



Two-tiered entrepreneurship and economic development

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ABSTRACT

This paper argues that there are two tiers of entrepreneurship important for economic development. One is concerned with investments in productive technologies that improve productivity and better service consumer needs. The other is concerned with the creation of protective technologies that secure citizens' private property rights vis-à-vis one another. In the developing world where governments cannot or do not protect citizens against predation, "institutional entrepreneurs" devise private mechanisms of property protection, providing the security required for productive entrepreneurship to grow. However, private protection technologies can be a double-edged sword. While private protection technologies enable some investment and exchange by securing citizens' property where government does not, potential constraints on these technologies' effectiveness may simultaneously limit their ability to expand investment and exchange beyond modest levels.

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1. Introduction

A growing body of research shows that the strength of the positive relationship between economic freedom and development stems largely from presence of "good" institutions in economically free countries and "poor" institutions in unfree ones.¹ Most fundamental to "good" institutions are those that protect private property rights (see, for instance, Acemoglu & Johnson, 2005; Acemoglu, Johnson, & Robinson, 2001a; Acemoglu, Johnson, & Robinson, 2001b). Property protection has two components: freedom from government expropriation, which requires rulers to refrain from confiscating citizens' property, and protection against threats of private predation posed by other citizens. Where government is

well-functioning the state provides this protection through institutions such as police, courts, and the law.

It is widely recognized that where property rights are secure entrepreneurship thrives. Property rights institutions create a stable, certain, and incentive-compatible business climate in which, free from the fear of public or private predation, individuals have the incentive to "place bets" on new ideas and the ability to bring these ideas to life (see, for instance, Brenner, 1994, pp. 51–83). Far less recognized is that where property rights are insecure, entrepreneurship also thrives but at a different, "higher tier" of economic activity.

Conventional discussions of entrepreneurship focus on entrepreneurship at a "lower tier" of economic activity—entrepreneurial activity within a given institutional framework. Building on Baumol (1990), Boettke and Coyne (2003) and Coyne and Leeson (2004), for example, argue that entrepreneurship is omnipresent; its form is simply guided by the institutional context in which it operates, which shapes whether entrepreneurial activity is positive or negative sum. In this framework we tend to associate positive-sum entrepreneurial activity with recombining resources or seizing profit opportunities in the context of a well-functioning system of government-protected property rights, as described above. Further, we tend to associate negative-sum entrepreneurial activity with predation where there is no such system. This paper argues that there is a third possibility: entrepreneurial activity directed at creating private protection technologies that restrict predation in the absence of well-functioning government.

While existing research considers entrepreneurship within given "rules of the game," our analysis considers entrepreneurship at a "higher tier" of economic activity—entrepreneurial activity over the rules of the game. We explore entrepreneurship directed

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¹ Political economists from Adam Smith to P.T. Bauer understood the fundamental role played by cultural and political institutions in economic development. As Smith (1776, xliii) put it, "little else is required to move from poverty to opulence but peace, easy taxes and the administration of justice." In more recent times Bauer challenged the conventional wisdom in development economics that there was a "vicious cycle of poverty"—that poor countries cannot emerge from poverty because low per capita income cannot generate the savings and investment necessary to raise per capita income. Bauer pointed out that this view overlooked the reality that the currently rich countries were once poor and yet they somehow escaped this "vicious cycle." Instead of looking for a solution in foreign aid, Bauer argued that small-scale domestic trade was the first step in the process of development. A major determinant of economic performance is the cultural and political institutions that either promote or discourage trading behavior. "The misery in Ethiopia, Sudan, and elsewhere in Africa is not the result of unfavorable weather, external causes, or population pressures. It is the result of enforced reversion to subsistence conditions under the impact of the breakdown of public security, suppression of private trade, or forced collectivization" (2000, p. 8).

at altering the institutional context within which other economic activity takes place. Accordingly, we argue there are two tiers of entrepreneurship important for economic development. The lower one, which we call the “productive tier,” is concerned with investments in productive technologies that improve productivity (innovation) and better service consumer needs (arbitrage). The higher one, which we call the “protective tier,” is concerned with the creation of protective technologies that secure citizens’ private property rights vis-à-vis one another (governance). In the developing world where governments cannot or do not protect citizens against private predation, “institutional entrepreneurs” devise private mechanisms of property protection, providing the security required for productive entrepreneurship to grow.² However, private protection technologies can be a double-edged sword. While private protection technologies enable some investment and exchange by securing citizens’ property where government does not, potential constraints on these technologies’ effectiveness may simultaneously limit their ability to expand investment and exchange beyond modest levels.

