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Institutional Entrepreneurship: An Introduction

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INSTITUTIONAL ENTREPRENEURSHIP: AN INTRODUCTION[‡]

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Abstract: In this introductory chapter to a collective volume,[*] we build on Baumol's (1990) framework to categorize, catalog, and classify the budding research field that explores the interplay between institutions and entrepreneurship. Institutions channel entrepreneurial supply into productive or unproductive activities, which likely accounts for a great deal of the disparate economic development of nations. What's more, entrepreneurship is not only influenced by institutions—entrepreneurs often shape institutions themselves. Entrepreneurship *abiding* by existing institutions is occasionally disruptive enough to challenge the foundations of prevailing institutions. Entrepreneurs also have the opportunity to *evade* institutions, which tends to undermine the effectiveness of the institutions in question, or cause them to change for the better. Lastly, entrepreneurs can directly *alter* institutions through innovative political entrepreneurship. Similar to business entrepreneurship, innovative political activity can be either productive or unproductive, depending on the entrepreneurs' incentives.

JEL Codes: H32; L5; M13; O31; P14.

Keywords: Entrepreneurship; Innovation, Institutions; Property rights; Regulation; Self-employment.

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INTRODUCTION AND FRAMEWORK

The growing recognition of how institutions determine economic outcomes has been one of the most important developments in economic research and policy analysis in the last two decades. At the same time, the entrepreneur himself has made a comeback, resurrected as one of the prime movers in society. Needless to say, the two subjects are not unrelated. Baumol's seminal work (Chapter 1), followed by Murphy, Shleifer and Vishny's (Chapter 2) related, yet independent contribution, showed that institutions determine not only the *level*, but also the *type* of entrepreneurship. Individuals put their entrepreneurial talent to use in activities that are productive, unproductive or destructive. The institutional setup—or, "the rules of the game"—dictate relative returns, and hence the allocation across these activities.

However, institutions do not merely control entrepreneurs—entrepreneurs also control them, through business activity, evasive methods and political entrepreneurship (Henrekson and Sanandaji 2011). This volume explores both sides of this important interaction: how the institutional framework influences entrepreneurship and how entrepreneurs in turn influence the emergence and evolution of institutions.

In organizing this collection, we follow Baumol's lead in distinguishing between productive and unproductive/destructive entrepreneurship. We simplify his classification, however, by merging destructive and merely unproductive entrepreneurship into just one category, unproductive entrepreneurship. By doing so, we can direct our attention toward another element: entrepreneurs' response to institutions. Entrepreneurs can *abide* by institutions, or *evade* them; sometimes, they may even *alter* institutions. This creates a 2 x 3 matrix, where each entrepreneurial activity can be assigned to one of the six types.

	ABIDE	EVADE	ALTER
PRODUCTIVE	Pursue a business opportunity within prevailing institutions.	Sidestep stifling labor market regulations through a new contractual form.	Provide a new local public good, private security firms.
UNPRODUCTIVE/ DESTRUCTIVE	Sue competitors for a share of their profit. Rogue states; rivalry between warlords.	Bribe a government official to obtain a contract. Illegal syndicates.	Lobby for new regulation to protect an industry. Repeal property rights to plunder a wealthy group.

Figure 1. A typology of entrepreneurship and some illustrative examples.

ORGANIZATION OF THE VOLUME

The volume is divided in eight parts, six of which follow the matrix defined in *Figure 1*. Only brief summaries or representative samples of each article will be provided here; we encourage the reader to explore each in full.

- Part I presents the two seminal articles that set the tone for this area of research.

- Part II discusses traditional productive business entrepreneurship that adheres to the rules of society, and how institutions mold this behavior.

- Part III tackles entrepreneurship in dire institutional settings, where entrepreneurs have an incentive to pursue rent-seeking purposes rather than wealth creation. Rent-seeking entrepreneurship in post-transition Russia is explored to illustrate this phenomenon.

- Part IV and V show how alert individuals can change the broader rules of the game in ways that either benefit or harm society. In addition to the traditional business entrepreneurs from the economic sciences, political entrepreneurs can also endeavor in a similar fashion.

- Parts VI and VII take up entrepreneurs who evade prevailing rules while engaging in productive and unproductive activities, respectively.

- Part VIII presents the institutional entrepreneur as customarily defined in sociology, discussing how this creature compares to the entrepreneur in the economic and political sciences.

PART I GENERAL

Both Baumol (Chapter 1) and Murphy *et al.* (Chapter 2) define the entrepreneur according to a set of talents. There is no consensus in the literature regarding the nature of these talents; some scholars emphasize cognitive abilities while others point to motivation or preferences. Our definition includes both: entrepreneurial talent combines perceptiveness and the ability to detect opportunities—and undertake new ventures in response. Profitable business projects, the chance to appropriate or earn rents and the possibility to affect policy are all explored in this volume.

Self-employment and start-ups embody the most typical forms of business entrepreneurship. Yet our way of defining entrepreneurship excludes many forms of self-employment, however. Most importantly, non-innovative self-employment does not qualify as entrepreneurship. In reality, though, it is impossible to draw a clear boundary between truly innovative entrepreneurship and non-innovative self-employment; as a result, we organize self-employment activity into a continuum stretching from purely non-innovative to highly dynamic entrepreneurship.

