors will be selected and paid based on their political connections. Business participants will be

expected to pay bribes for any “free” benefits they receive. And programs will often ensure the success of their business participants by using political influence to punish the competition. (Naude 2007, p. 6)

Third, low-income conflict countries may have only a relatively small pool of persons capable of planning, coordinating, and managing a targeted policy to encourage entrepreneurship. (Naude 2007, p. 22) Is hiring one of these few people to work for the government running a targeted entrepreneurial policy the optimal use of this scarce resource?

Finally, targeted programs are often used as a distraction for countries unable or unwilling to establish good business fundamentals. For example, at the 2012 Global Entrepreneurial Congress, a successful Greek entrepreneur praised his country’s entrepreneur incubator system. These incubators not only helped potential entrepreneurs with business basics, networking, marketing, management, but also provided a variety of business services. A Venezuelan entrepreneur who spoke enthusiastically about his country’s entrepreneurial mentoring program followed him. Successful entrepreneurs are matched with potential entrepreneurs in the same area so that the experienced entrepreneur could mentor the newcomer and increase chances of success.

However, the reported success of these programs gives a false image of the entrepreneurial environment in both countries. Based on the World Bank’s Ease of Doing Business report, both countries make it very difficult to start a new business; Greece ranks 146th in ease of starting a new business while Venezuela ranks 152nd. While conflict countries are attempting to achieve the fundamentals of finance, education, reduced corruption, and a more favorable regulatory environment; targeted programs are,

at best, a distraction and, at worst, a cynical attempt to disguise lack of progress in dismantling more damaging anti-entrepreneurial policies.

Summary

In view of the failure of top-down macroeconomic policies to accelerate economic development and reduce politically destabilizing mass unemployment and underemployment in low-income conflict countries, there is increased interest in encouraging entrepreneurship, a bottom-up strategy. However, it is important to realize that the binding constraint in low-income conflict countries is not a shortage of the Schumpeterian entrepreneurship that receives most of the research attention in high-income countries. Rather, the binding constraint is a shortage of Kirznerian arbitrage/speculative entrepreneurship.

Increased entrepreneurship tends to increase the probability of political stability by accelerating economic growth and providing more mobility options. And unlike public sector jobs, that may be politically destabilizing because they create loyalty to political, religious, tribal, or criminal groups that oppose the existing government; private sector employment tends to strengthen the sense of community.

Understanding the demand and supply of entrepreneurship in low-income conflict countries requires modeling the interaction of conflict, corruption, and entrepreneurship. There is a symbiotic relationship between conflict and corruption while it is not clear in theory whether the net effect of conflict on entrepreneurship is positive or negative. There is no ambiguity with respect to the effect of corruption on productive entrepreneurship; it is negative.

Since it is very difficult to identify entrepreneurs in low-income conflict countries, pro-entrepreneurship strategies should concentrate on increasing the complementary inputs of entrepreneurship while reducing the transaction costs involved in running a private sector business. The most important inputs are probably finance and literacy education. The most damaging transaction costs arise from corruption and regulator hostility towards private business. For a businessman or woman to simply survive in a low-income conflict country is inherently a successful entrepreneurial act. (Gunter 2009a) So if governments can find the political will to unleash their entrepreneurs from the corruption and regulatory morass while increasing access to the complimentary inputs then there is the potential for a rapid increase in productive employment. And such an increase in private sector employment should reduce social frustration and improve worker mobility, reducing the likelihood of political instability or conflict.

However, it is tough to convince most governments in low-income conflict to turn their attention from day-to-day fights for political and regime survival to efforts to encourage entrepreneurship that should result in long-term political stability. But without this change in priorities, the likelihood of continued conflict is high. Or in other words: *It is difficult to think about draining the swamp when the alligators are attacking. But if you don't drain the swamp, the alligator attacks will never end.*

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