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INSTITUTIONS AND ENTREPRENEURSHIP

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Abstract

In order for entrepreneurs to be successful in developing countries there must be institutional support for their efforts. This report explores some of the empirical evidence on the relationship between institutions, entrepreneurship and economic growth and describes some of the steps that countries need to take in order to promote economic freedom and productive entrepreneurship.

Olson tackled the question of why there continues to be widely differing standards of living around the world if, in fact, markets everywhere are working efficiently.[2] He first investigates whether the variations among countries might be attributable to different resource endowments (i.e., poorer countries have problems with economic growth and social development because "they lack land and natural resources, physical and human capital, or access to the latest technology"[3]). He systematically dismisses this proposition noting, for example, that there is evidence showing that knowledge is equally available to all countries at a reasonable cost, population density does not explain economic performance, capital flows are driven by the quality of institutions and there is no basis for assuming that citizens of richer countries are innately "smarter" than citizens of poorer countries. Olson thus concludes that "the large differences in per capita income across countries cannot be explained by differences in access to the world's stock of productive knowledge or to its capital markets, by differences in the quality of

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[2] M. Olson, "Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor" in B. Powell (Ed.), Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development (Stanford, CA: Stanford Economics and Finance, 2008), 25-53.

[3] B. Powell, "Introduction" in B. Powell (Ed.), Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development (Stanford, CA: Stanford Economics and Finance, 2008), 1-22, 3.

marketable human capital or personal culture".[4] Assuming this to be true, "[t]he only plausible explanation left is that differing performances are caused by differences in the quality of countries' institutions and policies".[5] Olson predicted that poorer countries that elect to adopt better economic policies and institutions will enjoy higher rates of growth in per capita incomes in relation to richer countries because they have been so far short of their potential prior to the adoption of the new policies and there is such a huge gap to close between actual and potential income in those countries.[6]

Baumol identified a set of entrepreneurial activities that appear in all countries and argued that divergent economic performance among countries can be explained by the allocation of entrepreneurial efforts among these activities rather than by the total supply of entrepreneurial activities in those countries. Specifically, Baumol identified the following six types of entrepreneurial activities, the first five of which were based on the prior of Schumpeter: introduction of new goods; introduction of new methods of production; identification and opening of new markets; discovery and exploitation of new sources of supply for needed raw materials or intermediate goods; new organization of industries (i.e., creation or destruction of a monopoly position); and, finally, "rent seeking" (e.g., legal and illegal lobbying of regulators and politicians for favors, commencing legal actions to impede the progress of competitors, engaging in military activities to achieve and/or maintain power and imposing taxes that impact incentives to engage in certain activities).[7] Activities constituting "rent seeking" are considered to be unproductive, or even destructive, entrepreneurship and Baumol concluded that countries with cultures, policies and/or institutions that incentivize rent seeking (or lack of institutions that encourage entrepreneurial activities other than rent seeking) are likely to have poor performing economies.[8]

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[4] M. Olson, "Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor" in B. Powell (Ed.), Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development (Stanford, CA: Stanford Economics and Finance, 2008), 25-53, 44.

[5] Id. Olson's article also includes citations to other studies that he and other conducted that provide "direct evidence of the linkage between better economic policies and institutions and better economic performance". Id. at 47.

[6] Id. at 45-46. Olson noted during the 1970s the fastest growing countries in the world (apart from the oil-exporting countries) were poorer countries that grew at rates that far exceeded the growth achieved by the US economy during that period. Id.

[7] W. Baumol, "Entrepreneurship: Productive, Unproductive, and Destructive" in B. Powell (Ed.), Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development (Stanford, CA: Stanford Economics and Finance, 2008), 79-111, 82-83 (citing and quoting J. Schumpeter, The Theory of Economic Development (Cambridge, MA: Harvard University Press, 1912/1934), 66).

[8] What Baumol might consider "unproductive" avenues for entrepreneurs can also be found in industrialized countries such as the US if one considers the potentially adverse consequences of expensive and time-consuming litigation as a competitive tool and/or financial incentives that divert highly-educated young professional toward jobs in the financial sector rather than launching and building new and dynamic businesses.

Holcombe has claimed that differences in economic performance of countries can be explained by the "entrepreneurial opportunities" that are available in those countries and has argued that decentralized free economies are the ones that do the best job of generating more opportunities that can be seized for their profitability and which also continuously generate new opportunities that ultimately will create an "endogenous engine of economic growth".[9] He places so much importance on the availability of entrepreneurial opportunities that he argues that often-used techniques for launching economic development such as encouraging investment in industrial activities and research and development, calling for increased savings and funding education will not, in and of themselves, be successful unless and until fundamental market reforms, including the creation and support of appropriate institutions, are made to facilitate creation of entrepreneurial opportunities. As an example, Holcombe points out that when developing countries have educated their citizens they often migrate to other countries due to lack of entrepreneurial opportunities in their homelands.[10]

Accepting that institutions matter and the "rules of the game" should be set to encourage productive entrepreneurship, the question becomes just what steps should be taken in developing countries to enhance their competitiveness. Lawson makes a strong case for the proposition that productive entrepreneurship requires an institutional environment grounded in economic freedom and property rights and concluded that "the empirical evidence is overwhelmingly clear: [s]ocieties that organize themselves with private property, rule of law, and free markets outperform, on almost every measurable margin, societies that are less economically free".[11] In a similar vein, Olson has argued that the lack of impartial third-party enforcement of contracts causes economic actors in developing countries to lose gains that should normally be realized in economic exchanges; the failure to create institutions for recognizing and securing property rights leads to the loss of most of the potential gains from capital intensive production; private and public predation, which occurs due to a lack of institutional policing, also holds developing economies back; and, finally, the inability of create a sophisticated array of markets deprives developing countries of the potential advantages of social cooperation.[12]

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[9] R. Holcombe, "Entrepreneurship and Economic Growth" in B. Powell (Ed.), Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development (Stanford, CA: Stanford Economics and Finance, 2008), 54-78.

[10] Id. at 71.

[11] R. Lawson, "Economic Freedom and Property Rights: The Institutional Environment of Productive Entrepreneurship" in B. Powell (Ed.), Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development (Stanford, CA: Stanford Economics and Finance, 2008), 112-133, 131.

[12] M. Olson, "Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor" in B. Powell (Ed.), Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development (Stanford, CA: Stanford Economics and Finance, 2008), 25-53, 48.