Baumol's analysis extends Schumpeter's (1934) theory of innovations into new combinations, particularly in regard to *productive* entrepreneurship. Innovative entrepreneurship may be, and often is, incremental in nature, progressing in small steps over long periods of time. The same is true for political entrepreneurship.

Unproductive/destructive entrepreneurship, on the other hand, entails some combination of rent-seeking technologies that enables the entrepreneur to appropriate rents from other agents. The social product may remain unaffected throughout this process, as in the case of a simple transfer, or be lowered, as in destructive entrepreneurship. Using the terminology of the neoclassical theory of the firm, the distinction between the different types amounts to an inward (destructive) or outward (productive) shift of the production possibility frontier.

Given the definition of entrepreneurship, it is simply hard to believe that entrepreneurs respond passively to institutions. Indeed, theories within the school of new institutional economics usually describe the entrepreneur as a key agent in institutional change. North (1990), for instance, holds that entrepreneurs act on the fringe of a given institutional setup, embodying dynamism and change in a setting where institutions are otherwise meant to determine their behavior. This is broadly consistent with the framework presented here. A second dimension of our typology distinguishes behavior within the institutions' limits from behavior directed at evading such constraints. *Evasive* entrepreneurship is an activity aimed at circumventing the institutional framework. Finally, entrepreneurs may *alter* institutions through political activity. These definitions are illustrated in *Figure 1*.[1]

The relative payoff of abiding, evading or altering institutions influences which type of entrepreneurship is pursued, much like the allocation between productive and unproductive/destructive entrepreneurship (Baumol, Chapter 1). It is important to keep the vertical distinctions in Figure 1 (from productive to unproductive/destructive) distinct from the horizontal ones (choosing to follow a career as an abiding business entrepreneur, an evasive [legal or illegal] entrepreneur or an altering political entrepreneur). It is for example unclear whether evasive entrepreneurship is prone to be productive or unproductive. This probably depends on the specific institutions being evaded, and whether the entrepreneur's alternative to evasion is either inaction or carrying out activity within the institutional framework. Baumol and Murphy *et al*. both make the point that it is usually a bad sign if talented potential business managers become trial lawyers or lobbyists instead. In our representation, however, this allocation constitutes both a horizontal and vertical move; if talent moves from the business world to *productive* altering

[1] As will be discussed, both abiding and evasive entrepreneurship can have the unintentional result of changing institutions. Altering entrepreneurship, on the other hand, involves a direct aim to change institutions.

entrepreneurship, improving policies and changing institutions for the better as a result, total social welfare may very well be bettered.

Baumol only describes business entrepreneurs as productive entrepreneurship, whereas other entrepreneurial activities (such as joining the bureaucracy) are discussed solely in unproductive terms. Similarly, Murphy *et al.* contrast productive entrepreneurship and unproductive (implicitly non-entrepreneurial) rent seeking in their discussion of talent allocation. In our categorization, both institution-abiding business entrepreneurship and institution-altering political entrepreneurship can be productive. Even evasive entrepreneurship can be productive, both directly (by evading institutions that hamper production) and indirectly (by forcing a change in such institutions). This does not amount to a disagreement with Baumol and Murphy *et al.*; rather, it merely arises from our including two categories—evading and altering—that they did not.

In practice, however, not all activity can be neatly categorized by our definitions. Entrepreneurship can incorporate aspects of evasion and alteration at the same time, seen in the example of employing both boycotts and passive resistance to change a law. The sole aim of the matrix is to give some structure to the discussion, and does not claim perfect and mutually exclusive categorization.

Finally, it should be noted that institutions that direct talent to different activities do not necessarily affect exactly the same individuals. If the rules of the game in a country were to change in favor of business entrepreneurship, a successful influence peddler would not automatically become an industrialist. Rather, some marginal individuals with talent for influence peddling might leave that profession, while agents with business talent (who may or may not have been political entrepreneurs previously) enter that sector.

PART II PRODUCTIVE ABIDING ENTREPRENEURSHIP

The abiding market entrepreneur is the archetypical entrepreneur, the one most discussed in the literature. Productive business entrepreneurship increases an economy's degree of innovation and its ability to adapt to exogenous conditions.

Innovativeness forms the core of Schumpeter's (1934) entrepreneur, whereas Kirzner's (1973, 1992, 2009) entrepreneur is marked by the ability to adapt.[2] While productive entrepreneurship is important in all economies, the need for adaptation and innovativeness depends on the external environment. For instance, when high rates of technological progress or new supplies of resources fuel rapid change, adaptability becomes paramount.[3]

The relationship between abiding entrepreneurship and the evolution of institutions is complex. On the one hand, truly innovative entrepreneurship can create so much change that the foundation of the current institutional structure becomes compromised. Truly disruptive entrepreneurship, such as the successful introduction of a revolutionary new technology, can lead to the reform and dissolution of extant institutions, notably in traditional societies. Technological progress can also alter the effect of institutions; one salient and recent example is the impact of the Internet on intellectual property rights.

