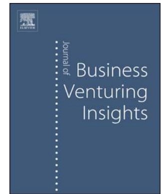
Journal of Business Venturing Insights 7 (2017) 45–49

Contents lists available at ScienceDirect

Journal of Business Venturing Insights

journal homepage: www.elsevier.com/locate/jbvi



Entrepreneurship: Productive, unproductive, and destructive—Relative to what?

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ARTICLE INFO

Keywords:
Entrepreneurship
Institutions
Regulation
Public venture capital

ABSTRACT

We identify an ambiguity surrounding institutions and entrepreneurship. While entrepreneurship creates social value at the economy level in the appropriate institutional environment, individual entrepreneurs may create or destroy value in *any* institutional environment. This raises the question: under what conditions does entrepreneurship create social value? Social value creation depends on the entrepreneur's next best alternative, and institutions are constraints on the relevant alternatives. Hence, society is better off when entrepreneurs navigate poor institutions relative to reduced entrepreneurial activity. Furthermore, entrepreneurs engaging in seemingly "productive" activity need not create social value. We illustrate the argument with two examples.

1. Introduction

Over twenty-five years after its original publication, Baumol's (1996) trichotomy of productive, unproductive, and destructive entrepreneurship is seminal to the entrepreneurship literature. Productive entrepreneurship is that which contributes to societal well-being, including the introduction of new products or new production processes. Unproductive entrepreneurship is aimed at obtaining transfers, typically via rent-seeking or violence. Entrepreneurship becomes destructive when resources are expended to capture rents or expropriate wealth.

Baumol suggests that the total quantity of entrepreneurial activity is relatively stable, but the allocation of entrepreneurial resources varies considerably across societies. The variation in entrepreneurial activity is determined by the "set of rules" governing social interaction—in other words, the institutional framework. He thus provides a meta-view of entrepreneurship. Where the rules of the game facilitate market-based innovation, entrepreneurs engage in productive activity; where the rules facilitate corruption or rent-seeking, entrepreneurs choose unproductive and destructive ends (Boettke and Coyne, 2003, 2009).

Empirical analysis broadly affirms Baumol's insights (Murphy et al., 1991; Sobel, 2008). Furthermore, a large body of literature documents that productive entrepreneurial activity has massive implications for economic development; indeed, productive entrepreneurship captures the very essence of economic growth (Holcombe, 1998). Meanwhile, barriers to wealth-creation (e.g., the regulation of entry) have deleterious consequences (Djankov et al., 2002).

Another foundational figure in modern entrepreneurship scholarship, Israel Kirzner, has written several essays on the relationship between entrepreneurship and public policy (Kirzner, 1979, 1982). Kirzner argues that an institutional environment of property rights, market prices, and the rule of law allows for the entrepreneurial discovery of opportunities that are both privately and socially value-creating. The opportunities to which entrepreneurs are alert are "profit" opportunities precisely because they improve social coordination, by directing prices toward market equilibrium; losses are downplayed this framework (Foss and Klein, 2010, p. 110). Meanwhile, socialism, cronyism, and interventionism all hamper this entrepreneurial discovery. Like Baumol, then, Kirzner suggests

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http://dx.doi.org/10.1016/j.jbvi.2017.03.001
Received 7 January 2017; Received in revised form 10 March 2017; Accepted 13 March 2017
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that entrepreneurship within good (poor) institutional environments improves (reduces) the well-being of society at large.[1]

At the economy-level, both of the above frameworks usefully identify the seminal role of institutions in the entrepreneur's creation of social value. Indeed, the aggregate effect of entrepreneurship within market institutions is productive: society is made better off whilst individuals aim to capture private value via production and exchange. At the level of the individual entrepreneur or venture, however, this distinction is theoretically ambiguous or even misleading. Since institutions constrain the individual's opportunities, any given entrepreneur or venture may create or destroy social value in *any* institutional context. When the analysis is restricted to relevant alternatives *for the actor* (e.g., the individual's opportunity cost), many actions that appear "unproductive" are indeed "productive"—and vice versa.

