

Small government is not a cure-all for entrepreneurship

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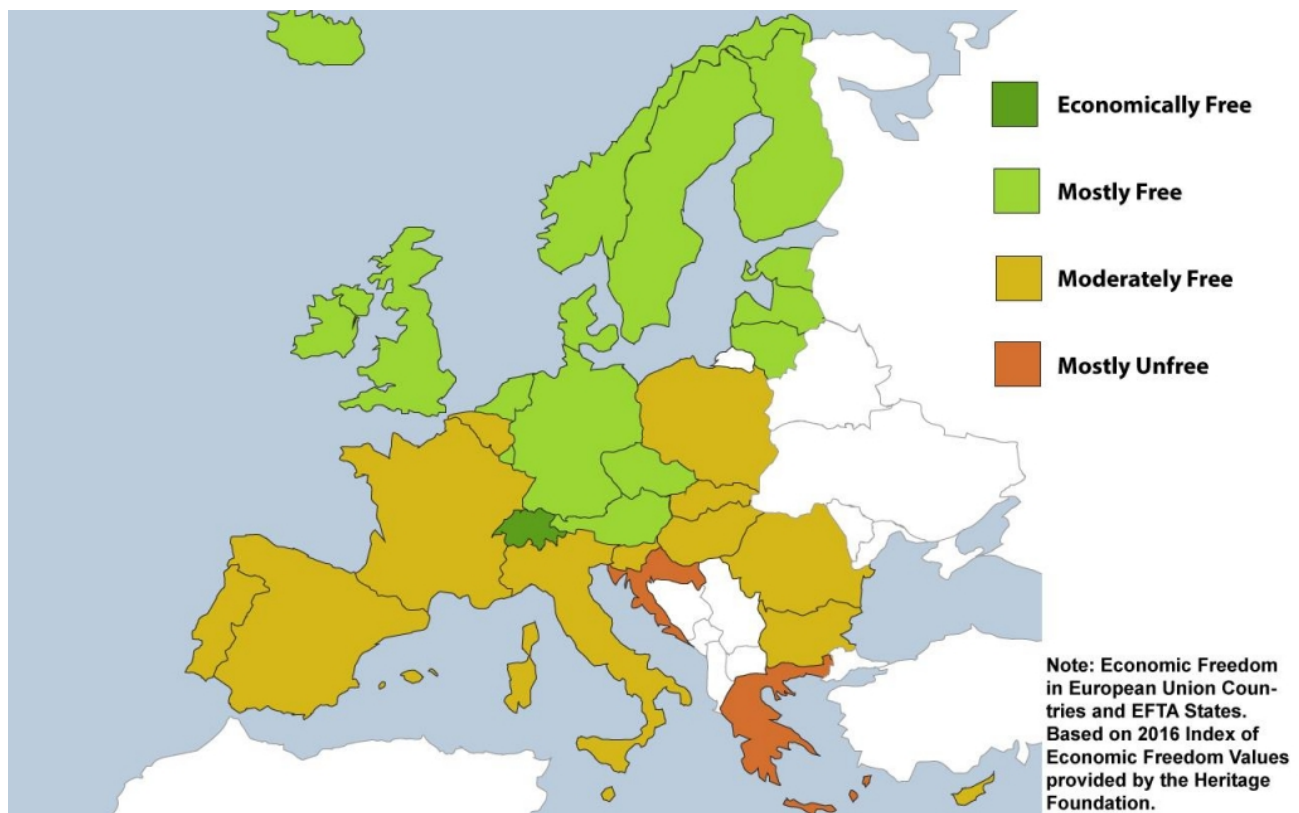
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At the Olympic Games, or when we see the GDP ranking of countries, or any other global comparison of countries, we tend to first look for the performance of the country we are from, live in, or have other ties to in the hope that this country has performed well against its global competition. Rankings of the level of economic freedom across countries published by US think tanks such as the *Fraser Institute* or the *World Heritage Foundation* evoke a similar reaction.

Both lists imply that most European countries need to put more effort into achieving higher levels of economic freedom. For instance, in the latest edition of the *World Heritage Foundation's Index of Economic Freedom* only one European country, Switzerland, is classified as completely free, while all other European countries could improve their economic freedom (as shown in the figure below). Whereas winning in the sports arena undoubtedly reflects a high level of performance and is a desirable thing, can we say the same about wanting to be the gold medal winner for economic freedom in an economy? Do the ranking results really suggest that we have a serious issue in Europe that must be addressed by policymakers?

Figure: Economic freedom in Europe



The answer is probably not. Of course, prior research has pointed to a generally positive effect of economic freedom on growth and development in general and on entrepreneurial activity in particular. However, the level of economic freedom in OECD countries is already [as high as it has ever been](#) in modern times. At the same time, the level of total early-stage entrepreneurial activity among the working-age population in innovation-driven economies – which includes most of the economies in the European Union – ranges from very low (e.g. Italy) to remarkably high (e.g. Netherlands) according to the [Global Entrepreneurship Monitor](#). This suggests that the relationship between economic freedom and entrepreneurial activity is not as straightforward as simple rankings and mono-causal explanations would suggest.

Economic freedom usually comprises a wide range of elements such as the degree to which the rule of law predominates over the rule of man, how large the government sector is, how efficient the regulatory system is and how open markets are. Particularly in times of economic crisis, policy makers need to know how to design the regulatory framework to stimulate growth. Economic freedom is probably not a panacea, and it is important to understand the effects of individual elements of economic freedom on targeted economic outcomes.

Our [comparison](#) of 63 OECD countries across different stages of economic development reveals that the situation is more complex than simply striving for the top place in the ranking. For instance, in Greece or Italy, a comparatively underutilised rule of law explains why there is only a low level of opportunity-driven entrepreneurial activity. This category of entrepreneurship is especially desirable as it consists of founders who decide to start a business having identified some great potential. Those start-ups are often highly innovative, technology-driven, and might – in the best of all worlds – spawn the next globally successful market leader. Consequently, countries such as Greece or Italy need to strive for a higher level of economic freedom by concentrating particularly on establishing more legal certainty.

The underutilisation of the rule of law in combination with limited government size on the other hand fosters high levels of necessity-driven entrepreneurial activity, as is the case in the Slovak Republic. Necessity-driven entrepreneurs start a business because they simply do not have any other option to generate a decent income, and therefore it is generally considered a less desirable form of entrepreneurship. Reducing economic freedom by enhancing government size through initiatives supporting more beneficial forms of entrepreneurship would run

contrary to extreme liberalist positions, but would carry the potential for substantial welfare effects.

Those two examples clearly illustrate that there is no point in maximising economic freedom as a single measure to stimulate growth. Entrepreneurial activity is a complex phenomenon, where there is no one-size-fits-all solution. Instead, policymakers need to establish and safeguard adequate levels of economic freedom, and be sensitive to threats to that freedom, while resisting uncritical maximisation by any and all means.



Notes:

- This post is based on the authors' paper [The more the merrier? Economic freedom and entrepreneurial activity](#), in *Journal of Business Research*, Volume 69, Issue 4, April 2016, Pages 1288–1293
- The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.
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