On the other hand, entrepreneurship can be self-perpetuating. It creates a constituency of consumers, private-sector workers and self-employed who support productive institutions. Technological breakthroughs often offer opportunities for new entrepreneurship, both of the market and political type. No less importantly, productive entrepreneurship legitimates the institutions that foster it by creating demonstrable new wealth, products and jobs. The American economic system, with its high degree of inequality coupled with the opportunity to grow fabulously rich, has maintained its legitimacy largely because entrepreneurs ranging from Andrew Carnegie to Bill Gates have created new value that has benefited the public as a whole (Acs and Phillips, 2002). Furthermore, entrepreneurs (and non-entrepreneurs) who abide by institutions tend to strengthen these very institutions. This is particularly important for informal institutions, such as codes of conduct and traditions, which are

[2] See Baumol (2010), Holcombe (2007) and Yu (2001) for discussions of these two aspects and how they can be combined in the same system. See also Kirzner (2009) for a critical assessment of such merging.
[3] It could be noted that abiding entrepreneurship is not limited to market or business entrepreneurship. The non-profit sector is a sizable share of the economy in countries such as the United States, and includes a large amount of productive non-market entrepreneurship. Boettke and Coyne (2009) discuss social entrepreneurship and its relation to institutions further. Compared to market entrepreneurship, social entrepreneurship is more likely to be a combination of abiding and altering activity towards institutions.

reinforced each time they are acknowledged and allowed to guide behavior. In terms of more formal institutions, the law itself derives much of its value from the respect that it is awarded (Kasper and Streit, 1998). Becker and Murphy (2000) use the neoclassical economic framework to argue that institutions are reinforced through abiding behavior. They cite the United States Constitution as an example of an institution whose rules have been strengthened as Americans throughout history have followed its guiding principles. In contrast, similar constitutions in other countries, notably in Latin America, have been weakened over time as each violation of its principles has reduced people's respect for both the constitution and tradition.

Guiso, Sapienza and Zingales (Chapter 4) empirically demonstrate that informal institutions impact economic activity. They show in particular that an individual's level of trust in the United States (their proxy for trustworthiness) has a significant impact on the probability of their becoming self-employed. Employing a cross-country setting, Lerner and Schoar (Chapter 3) demonstrate the importance of formal institutions such as the legal system for private equity investments in developing countries. Private equity investments in nations with effective legal enforcement are more likely to use preferred stock, and have more contractual protection of the private equity group.

Davidsson and Henrekson (Chapter 5) investigate the role of institution and policy in Sweden, arguing that the low prevalence of high-growth firms can be tied to welfare state institutions that fail to provide fertile ground for entrepreneurial activity.

Acs *et al*. (Chapter 6) is perhaps the article in this volume that least directly connected to institutions. However, the theory outlined in the paper gives an important clue as to *why* the institutional setup is so important for productive business entrepreneurship, and why entrepreneurship in turn is important for innovation and growth. The authors note that full property rights for knowledge do not exist; existing firms are unable to appropriate all knowledge of the economy. The resulting knowledge spillovers endogenously explain entrepreneurial activity. Importantly, knowledge is separated from economic knowledge, the later requiring entrepreneurship to be brought to the market. In their model, institutions impose a gap between knowledge and economic knowledge. Furthermore, taxes, stricter regulation, administrative barriers and government intervention are thought to reduce entrepreneurship and the marketization of knowledge.

PART III UNPRODUCTIVE ABIDING ENTREPRENEURSHIP

Of course, not all rent seeking is truly entrepreneurial in the Schumpeterian sense of being innovative. Even Kirzner's broader definition of alertness to opportunity cannot place all rent seeking in the entrepreneurial camp, even if bribery were fully institutionalized. Defining evasive entrepreneurship involves delineating a continuous variable into a discrete definition. This is not unique to unproductive abiding entrepreneurship; the same problem exists within traditional productive entrepreneurship, especially when determining which self-employed business owners can truly be labeled entrepreneurs. For our purposes it suffices that some of the rent-seeking activity be novel in nature, for example corrupting a hitherto honest government official.

In addition to historical examples from underdeveloped societies, Baumol (Chapter 7) discusses institutional entrepreneurs in developed countries as professional influencers of the law. He describes enterprising methods of molding institutions in the United States, as well as more routine lobbying activities. This chapter is an important reminder that unproductive entrepreneurship is not confined to historic states or underdeveloped societies, but is still part of the American (and Western European) economy. Clearly, our institutions still direct part of society's talent into individually profitable but socially wasteful activities. This is not only relevant from a policy perspective, but also as a part of the research agenda of institutions and entrepreneurship.

Faccio (Chapter 8) documents that firms undertake rent-seeking behavior in most countries under review, including most Western societies. Corporate political connections occur in thirty-five out of the forty-seven nations that Faccio studies. The analysis details that such rents are likely to be shared between politicians and the corporate sector, or, in our terminology, between political entrepreneurs and unproductive business entrepreneurs. We have seen that entrepreneurial talent is funneled into rent seeking in all societies, to varying extents. Yet few countries can hold a candle to post-transition Russia in illustrating the vicious cycle of unproductive entrepreneurship. In Faccio's study, politically connected firms in Russia account for an astonishing 87 percent of market capitalization, the highest rate in the world. In comparison, politically connected American firms account for just 4 percent of U.S. market capitalization.