The above considerations beg a broader question: under what conditions does entrepreneurship create social value? While this question has been studied in depth at the economy level (e.g., the frameworks above), the relationship between this work and individual entrepreneurs or ventures is often unclear. We suggest that social value creation is only determined relative to the individual's next best alternative, and that institutions constrain the relevant alternatives. This yields two implications. First, society is better off when entrepreneurs navigate poor institutions relative to reduced entrepreneurial activity, and society becomes increasingly better off as entrepreneurs interact with better institutions. Second, social value need not be created by entrepreneurs engaging in seemingly "productive" activity (e.g., startup activity, research and development), particularly when those activities are publicly funded.

The paper proceeds as follows. Section 2 describes how entrepreneurs can navigate cumbersome institutions to create social value. Section 3 highlights the ambiguous social value of subsidized entrepreneurial activity. Section 4 offers a discussion. Section 5 concludes.

2. Regulation, entrepreneurship, and relevant alternatives

Institutions enable and constrain entrepreneurial action. This suggests that some institutions may be comparatively superior to others at facilitating entrepreneurial innovation and production. Conversely, more cumbersome regulatory environments, for example, may make research and development, startup activity, and new product development more difficult.[2] Regulation can reduce production and divert entrepreneurial effort to capturing existing value. Weak enforcement of property rights can also hinder economic activity. However, individual entrepreneurs subject to a "poor" institutional environment can still act to increase social value in spite of that environment.

Consider a hypothetical example. Imagine that an enterprising oil company owns land above an untapped oil reserve. Part of the reserve is under a valley, while part is under a mountain; the altitude of the ground above the reserve varies dramatically (see Fig. 1). The cost-minimizing choice of where to drill is where at the lowest possible altitude (Hole A).

Now consider that same oil company facing a regulated price for its product. Under the regulation, any oil obtained from wells of up to a specified depth is subject to a fixed price. This regulation might be thought of as reducing the relative payoff to productive entrepreneurship by making some ventures more costly. With the price regulation, it may not be profitable for the firm to drill the well.[3] The forgone output from this reserve is an example of such a reduction.

Imagine now that the regulation contains a caveat: oil obtained from wells that are drilled to at least a certain depth is not subject to the price control. So as to not deter deep well drilling, the regulation only applies to standard-depth wells. Learning this, the entrepreneur in charge of this oil company becomes alert to an opportunity: if the firm drills some distance up the mountain (Hole B), the well will be considered "deep." The extracted oil will then not be subject to the regulated price. The entrepreneur estimates the additional cost of a deeper well and the additional return from the higher price. She hires lawyers to confirm the legality of the decision. All goes as planned. With the expectation of profit, she arranges for the well to be dug at Hole B.

Has the entrepreneur destroyed social value by expending resources to avoid the formal legal institution? A common reading suggests that the answer is yes: the evasive effort is unproductive. The additional resources that the firm expends on a deeper well are wasted for the purpose of obtaining a greater share of surplus at consumers' expense. An insightful scholar might even invoke Bastiat to highlight "that which is unseen." The opportunity cost of the resources employed in drilling at Hole B is unobserved, but would seem to be surely significant.

The problem is that this answer considers the relevant alternative to be "drilling Hole A without price regulation." This is an unconstrained vision (Sowell, 1987). In other words, the relevant alternative is taken to be one where currently binding constraints do not exist. In a world without the price ceiling, Hole A will be drilled, and resources will be saved relative to Hole B.[4]

However, *given that the price regulation is in place*, this entrepreneurial activity increases social value. From the perspective of the entrepreneur, the regulation is a binding constraint. The decision to drill Hole A is no longer the relevant alternative for the firm. As the problem is constructed, a well for price-regulated oil is unprofitable—even at the shallowest possible depth. Hole A is not the

[1] In many ways, both Baumol's and Kirzner's notions share conceptual ground with the standard distinction in economics between "efficiency" and "rent seeking" by private actors (see, for instance, Tullock, 1967). Baumol focuses on the role of innovation in the entrepreneurial creation of social value, while Kirzner emphasizes entrepreneurial discovery. Both are argued to result from entrepreneurship within market institutions.

[2] Alternatively, some regulations may actually increase the quantity of activities such as R & D. For example, regulation may incentivize innovation for compliance reasons.

[3] This holds as long as supply is not perfectly inelastic.

[4] One is reminded of the Biblical account of the deceased Lazarus, whose sister lamented to Jesus, "If you had been here, my brother would not have died" (John 11:21, NIV).

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