Most treatments of underdeveloped economies neglect the “protective tier” of entrepreneurship and in doing so overlook a critical component of economic activity in the developing world. Failure to appreciate this tier of entrepreneurship has also led researchers to underestimate the extent of entrepreneurial behavior in impoverished nations and to overestimate the importance of introducing public technologies of property protection. By highlighting this tier of entrepreneurship, its relationship to “productive-tier” entrepreneurial activity, and its positive and negative forces for progress, we hope to shed light on the connection between entrepreneurship, property protection, and economic development.

Our analysis is connected to the literature in both property rights economics and development economics. In the former literature Harold Demsetz’s (1967) seminal paper on the emergence of property rights paved the way for subsequent discussions of endogenous property rights institutions. Later research by Anderson and Hill (2004), Benson (1989), Friedman (1979), Haddock (2002), Leeson (2007b,c, 2008b, in press), Libecap (2002), and Umbeck (1981) among others explores the emergence of self-enforcing property rights without the state. In the development economics literature Coyne (2006), Nenova (2004), Nenova and Harford (2004), Leeson (2007b), Powell, Ford, & Nowrasteh (2008), and others show that in weak and failed states production and exchange continue despite the absence of effective government-provided property protection. This paper bridges the gap between these two important streams of research by examining institutional entrepreneurship’s role in facilitating property institutions’ endogenous emergence. Our analysis fills the lacuna between these literatures by adding a new dimension to the relationship between entrepreneurial activity and property rights. We show that entrepreneurship is not only a product of property rights, but that, critically, it is a producer of these rights as well.

2. Two technologies of development

2.1. Productive technologies

Productive technologies are crucial to the process of economic development. These technologies refer to investment in

activities that improve productivity and better service consumer needs. For economies to grow citizens must be willing and able to invest in capital and new technologies of production. Unless production exceeds what is necessary to sustain the producer there is no “surplus” for sale to others, no capacity for trade, and thus no economic development. Peter Bauer’s (1954, 1991, 2000) insightful work highlights that in much of the developing world these technologies take rudimentary forms unlike the modern machinery they are associated with in the developed world. This fact has led many development economists to mistakenly believe that productive technologies are not actively developed and employed in poor countries and to significantly underestimate the extent of developing nations’ investment. As Bauer (2000, p. 11) puts it, “These forms of investment, when made by small farmers, are generally omitted from official statistics and are still largely ignored in both the academic and the official development literature.”

Simple investments, such as the clearing of brush, terracing of land, and the planting of cash crops for sale, constitute important and sizable capital formation in developing, usually agricultural, economies. Indeed, “millions of poor producers in the Third World ha[ve] in the aggregate made massive investments in” these forms (Bauer, 2000, p. 6). As part of these investments developing world producers have contributed to another economic activity crucial to development: trade. As Bauer notes, the large majority of agricultural producers in much of Africa, for instance, are also active small-scale traders. These “trader-entrepreneurs,” as he calls them, “are productive in both static and dynamic senses” (2000, p. 6). They entrepreneurially identify market demands, produce for their satisfaction, and engage in the process of connecting buyers with their supplies. Trader-entrepreneur activities do more than simply improve the allocation of existing resources. They habituate an outward-looking, market-oriented perspective crucial to an exchange- rather than subsistence-based economy. Trader-entrepreneurs’ production and exchange enterprises stimulate new contacts, such as those with individuals supplying input markets, disperse new ideas, communicate new methods of production, acquaint individuals with new products, encourage specialization, and initiate more complex forms of exchange, such as credit, which is often necessary for seasonal agricultural production.

This form of investment in productive technologies, however basic, constitutes the economic backbone of much of the developing world. Although at the individual level this activity is small-scale, as Bauer highlights, in aggregate it is indispensable to raising inhabitants’ living standards above subsistence. These production, investment, and trading activities constitute investments in productive technologies and occupy the “productive tier” of entrepreneurship that is significant for economic development.

2.2. Protective technologies

Protective technologies refer to the methods of creating and enforcing individuals’ property rights. Where property is at risk, either from state predation or from predation by private individuals, citizens have little incentive to invest in the productive technologies discussed above. The reason for this is straightforward. If citizens cannot reap the rewards of investment in production for exchange, they will not invest or produce beyond the level necessary to sustain themselves. Protective technology is therefore primary over productive technology in that the latter is impossible without the former.

There are two kinds of protective technologies: public institutions of government (public protection technologies) and private

² Following North (1990), we define institutions as “rules of the game” and mechanisms of these rules’ enforcement. The protective technologies that entrepreneurial activity in the protective tier develops thus include private activities that define property rights (such as, for instance, the development of private legal rules) and private mechanisms of enforcing these rules (such as, for instance, private courts, multilateral punishment strategies, etc.).

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