According to Åslund *et al.* (2002), post-Soviet Russia is locked in an "under-reform trap". Institutions that reward rent-seeking activities over productive activities dominate the economy, and political influence from the Russian private sector can often be traced to oligarchs (Guriev and Rachinsky, Chapter 9). This group consists of people from the former Soviet nomenclature who seized power over the companies they managed after the fall of the Soviet Union. The oligarchs took advantage of the huge arbitrage opportunities created by partial reforms and the co-existence of regulated and quasi-market prices during the Gorbachev era. Djankov *et al*. (Chapter 10) investigate the role of perceptions of the institutional environment for business owners in post-transition Russia, also touching on the importance of bribing officials in that climate.

There is no denying that rising from virtually nothing to amassing billions in the era of post-Soviet reform requires entrepreneurial talent. However, most activity was non-productive; wealth was generated by taking control over firms or plundering them rather than creating new value. Kalantaridis and Labrianidis (2004) argue that the most important group of entrepreneurs during the transition period were "directors of the Socialist Era" who were "individuals in positions of authority during the socialist era, who adapted successfully to change".

Unproductive entrepreneurship in Russia has proven self-reinforcing in at least two ways. First, the legitimacy of free market capitalism was deeply damaged by the initial era of unproductive entrepreneurship. Second, today's oligarchs continue to use their political power to defend the current system, exemplified by their takeover of the Russian Union of Industrialists and Entrepreneurs. Slinko *et al.* (2005) underscore the negative effects of the establishment's political influence, finding that large firms with high political stakes can prevent the entry of new firms. Aidis *et al.* (Chapter 11) show that Russia has less business entrepreneurship than other transition countries, and that Russian institutions provide advantages to insiders over new ventures. In comparison to other transition economies, Russian entrepreneurs face more corruption, higher official and unofficial start-up costs, higher tax rates, more bureaucracy, and weaker protection of property rights (Åslund *et al.*, 2002).

Russia illustrates the difficulty in delineating abiding and altering institutional entrepreneurship. Since entrepreneurship is defined by change, all political entrepreneurship is altering in some sense. However, most of this activity in Russia focuses on pure rent seeking, and at best only marginally amends the broader institutional setup. Indeed, Russia is now well into its second decade of institutionally stable crony capitalism, with roughly one hundred individuals having amassed fortunes in excess of one billion dollars, for a total wealth of almost 250 billion dollars (Sanandaji 2010).

PART IV PRODUCTIVE ALTERING ENTREPRENEURSHIP

Baumol (Chapter 1) describes productive entrepreneurship solely in terms of private sector business activity. However, other types of entrepreneurship can also be productive. Clearly, not all political activities can be defined as rent seeking; policy innovations often improve welfare, especially in favorable institutional environments. The National Science Foundation, for example, was created in part through political entrepreneurship (Polsby, 1984). Similarly, Murphy *et al.* (Chapter 2) identify talent directed toward the political sector as rent seeking, assuming that the institutional setting that directs the allocation of talent is exogenously determined. Good institutions do not rise out of nowhere, though, and are often the result of policy entrepreneurship by gifted pivotal individuals. The productive political entrepreneur deserves recognition as a fundamental player in the economy, just like the productive market entrepreneur.

The idea that innovative individuals contribute to institutional change has a long history in political science. In his case study of political power in New Haven, Dahl (1961) introduced the term "political entrepreneurs," which he defined as individuals who recombine resources in the policy arena to bring about change. The political arena in New Haven was entrepreneurial in its alertness to "citizen desires" and "the ease with which the political stratum can be penetrated" (Dahl, 1961, p. 93) by new individuals. In accordance with political scientists, we also use the term political entrepreneurship to refer to entrepreneurship with the direct aim of altering institutions. The expression business or market entrepreneur is used here, somewhat loosely, to refer to traditional Schumpeterian entrepreneurs, distinct from political entrepreneurs. Similar to business entrepreneurs, political entrepreneurs are alert to opportunities, bear risk, reorganize coalitions and resources, and ultimately bring about innovation, be it socially positive or negative.

Ostrom (1965) in her study of ground water basin management observed that

> the vast variety of organizational forms among municipal and public corporations would appear to provide substantial latitude for the exercise of a public entrepreneurship. In such an institutional setting there should be opportunities for persons to engage in public entrepreneurship by organizing new enterprise to secure appropriate forms of community action in providing common goods and services. (Ostrom, 1965, p. 5)

She also points out the importance of the quality of the broader institutional environment for enabling productive policy entrepreneurship:

> The capacity to engage in public entrepreneurship is defined by a political system. Constitutional ground rules which stress the right of local communities to self-determination lay a framework for an extensive and varied public enterprise system. Legislative enactments which specify the general rules of procedure for incorporation of municipalities or public districts or other public corporations provide the working rules which public entrepreneurs must follow in proceeding to undertake a new enterprise. (Ostrom, 1965, p. 6)

Inspired by emerging markets in Asia, Li *et al.* (Chapter 12) define a new form of institutional entrepreneurship. While seeking profits in undeveloped institutional environments, business entrepreneurs help advance market institutions, a kind of positive social externalities in institutional terms. This type of entrepreneurship straddles abiding, evading and altering entrepreneurship, containing elements of all three types. Of the four categories in Li *et al.*, the first two involve lobbying for better institutions and can be neatly categorized as altering entrepreneurship. The third and especially fourth type are mixtures of abiding and evading entrepreneurship, resulting in changes for the better in the institutional climate in developing countries.

Leeson and Boettke (Chapter 13) advance research on institutional entrepreneurship by exploring the production of technology designed to protect property rights. This type of entrepreneurship can improve the institutional environment, especially if a well-functioning state is absent. They illustrate this idea with examples from Somalia, where private protection technology can have led to an increase in some economic activity since the collapse of the government.

Hwang and Powell (Chapter 14) survey the neo-institutionalist literature on entrepreneurship, and discuss a variety of institutional alterations, including changes in informal institutions and the professional standards as part of the rules of the game.

Schneider and Teske (Chapter 15) show how the standard market theory of entrepreneurship can be fruitfully applied to altering political entrepreneurship, including innovation in local government.

PART V UNPRODUCTIVE ALTERING ENTREPRENEURSHIP

DiLorenzo (1988) emphasizes the unproductive and destructive activities of rent-seeking political entrepreneurs, writing that "[t]he essence of political entrepreneurship is to *destroy* wealth through negative-sum rent-seeking behavior" (p. 66, italics in original). He maintains that ignoring political entrepreneurs has led public choice theorists to underestimate the destructive effects of politics. We conclude in turn that focus on rent seeking has led to an underestimation of the total dynamic potential embodied in institutional change, both when channeled productively and unproductively/destructively.

Holcombe (Chapter 16) presents the Austrian perspective on political entrepreneurship, concluding that due to the differences in incentive structures, political entrepreneurship is by nature more likely to be unproductive than market entrepreneurship. He remarks that (p. 147)

> if political goals are not being implemented in the least-cost way, then there is a profit opportunity from restructuring the nature of the government activity so that the goals are achieved at least cost. The cost savings are a political profit that the entrepreneur can then apply toward the satisfaction of other goals.

Both types of activities are carried out in modern developed democracies—at times, even concurrently—often leaving the observer to decide whether the policy innovation was productive or destructive (at least as long as the reform does not clearly violate the Pareto efficiency). Wagner (1966) argues that political entrepreneurs can act as a substitute for the rent-seeking activities of large interest groups, mitigating in turn the central difficulties in overcoming collective action problems and organizing interest groups emphasized by Olson (1965).

The incentive structure guides the allocation of political entrepreneurial effort, just as it guides the allocation of business entrepreneurship. All societies enjoy a mix of incentives; political entrepreneurship is allocated to both productive and unproductive/destructive institutional reform efforts, akin to other types of entrepreneurship. Baumol's (Chapter 1) broader theory of entrepreneurship holds true for political entrepreneurship in particular. While all three types take place in all societies, relative allocation can vary greatly, helping to determine the societies' level of welfare and rate of growth.

Glaeser and Shleifer (Chapter 17) provide an engaging account of James Michael Curley, a political entrepreneur in Boston. Curley intentionally worsened the political institutions in the city in order to benefit himself and his constituencies. The authors develop a more general model of unproductive political activity, which differs from standard models in political economy in important ways.

Entrepreneurial activity in the market is governed by a strong feedback mechanism, namely profit and survival. Where institutions are productive, individuals with socially beneficial activities make profits, thereby guiding entrepreneurial talent to inherently productive activities. Market entrepreneurship is particularly beneficial in a social sense as it can efficiently allocate resources using profit and loss as a guide; where institutions are unproductive or destructive, individuals can become rich through activities that redistribute wealth, or that are purely predatory. The feedback mechanism is less powerful for political and institutional entrepreneurship, however (Glaeser, 2005). Politicians can hope to be re-elected or elected/appointed to higher office, but not all policy entrepreneurs are office holders, and the political reward mechanism is rather noisy. Singapore's national leader Lee Kuan Yew was rewarded for his social reforms with a long tenure, but so were Curley, Cuba's Fidel Castro, and Zimbabwe's Robert Mugabe. Constructive policy entrepreneurs are more often rewarded for beneficial activity and punished for destructive reforms when the broader institutional setting is propitious. The quality of the meta-institutions includes the norms, values and beliefs of the general public—better informed and more socially oriented voters are more likely to reward socially beneficial reforms (Caplan, 2007; Strömberg, 2004). Rudolf Giuliani's tenure as mayor of New York City (1994–2001) elevated him to national prominence, since the public perceived him as having responded to the needs of the city with successful reforms.

Another, perhaps more controversial, conclusion is that market entrepreneurship is more likely to be efficient and productive than policy entrepreneurship, precisely because of the weaker feedback mechanism of the latter. Although both types of activities can be unproductive when the broader institutional setting is of low quality, weak feedback mechanisms ensure that policy entrepreneurship may not be directed in a productive way even if the meta-institutions are generally favorable. Furthermore, many barriers to political reform exist even in favorable institutional settings, including the need to mobilize a majority, whereas market innovations enjoy lower barriers to entry.

PART VI PRODUCTIVE EVASIVE ENTREPRENEURSHIP

In the case of evasive entrepreneurship, the activities of the entrepreneur do not alter the formal institutional setup but rather the impact of institutions already in place. Imperfections in the institutional framework can be innovatively used to appropriate rents from a third party, exemplified well by the shortcomings in the protection of private property rights. Agents may act on such institutional flaws by outright theft or fraud, or by pursuing litigation and more sophisticated economic crimes. Productive examples include entrepreneurs who aspire to contractual arrangements to escape some costly institution. Tax avoidance (legal) and tax evasion (illegal) are typical examples. A business-owning entrepreneur may engage in such evasive entrepreneurship to reduce costs, while other entrepreneurs, notably within tax consultancies and law firms, may found a new business based on an innovation that enables others to circumvent institutional barriers. While illegal and harmful for public finances, tax evasion can be productive if the economic activity in question would not have taken place without such evasion. For example, in many Western European countries with high taxes and strict labor market regulations, immigrants are unable to enter the regular labor market. Instead, many of them support themselves as self-employed in price-sensitive service professions that are highly substitutable for household production, such as taxi drivers, barbers or fast food vendors. It is common for this type of worker to evade some or all taxes. However, supplying those services paying full taxes may not be viable if enough consumers are unwilling to pay the true price of the services, including taxes. The alternative to evasion is in these cases is an increase in unemployment and social exclusion of the immigrants, while the consumers are deprived of the service in question.

Other, more mundane, instances of this type include the businessman who uses his entrepreneurial talent to trace the right bureaucrat to approach with a bribe. In the simplest case, this constitutes an instance of evasive entrepreneurship. One can think of yet more elaborate situations where the entrepreneur earns money by selling services, all while utilizing knowledge of bureaucratic procedures or personal acquaintances. The bureaucrat who receives the bribe can also act entrepreneurially by increasing the cost of abiding by the institutions, for instance.

Evasive entrepreneurship can be productive or unproductive depending on the circumstances. Other times, the evasion of institutions results in a waste of resources (such as costly cross-border smuggling, rather than regular bulk import). More obvious examples of destructive evasive entrepreneurship include predatory (innovative) criminal activity, as shown in the various contributions that take up altering entrepreneurship.

One criterion to determine if evasive entrepreneurship is productive or unproductive is whether the economic activity would have occurred in the absence of evasion. In the case of weak institutions prohibiting economic activity, evasion may well be productive. When evasion redirects talent to actions designed to reorient resources, and when the underlying activity would have occurred anyway within the pre-existing institutional channels, the evasion is often unproductive. Méon and Weill (Chapter

18) provide empirical evidence that corruption is less harmful, perhaps even beneficial, in countries where institutional quality is low.

Rodrik (Chapter 19) helps define the field by providing many interesting examples that emphasize the importance of creating second-best institutions when the first-best institutions have failed.[4]

The Hayekian tradition emphasizes the importance of spontaneous order, an evolved rather than constructed system of formal and informal institutions. The institutional entrepreneur has a natural place in this line of enquiry as agents of change in the continuously evolving social organization, whose actions are in turn constrained by the pre-existing institutions. Boettke (Chapter 20) persuasively argues for the role of institutional entrepreneurs in Africa, the region in the world with the greatest need for institutional improvement. Because of the inherent weakness of the current institutional structure, productive entrepreneurship is often evasive—and abiding entrepreneurship is often unproductive and predatory.

In economies with flawed structures and a lower level of organization, such as developing and transition economies, the coordinating role of the entrepreneur is particularly important (McMillan and Woodruff, 2002). In these dysfunctional economies, entrepreneurial initiative has been observed to provide "the required protective infrastructure for exchange relations when public governance is failing" (Boettke, Chapter 20, p. 3).

Evasive behavior by entrepreneurs, including the creation of contracts to overcome institutional impediments, tends to weaken the institutions that are being evaded. Indeed, a formal institution that is not enforced will likely lose its practical relevance. New contractual arrangements drawn up to evade labor regulations are yet another example of this process. As evasion spreads, regulations lose some of their bite, and may in time be modified or even abolished to tackle evasion attempts.

[4] See also Douhan and Henrekson (2010) for a further elaboration along these lines.

This race between regulators and innovative evaders also defines the financial sector. Destructive evasive entrepreneurship in the subprime security market contributed to the 2008 financial crisis as traders exploited implicit government guarantees by assuming excessive risk (Calomiris, 2009). Evasive entrepreneurship also initiated institutional changes in this case—albeit in the other direction—leaving them more binding and comprehensive.

PART VII UNPRODUCTIVE EVASIVE ENTREPRENEURSHIP

One of the best examples of unproductive evasive entrepreneurship is the growth of organized crime. Milhaupt and West (Chapter 21) provide theory as well as empirical evidence for the idea that organized crime provides property right enforcement and protection services, competing with the state in this provision. By our definition of entrepreneurship, individuals who initiate and develop criminal organizations, such as Al Capone or Mario Puzo’s (1969) fictional Don Corleone, clearly fall into the category of entrepreneurs (as generally unproductive ones, of course).

Bandiera (Chapter 22) ties the growth of the Sicilian mafia to the inability of the central government to enforce property rights. The Mafia developed as an alternative law enforcement mechanism, and evolved into a parasitic organization, although it never fully abandoned its role as enforcer of institutions. Bandiera also provides evidence suggesting that the development of the Mafia grew out of a collective action problem faced by landowners: the benefits of hiring thugs to protect one’s land were private, while the cost of the growth of this organization was public and not fully internalized.

Investigating a more commonplace topic, Torrini (Chapter 23) studies the role of taxes and the size of government on self-employment. While high taxes typically reduce the payoff from entrepreneurial ventures, especially since self-employment is more directly tied to individual effort, taxes simultaneously increase the return from tax evading self-employment. Torrini presents evidence that greater perception of corruption is associated with more self-employment, which he interprets as resulting from more tax evasion.

PART VIII INSTITUTIONAL ENTREPRENEURSHIP IN SOCIOLOGY

Sociological literature treats institutional entrepreneurship similar to the concepts discussed so far, although its framing and perspective are different (Scott, 2004). In this rich literature, institutions appear as deeper and firmer aspects of social structures. Scott writes, for example, that (1995, p. 33) “institutions are social structures that have attained a high degree of resilience. [They] are composed of cultural-cognitive, normative, and regulative elements that, together with associated activities and resources, provide stability and meaning to social life.” Institutional entrepreneurship can “account for institutional change endogenously” (Battilana, Chapter 25). DiMaggio (Chapter 24)[5] introduced this function to explain how individuals can bring about radical change that oversteps the reach of prevailing institutions.

Prior to DiMaggio, prevailing sociological theory could only explain institutional change in terms of isomorphism, the process in which organizations spread their rules of behavior. Sociological theory had difficulty accounting for situations in which dramatic change takes place in the opposite direction of initial institutional inertia, such as a rapid shift in the market structure or the fact of a mature firm suddenly changing its core business and strategy. Other types of discontinuous change also represented something of a puzzle to this theory. “How can organizations or individuals innovate if their beliefs and actions are all determined by the very instructional environment they wish to change?” (Battilana, Chapter 25, p. 654). The paradox is to some extent resolved by introducing the entrepreneur. This allows for the capacity of agents to “make a difference” and act contrary to what the prevailing institutional structure would predict, even changing it in the process.

The sociological perspective that builds on DiMaggio’s institutional entrepreneur coincides in part with the definition of institutions found in economics and political science, namely informal institutions such as norms and culture. Discontinuous change of institutions through individual actions fits well with the idea of political entrepreneurs altering institutions. The sociological view of structures and

[5] Rather, this constitutes one school of thought on entrepreneurship in sociology. For a seminal sociological treatment of market entrepreneurship, see Swedberg (2000). Hwang and Powell (2005) survey the neo-institutional literature on institutional entrepreneurship.

institutions, which is reinforced every time individuals act in line with them, resembles most economists' definition of habits and hardwired preferences (Becker and Murphy, 2000).

Unlike sociologists, economists see no paradox arising from the fact that entrepreneurs are influenced by institutions at the same time as they contribute to institutional change and evolution. Nor do economists view agents as "trapped" in institutions, requiring entrepreneurs to escape. This reflects sociologists' much broader definition of institutions and structures, including most beliefs and preferences. (Sociologists view these institutions as stronger and more binding, and comparatively more important than economic incentives or relative prices.) Ultimately, this difference in perspective mirrors the classical disagreement between sociologists and economists regarding the extent to which individuals are free to make choices and control their own circumstances. Nevertheless, since sociologists allow for entrepreneurs to escape their structural bonds while economists emphasize the role of broad institutions and social context in forming individual choice, the two disciplines are closer to each other regarding institutional entrepreneurship than on many other issues.

CONLUDING REMARKS: The Interaction between the Entrepreneur and Institutions

The influence of entrepreneurs on institutions should not be underestimated. Market entrepreneurs generate direct changes in institutions, such as transaction costs or protective technology. Technological change results in new habits of thought and life, thus giving rise to new institutions.[6] Much technological change is introduced by entrepreneurs, and a considerable part of non-technological market entrepreneurship also alters economic structures and occasions new institutions.[7]

[6] This argument was first made a long time ago by Thorstein Veblen (Walker, 1977).
[7] Veblen himself did not emphasize the individual entrepreneur as a driver of technological change (Gurkan, 2005). Nevertheless, his thesis can be extended to entrepreneur-driven technological change in a rather straightforward manner.

Yet Leeson and Boettke (Chapter 13, p. 253) point to another, less circuitous way of altering institutions: productive entrepreneurs' "creation of protective technologies that secure citizens' private property rights vis-à-vis one another." These activities are most important in weak institutional environments, such as in many third world countries. In the absence of a well-functioning government, entrepreneurs help improve institutions by creating private protection methods that restrict predation. These include private law and courts, private police protection, bilateral punishment schemes (for example ostracism), reputation mechanisms for multilateral punishment of dishonest conduct, and social norms and customs. An example of this process can be found in the informal, unwritten rules of commercial activity and private courts in tribal units in Africa. Hwang and Powell (Chapter 14) consider the creation of standards to guide the activities of organizations—itself a form of institution—as an entrepreneurial act. In his discussion of second-best institutions, Rodrik (Chapter 18) points out that Ghanaian firms find courts too costly as a method of contract enforcement. Such firms have relied on self-organized measures of contract enforcement instead, namely relational contracting through personal relationships and repeated interactions.

Political entrepreneurship obviously houses an endogenous component. Productive political entrepreneurship improves the quality of institutions, but only in such environments with institutions of high quality where political entrepreneurship can be directed towards productive activities in the first place. Conversely, political entrepreneurs in countries with low-quality institutions are more likely to engage in rent-seeking activities, some of which are likely to cause institutional quality to deteriorate even further. This mechanism forms the root of the so-called natural resource curse (e.g., Boschini *et al*., 2007).

The interaction between institutions and entrepreneurship is not limited to political entrepreneurship. Productive market entrepreneurship can also change the playing field and create new opportunities for political entrepreneurship. British institutions, for example, not only encouraged the Industrial Revolution, they adapted rapidly to the new technology and production methods introduced by market entrepreneurs. The same is true for the recent revolution in information and communications technology centered in the United States, which evolved in tandem with institutional changes pursued by politicians that aided the growth of the venture capital industry (Fenn *et al.*, 1995; Gompers and Lerner, 2004).

These examples illustrate that abiding market entrepreneurship can be complementary to altering political entrepreneurship, both increasing the scope of the other by creating new opportunities. Traditional market entrepreneurship differs from other factors of production in the sense that its marginal product does not typically diminish in the supply of the factor. Additional capital competes with and generally lowers the marginal productivity of already existing capital. The same is true for additional labor. While entrepreneurs also compete with each other, entrepreneurship is distinct as a factor of production in that other people's innovations can pave the way for one's own innovations by creating further opportunities for new ventures (Holcombe, 2007). As we see it, such complementarity may also be true for political and business entrepreneurship. Yet there is no guarantee that opportunities created by new reforms will be used solely for productive policy innovations. Productive market innovations may lead to destructive political innovation, especially when the broader institutional setting is less geared towards socially beneficial activity. For example, surveillance technology developed largely by entrepreneurial IT firms has been used to increase political oppression in countries such as Iran and China.

The feedback between entrepreneurship and institutions can help explain the discontinuous nature of the dynamics of economic growth. This provides one possible explanation for the sudden growth of economies long mired in stagnation, propelled by a virtuous cycle of entrepreneurship and institutional change. The breaking point of stagnation can usually be traced to either reforms by political entrepreneurs that create opportunities for market entrepreneurship, or technological change promoted by business entrepreneurs that in turn creates opportunities for productive political entrepreneurship. The growth and reform cycle continues as more market entrepreneurship increases the possibility for additional institutional reforms and political returns, which leads to further growth and entrepreneurship.

This volume has investigated the interplay between entrepreneurship and institutions, building on the framework introduced by Baumol (Chapter 1) and expanded on by the authors included in this volume. Entrepreneurship is not only shaped by institutions, it also influences them in turn. On the one hand, entrepreneurs choose how to employ their entrepreneurial talent depending on the incentive structure determined by relevant institutions. In this way, institutions fundamentally determine the distribution across productive, unproductive and destructive entrepreneurial activities. On the other hand, entrepreneurs respond actively to the environment they face, which affects the institutions themselves. Thus, changes in institutions should take into account not only the direct response of entrepreneurs, but also the subsequent change of institutions through entrepreneurial feedback.

This feedback may be direct or indirect. Indirect feedback occurs when policy makers or political entrepreneurs feel the need to change institutions due to the response of entrepreneurs to institutions within the given framework. Examples of indirect feedback include the effects of evasive entrepreneurship that weaken institutions (or their actual impact), a decline in productive entrepreneurship that forces institutional reform, or an increase in rent-seeking entrepreneurship that reduces the legitimacy of free-market reform.

Since these types of activities all involve a measure of innovation, politicians cannot fully anticipate these effects when designing institutions. The formation of institutions should be viewed as an adaptive process. Politicians cannot design optimal institutions once and for all; unpredictable entrepreneurial responses to these institutions force them to continually change and amend the institutional environment. Research on the political economy of entrepreneurship cannot be restricted to analyzing how institutions affect the level and type of entrepreneurial activity. It is also necessary to consider how entrepreneurial activities affect institutions and thereby the prospects for long-term growth. Institutional changes aimed at promoting entrepreneurship must always be evaluated with respect to what kind of entrepreneurship is promoted. A tax hike may not only deter productive entrepreneurs, but also encourage unproductive entrepreneurship.

Finally, it is worth asking whether altering political entrepreneurship can change the allocation of political entrepreneurship. Most political entrepreneurship is too insignificant to palpably change the broader incentive structures. The allocation and lucrativeness of policy entrepreneurship changes, however, either through comprehensive acts of reform by single policy entrepreneurs or slow incremental change. Klein *et al.* (2010, p. 7) make a similar argument, writing:

> While entrepreneurship, like bargaining, takes place in the shadow of the law…, public entrepreneurship also involves changes to the very law and its shadow! That is, public entrepreneurship involves novelty, change, and innovation vis-à-vis the rules of the game.

In terms of contemporary protracted reform, various reform-minded policy entrepreneurs are slowly bringing the old statist system to an end. An example of more radical change is the promise to stifle lobbying in the United States (not yet realized at the time of writing). Such an act of large-scale policy entrepreneurship could change institutions enough to alter the allocation of multitudes of smaller scale policy entrepreneurship, presumably reducing unproductive political entrepreneurship. Positive multipliers associated with this reform would arise due to the mechanisms we have underlined. Not only would unproductive lobbying be reduced, but some of the entrepreneurial resources may be redirected to business entrepreneurship or more productive political entrepreneurship. Perhaps some of these activities would someday lead to additional institutional improvements. The gains from channeling entrepreneurship into productive use is thus larger than a narrow look at market activity would suggest, and larger still due to innate, hard-to-anticipate improvements in institutions.

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